CHAPTER FIVE
PERSONAL INCOME TAXES

The **personal income tax** can be—and usually is—the fairest tax. When properly structured, it makes wealthier taxpayers pay their fair share, eases the tax load somewhat on middle-income families and completely exempts the poor. Because the personal income tax is the only major progressive tax levied by states, it provides an important counterbalance to regressive sales, excise and property taxes.

But in many states, the income tax fails to live up to its potential. Some states have flat tax rates, while others tax at least some of the income of families living in poverty. And many states allow expensive, poorly targeted tax breaks that favor wealthier taxpayers. This chapter explains the basic workings of the income tax and discusses important issues that should be addressed in order to ensure the continued fairness and adequacy of this tax.

How It Works

Almost all states with personal income taxes tie their income tax base to federal tax rules. This means that income taxpayers can do their federal income taxes and then copy their total income from the federal tax forms to their state tax form. This time-saving step makes income taxes easier to file—and makes it easier for tax administrators to monitor compliance. Most states link to federal adjusted gross income (AGI), which is income before exemptions and deductions, and then allow their own special exemptions and deductions. A few states link to federal taxable income, which already includes the generous federal exemptions and deductions, and then apply their own tax rates. A few states do not link to the federal tax base at all.

Which Income is Taxed—and Which Is Exempt?

The federal income tax and most state income taxes apply to most, but not all, types of money income.[7] But different types of income are, in some systems, taxed differently:

- **Wages and salaries** are almost always taxed. However, "fringe benefits" such as employer-paid health insurance are usually tax-exempt, and taxes on employer contributions to pension plans are deferred until the money is paid out at retirement.
- **Interest** from bank accounts and bonds is generally taxed. A few states, however, exempt some interest. For example, Massachusetts excludes the first $100 ($200 for a married couple) of interest received from Massachusetts banks. Interest from government bonds usually gets preferential treatment: interest from federal treasury bonds is exempt from state taxation, and interest from state and municipal bonds is exempt from the federal tax. States often exempt interest on their own bonds, while taxing other states' bonds.
- **Business income or loss** for individuals is the taxable profit (or loss) from unincorporated businesses. People who are self-employed report their taxable business results on Schedule C. For example, if someone makes and sells furniture, he or she reports the gross proceeds from selling the furniture minus deductible expenses such as the cost of wood, tools and advertising. Partnership income is reported similarly: each partner reports his or her share of taxable partnership profit or loss on Schedule E. Farm profits and losses are reported on Schedule F. Because of a variety of special tax concessions for farming, most people filing farm tax returns claim "losses" rather than profits for tax purposes.

[7] New Hampshire and Tennessee tax only interest and dividend income, and half a dozen states have local income taxes that apply only to wages.

From 1988 to 2002, taxable farm profits reported to the IRS were $138 billion, but tax-deductible losses totaled $223 billion.

- **Rental income** is reported on a separate form on federal tax returns. Gross rents are offset by various expenses. One "expense" that is commonly used to reduce taxable rental income is "depreciation." For tax purposes, rental real estate is assumed to gradually lose its value, or depreciate, over time. (Of course, this is usually a fiction—rental real estate typically becomes more valuable over time.) For some real estate professionals (broadly defined), depreciation expenses can be used to reduce not just rental income but other income as well. But for most people, depreciation can only reduce taxable rental income. This makes it less attractive for people to invest in real estate solely as a tax shelter—a widespread tax-avoidance scheme before 1986 federal legislation narrowed this loophole.
- **Capital gains** are profits from the sale of assets such as stocks, bonds and real estate. Income tax on a capital gain is paid only when the asset is sold. Thus, a stockholder who owns a stock over many years doesn't pay any tax as it increases in value each year. He or she pays tax only when the stock is sold. At that time, the capital gain is calculated by taking the difference between the original buying price and the selling price.[8] The federal government now taxes capital gains at a far lower rate than wages. A few states also provide capital-gains tax breaks. State capital-gains tax breaks are discussed on page 34.
- **Dividends** are the part of a corporation's earnings that are distributed to its shareholders. Until 1986, the first $100 ($200 for married couples) of dividends was exempt from the federal personal income tax. From 1986 to 2002, dividends were taxed as regular income. The 2003 Bush tax cuts created a special set of lower tax rates for dividend income. A few states allow special dividend exclusions of their own.
- **Transfer payments**, such as welfare benefits, unemployment compensation and Social Security benefits are subject to a variety of different rules. The federal income tax exempts welfare, treats unemployment compensation the same as wages and taxes a fraction of Social Security benefits above certain income levels. A few states follow the federal rule and tax some Social Security benefits, but most states completely exempt Social Security.
- **Pension income** is generally taxable at the federal level, with an offset for already-taxed employee contributions to pension plans. Many states exclude all or some government pension income from taxation, and some even exempt private pension income. Some states provide targeted pension tax relief, available only to lower-income taxpayers.

"Adjustments" and Adjusted Gross Income

Once all of a taxpayer's taxable income is added up, **adjustments to income** are subtracted. Some adjustments appear on federal tax forms—and most states following federal rules will include these adjustments, too. For example, contributions to retirement accounts by self-employed people are subtracted from total income as an adjustment on federal forms, and most states have chosen to conform to federal rules by allowing the same tax break. Other examples of typical adjustments are alimony and health insurance payments by the self-employed. On federal forms, **adjusted gross income** is the income that is subject to tax after subtracting these adjustments.

In addition to these federal adjustments, most states diverge from the federal starting point to allow at least one special deduction or targeted tax break of their own invention. These special

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[8] People who inherit property don't pay income tax on capital gains that accrued during the original owner's life. If Sally Jones buys stock in 1990 worth $1,000, then dies in 2000 with it having a value of $10,000, no income tax is ever paid on the $9,000 of gain from 1990 to 2000. If her heirs sell the stock in 2002 for $12,000, the heirs pay tax on only the $2,000 gain from 2000 (the date of inheritance) to 2002.

breaks are the difference between the federal starting point (usually federal AGI) and a state's own adjusted gross income. Among the tax breaks commonly granted by states are:

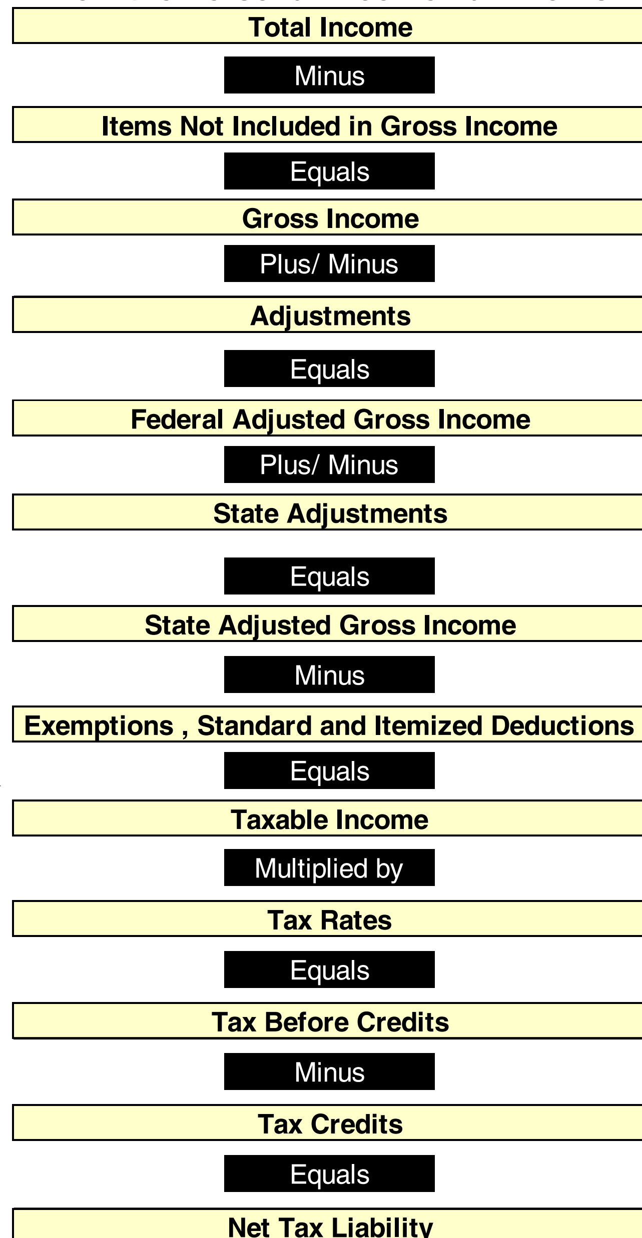
- Exemptions for capital gains or dividends;
- Tax shelters for pension or Social Security benefits;
- Deductions for federal income taxes paid.

Every special state tax break has to be subtracted from income—which means it takes at least one line on your state's tax form. The main reason why state income tax forms—and instructions—are so complicated is because taxpayers must wade through these special tax breaks.

When these tax breaks discriminate between taxpayers who have a similar ability to pay, such unfair distinctions can make the tax system seem more arbitrary—and can undermine public confidence in the system. These tax breaks also make it harder to understand the overall effect of a tax system on people at different income levels.

Computing Taxable Income

Taxable income is the amount of income that is subject to tax after subtracting deductions and exemptions from AGI. This is the amount to which the income tax rate(s) are applied.



In computing their taxable income, taxpayers usually have a choice of subtracting from AGI either a standard deduction or their total itemized deductions—whichever is larger. Generally, better-off families are more likely than lower-income families to have enough deductions to make itemizing worthwhile. Deductions related to homeownership are often what makes a family's itemized deductions exceed its standard deduction.

Itemized deductions are allowed for two main reasons. Usually the primary reason is to take account of large or unusual personal expenditures that affect a taxpayer's ability to pay. 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 income 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 on 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. (By con-

trast, most states don't allow a deduction for their own income taxes, but do allow a deduction for property taxes.) Sales and excise taxes are generally not deductible, however, because Congress found that (a) they don't affect ability to pay very much for those who itemize, (b) they are difficult for taxpayers to compute and hard for tax agencies to audit, and (c) since they are regressive, states shouldn't be encouraged to rely too heavily on them. (Federal legislation in 2004 allows an optional, temporary deduction for sales taxes paid on 2004 and 2005 federal tax forms, but taxpayers claiming the deduction cannot write off their state and local income taxes—which means that this temporary deduction will generally only be useful—very modestly—for residents of non-income tax states.)

- 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 that exceed 7.5 percent of a taxpayer's adjusted gross income are deductible.

A **standard deduction** is a basic zero-tax amount, used by people whose itemized deductions total less than the standard deduction amount. The theory behind a standard deduction is that even those who do not have significant itemized deductions have a certain amount of income that should not be subject to tax.

On federal returns, the standard deduction is set at $9,700 for couples, $7,150 for unmarried parents and $4,850 for single filers in 2004. (These amounts are increased every year to allow for inflation.) Twelve states allow the same standard deductions as the federal amounts; three allow larger amounts; and the rest have smaller standard deductions or don't allow one at all.

The final step in arriving at taxable income—the tax base to which income tax rates are applied—is to subtract **personal exemptions**.

At the federal level, the personal exemption is currently $3,100 for each taxpayer and dependent (indexed each year for inflation). Thus, in 2004 a family of four gets a total of $12,400 in federal exemptions. State personal exemptions vary greatly, but are usually less generous than the federal amounts. Some states provide additional exemptions for the elderly, disabled or veterans.

The theory behind exemptions is that at any income level, a taxpayer's ability to pay declines as family size increases: the more mouths to feed, the less money is left over to pay taxes. So if two families each make $40,000 and family A has no children while family B has two, then family A has greater ability to pay. To adjust for this, family B gets two more exemptions than family A.

Some states tie their exemptions to the federal amount. Because federal exemptions grow each year with inflation, this is an administratively easy way to ensure that exemptions will not lose their value over time. States that fail to adjust their exemptions for inflation will end up imposing a hidden tax hike on their citizens over time. For instance, when the Illinois income tax was adopted in 1969, the state's personal exemption was set at $1,000—and was subsequently left unchanged for thirty years. 1998 legislation doubled the exemption to $2,000—but if the exemption had been kept up with inflation since 1969, it would currently be worth $5,100. In other words, the Illinois personal exemption is worth $3,100 less than it originally was. As a result, Illinois taxpayers paid $900 million more in income taxes in 2004 than they would have if the exemptions had been adjusted to preserve their 1969 value.

Tax Rates

Most states use **graduated rate** schedules where the **marginal tax rates** are higher as taxable income increases. In a graduated tax rate system, different marginal rates are assigned to different taxable income brackets. The table at right shows an example in which the first $25,000 of taxable income is taxed at 2 percent, income from $25,000 to $40,000 is taxed at 4 percent, income from $40,000 to $100,000 is taxed at 6 percent and income over $100,000 is taxed at 8 percent.

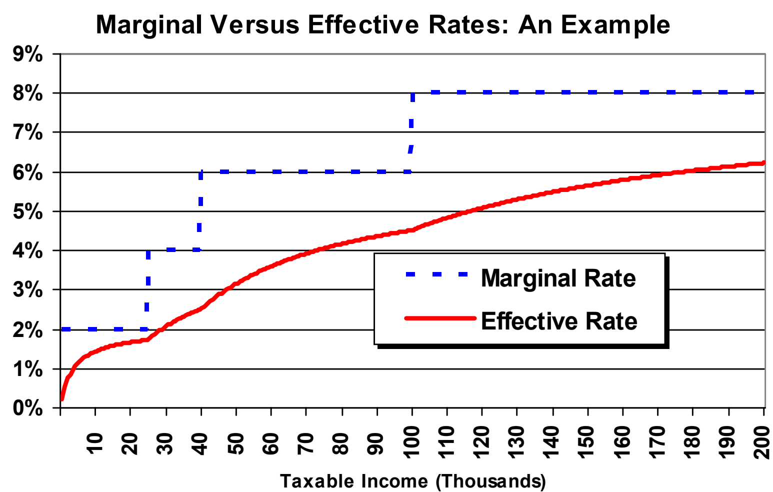
A Graduated Rate Schedule

Taxable Income Bracket	Marginal Rate
0 - $25,000	2%
$25,000 - $40,000	4%
$40,000 - $100,000	6%
Over $100,000	8%

What confuses some people is that they look at a tax table like this, know that they earn $45,000 per year, for example, and conclude that they must have to pay 6 percent of their income in tax. But that isn't the way it works at all.

First, the tax rate table is based on taxable income, not total income. Thus, someone making $45,000 per year probably has *taxable* income under $40,000 after deductions and exemptions are subtracted—and taxable income is what determines your tax rate. So this person is probably only paying tax at the 2 percent rate.

Second, because these tax rates are *marginal* tax rates, even if a family does have taxable income of $45,000, only the last $5,000 of that will be taxed at 6 percent. Marginal rates apply only to taxable income *over* the amount where the tax bracket starts. This means that the effective tax rate paid at any income level (that is, the percentage of your total income you pay in tax) will always be lower than the top marginal rate. The chart on this page shows how the effective tax rate on a married couple with no children compares to the marginal tax rate at each income level, assuming the state allows a $2,000 personal exemption and no other deductions. The first $25,000 of taxable income is taxed at 2 percent, so the effective tax rate starts at zero and gradually approaches 2 percent as taxable income approaches $25,000.[9] As the marginal rate increases, the effective rate increases too—but it always remains well below the top marginal rate.



Some states have **flat rate** systems that tax all taxable income at the same rate. For example, Illinois has a flat rate of 3 percent that applies to all taxable income.

Credits

After computing the amount of income tax based on the applicable tax rates, **credits** (if any) are subtracted. Credits are taken directly off the *tax* amount that would otherwise be owed, as opposed to deductions, which are subtracted from the amount of *income* that is subject to tax.

Low-income credits are commonly used at both the federal and state levels to reduce income taxes on those least able to pay. Other credits are designed to provide relief from other taxes. For example, low-income sales tax rebates and property tax circuit breakers are often administered as credits against the personal income tax.

Some credits are **refundable**. This means that if the amount of the credit exceeds the amount of tax otherwise calculated, a filer actually gets money back. The reason for making a credit refundable is to assure that deserving families get the full benefit of the credit, even if they don't owe much in income taxes. The best-known refundable credit is the federal earned-income tax credit (EITC), which allows low-income working families with children to get a direct payment from the government if the amount of the credit exceeds the income taxes they otherwise would owe. In 2004, 18 states allow earned income tax credits modeled after the federal credit.

[9] Even when taxable income is exactly $25,000, however, the effective tax rate remains less than 2 percent in this example. This is because the $2,000-per-person exemption means that this family's total income is $29,000, not $25,000. Not all of the family's income is subject to the 2 percent tax.

Local Income Taxes

In most states, local taxes are much less diverse than state taxes. But more than a dozen states, seeking to move away from the property taxes that have historically dominated local revenues, now allow local-option income taxes. States allowing these taxes usually do it in one of two ways: by granting authority to every taxing district of a particular kind in a state or by granting authority to specific named districts. One example of the broader approach is Maryland, where each county government levies a "piggyback" tax that applies to the same tax base as the state income tax.

In states that already levy state income taxes, these local taxes can be administered and collected by state tax administrators on state tax forms, requiring no new paperwork. An optional local income tax helps to achieve tax diversity, fairness and adequacy for local governments.

Revenue and Stability

Because of its direct link with growth in personal income, revenue from an income tax grows with a state's economy. In fact, the more progressive the income tax, the more it grows. Why? Because virtually all income growth over the past decade has been concentrated in the top of the income scale. Thus, a state that has high rates on the wealthy captures this growth better than a state with low rates on the well-to-do. Progressive income taxes will usually grow faster than personal income over time. This is important because the cost of providing public services often grows faster than income as well.

Of course, in a severe recession, personal income tax collections will decline. But in the long run, the personal income tax is the most reliable source of revenue to fund public services.

Deductible in Computing Federal Income Tax

A final step in the calculation of state income taxes doesn't even appear on your state tax form: part of what people pay in state and local income taxes is offset by the deduction itemizers get in computing their federal taxable income. On average, every dollar that a state collects in income tax ends up costing its residents only about 80 cents, because about 20 percent of the cost of these state taxes is offset by federal tax cuts for itemizers. And, from the point of view of high-income taxpayers, every dollar paid in state income tax costs only 65 cents.

How Fair Is Your Income Tax?

A personal income tax can be designed to be as fair as lawmakers want it to be. Almost every income tax is at least slightly progressive. A progressive personal income tax is the key to a fair overall tax system: without it, a tax system is doomed to being highly regressive. With a sufficiently progressive personal income tax, the whole tax system can be made to be at least slightly progressive even if the system includes regressive sales, excise and property taxes.

But in practice, very few states have achieved this. Only a handful of states require their wealthiest taxpayers to pay as much of their income in state and local taxes as the poorest state residents. By this measure, very few tax systems can even be described as "flat." This section looks at the common pitfalls that limit income tax progressivity at the state level.

Graduated Rate Structures

The easiest way to make an income tax adequately progressive is through graduated rates. The higher the rates are on wealthier taxpayers, the lower the rates can be on everyone else to raise the same amount of revenue. But many states fall short of this goal, for a variety of reasons:

- Six states don't apply graduated rate structures at all, but use a flat tax rate that applies to all taxable income. These states are Colorado, Illinois, Indiana, Massachusetts, Michigan and Pennsylvania. Most of these states do this because constitutional rules require it.

- Some states use nominally graduated rate structures that don't mean much in practice. For example, Maryland's top income tax rate begins at just $3,000 of taxable income. As a result, 79 percent of Maryland families pay at the top rate. In states (like Maryland) that do not index their income tax brackets for inflation, this problem grows worse every year. (See the text box on the next page for more information on indexation.)
- Other states use much wider income brackets, but apply relatively low rates. For example, Arizona's top tax rate takes effect for married couples earning over $300,000—but these taxpayers pay a marginal rate of just 5.04 percent. The relatively small difference between the bottom tax rate and the top tax rate makes the Arizona income tax less progressive.

Capital Gains Tax Breaks

High nominal tax rates on the rich are indeed the simplest way to make the wealthy pay their fair share. But high rates don't do much good if there are major tax shelters for the wealthy in the tax law. The federal income tax provides a special tax break from dividends and capital gains income. Since most dividend and capital gains income goes to the wealthiest Americans, this tax break mainly benefits the wealthy while offering only a pittance to middle- and low-income families.

Capital gains tax breaks have not been shown to encourage additional investment on the federal level—and this linkage is even more tenuous at the state level. A general state capital gains tax break is highly unlikely to benefit a state's economy, since any investment encouraged by the capital gains break could take place anywhere in the United States or the world.

In addition, a substantial part of any state capital gains tax break will never find its way to the pockets of state residents. Because state income taxes can be written off on federal tax forms by those taxpayers who itemize their federal income taxes, as much as 35 percent of any reduction in state capital gains taxes will be directly offset by an increase in federal income tax liability.

And capital gains tax cut promoters ignore the significant advantages capital gains already receive. First of all, the federal income tax applies a special lower top tax rate on capital gains than it applies to other income (15 percent versus 35 percent—so the top rate on capital gains is less than half the top rate on wages). Second, income tax is only paid on capital gains when the asset is sold. This is the equivalent of only paying tax on interest earned in a bank account when it is withdrawn. Also, no income tax is ever paid on capital gains that are inherited. Thus, a significant amount of capital gains (the amount held at the time of death) are never taxed at all.

Most states currently do not have a tax break for capital gains. The federal government, however, has the mentioned lower top rate and proposals for cutting it further frequently surface.

Pension Tax Breaks

Many states provide much more generous tax breaks for pension benefits than for other income sources. For example, New York exempts the first $20,000 of private pension benefits from tax. This type of exemption creates two glaring problems of tax equity: first, it provides a tax break to taxpayers at all income levels. The benefits of the wealthiest executive receive the same treatment as the benefits of the lowest-paid worker. Second, it provides special treatment for nonworking taxpayers, with no comparable break for the earned income of otherwise identical seniors. Over-65 workers whose earnings are based on salaries rather than pensions are completely excluded from this generous tax break. Since elderly taxpayers who work tend to be poor, this tax preference for unearned income is hard to justify.

Limiting pension tax breaks to low- and middle-income retirees—or replacing the pension tax break with a more general elderly exemption that applies to both earned income and unearned income—are two approaches to tax reform that would improve the perceived fairness of state income taxes.

The Importance of Indexing Income Taxes for Inflation

Many features of the personal income tax are defined by fixed dollar amounts. For instance, income taxes usually have various rates starting at different income levels. If these fixed income levels aren't adjusted periodically, taxes can go up substantially simply because of inflation. This hidden tax hike is known as "bracket creep."

Take, for example, a state that taxes the first $20,000 of income at 2 percent and all income above $20,000 at 4 percent. A person who makes $19,500 will only pay tax at the 2 percent tax rate. But over time, if this person's salary grows at the rate of inflation, she will find herself paying at a higher rate—even though she's not any richer in real terms. Suppose the rate of inflation is five percent a year and the person gets salary raises that are exactly enough to keep up with inflation. After four years, that means a raise to $23,702. Now part of this person's income will be in the higher 4 percent bracket—even though, in terms of the cost of living, her income hasn't gone up at all.

"Hidden Tax Hikes:" An Example

	Year 1	Year 5
Actual Income	$19,500	23,702
Taxed at 2%	$19,500	$20,000
Taxed at 4%	$0	$3,702
Inflation-Adjusted Income	***$19,500***	***19,500***

The way the federal personal income tax and some states deal with this problem is by "indexing" tax brackets for inflation. In the example above, indexing would mean that the $20,000 cutoff for the 4 percent bracket would be automatically increased every year by the amount of inflation. If inflation is five percent, the cutoff would increase to $21,000 after one year. After four years (of five percent inflation), the 4 percent bracket would start at $24,310. So, when the person in our example makes $23,702 after four years, he or she would still be in the 2 percent tax bracket.

Inflation has just the same impact on other features of income taxes, including standard deductions, exemptions, and targeted low-income tax credits. Unless these progressive tax breaks are indexed, they will gradually become less valuable over time—imposing a hidden tax hike on the low- and middle-income taxpayers for whom they are most valuable.

Deduction of Federal Income Taxes from State Taxable Income

Another pitfall for state income taxes is the deduction for federal income taxes paid. Since the federal personal income tax is progressive, this deduction significantly reduces the state income taxes paid by the wealthy in the nine states that allow it. In fact, for people in the top federal bracket, the state deduction for federal income taxes effectively lowers a state's top marginal tax rate by about a third. For low- and middle-income taxpayers, on the other hand, this tax break offers little or no relief.

Tax Breaks for Middle- and Low-Income Families

There are a number of ways, other than low tax rates, to keep income taxes affordable for middle- and low-income families. Large standard deductions and exemptions provide relief to all income groups, but are more significant to middle- and low-income families than to the well off. For instance, $10,000 worth of exemptions amounts to 25 percent of income for a family earning $40,000. But the same exemption offsets only 2 percent of income for a family making $500,000.

Targeted tax credits like the Earned Income Tax Credit are an even more effective (and less costly) way of making income taxes progressive. Because the benefits of these credits can be designed to phase out above a specified income level, these credits can be targeted to the low-income families who need them most, and the cost of the credit can be kept to a minimum.

Conclusion

State governments rely on three main sources of revenue—income, sales and property taxes. Of these, only the income tax is progressive. For this reason, an effective income tax, with graduated rates and a minimum of regressive tax loopholes, is the cornerstone of a fair state tax system. As noted in Chapter One, even the most progressive income taxes are usually insufficient to offset the unfairness of sales and property taxes. But a progressive income tax makes the difference between extreme and mild tax unfairness at the state level.