

Deduction for Federal Income Taxes: A Lopsided Loophole Costs Louisiana Millions

Louisiana is in the midst of a crisis of historic proportions. Public needs are growing and the resources it takes to meet them have shrunk. To solve this crisis—to get Louisiana's budget out of the ditch—without further damaging institutions and reducing services critical to the state's future growth, will take more than a cuts-only strategy. Instead we need a more balanced approach, one that includes additional sources of revenues. This Research Note is the fourth in a series of revenue proposals aimed at helping Louisiana solve its problems in a responsible way that promotes job-creation and future prosperity.

Louisiana has a lopsided tax loophole that costs the state \$643 million a year in lost income tax revenue, an amount equal to more than 40 percent of the \$1.6 billion deficit projected for the upcoming fiscal year.¹ Of the few states that allow the loophole, Louisiana will lose the greatest amount in the current tax year. That loophole provides state taxpayers a deduction from their state income taxes for federal income taxes paid. In other words Louisianans can reduce their state taxable income by the amount they paid in federal income taxes in that year. This one deduction reduces state income tax collections by 24 percent in Louisiana.

Louisiana is out of line with almost all other states in allowing this costly deduction. Only six states (Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon) allow *any* deduction for federal taxes. Louisiana is one of only three states that allow taxpayers to deduct the *entire* amount they paid in federal income taxes (Figure 1). In the two other states that allow for the full deduction (Alabama and Iowa), legislation has been introduced this year that would eliminate the deduction entirely. If these bills are enacted, Louisiana would be the only state in the country yet to address this unusual loophole.

The deduction for federal income taxes provides little benefit to low- and moderate-income families, while giving back thousands of dollars to families with the highest incomes. Because federal income taxes are designed to shelter the poorest from tax, these families typically pay little to no federal income taxes. So they receive no or little benefit from Louisiana's deduction for federal income taxes, seriously undermining the only major state tax that is based on ability to pay (unlike, for example, gasoline and sales taxes). On the other hand, the wealthiest Louisianans benefit enormously from being able to deduct their federal income taxes from their state taxable income.

Figure 1:
States Offering a Deduction for Federal Income Taxes Paid in 2011

State	Deduction Offered
Alabama	100% of federal income taxes paid are deductible.
Iowa	100% of federal income taxes paid are deductible.
Louisiana	100% of federal income taxes paid are deductible.
Missouri	\$5,000 (\$10,000 for married couples) of federal income taxes paid is deductible.
Montana	\$5,000 (\$10,000 for married couples) of federal income taxes paid is deductible for itemizers only.
Oregon	Maximum federal income tax paid deduction is \$5,950 and is further reduced for high-income taxpayers.
All Other States	Allow no deduction for federal income taxes paid.

One way to improve this backwards policy would be to limit the allowable deduction of federal income taxes from state taxable income to \$5,000 for persons filing single and \$10,000 for married couples filing jointly. This would stem the outflow from state coffers, and help to reduce the damage to vital institutions including public universities, school-based

health centers, and drug treatment centers – all of which are suffering from deep spending cuts because of the state’s revenue shortage. Capping deductions at this level for federal income taxes paid would recoup at least \$392 million a year.

Placing a limit on how much federal income tax can be deducted from state income taxes also would take a step toward fixing a serious imbalance in Louisiana’s tax system. Today, upper-income households pay a significantly lower percentage of their incomes in all state and local taxes combined – about 5% -- compared to those who make, on average, \$11,000, who pay 10% of their income. Capping the deduction for higher income taxpayers would raise taxes for these households, better balancing the state and local tax system while raising funds for investments in public services.

Virtually all of the tax increase would be paid by households who make greater than \$86,000 per year – more than twice as much as the median income of \$42,167 in Louisiana (Figure 2), based on an analysis done for the Louisiana Budget Project by the Institute for Taxation and Economic Policy. Over three-fourths of the tax increase would be paid by households making over \$170,000 a year. Most middle-income taxpayers and all low-income taxpayers would see no tax increase.

**Figure 2:
Capping Deductions for Federal Income Taxes Paid**

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Annual Income Range	Less Than \$16,000	\$16,000- \$31,000	\$31,000- \$49,000	\$49,000- 86,000	\$86,000- \$170,000	\$170,000- \$433,000	\$433,000 Or More
Average Income in Group	\$11,000	\$23,000	\$40,000	\$64,000	\$116,000	\$243,000	\$1,150,000
Tax as % of Income	0%	0%	+ 0.0%	+ 0.1%	+ 0.2%	+ 0.6%	+ 0.9%
Proposed State Tax Change	0	0	+\$2	+\$44	+\$244	+\$1,375	+\$10,443
Percent of Total Tax Change	0	0	0%	4%	18%	27%	51%
Percent of Residents With Tax Increase	0%	0%	6%	26%	59%	91%	99%

Capping deductions from state income taxes for federal income taxes paid would:

- Make Louisiana’s personal income tax structure more equitable by eliminating tax breaks for the wealthiest households.
- Bring the state tax code in line with the rest of the country.
- Provide \$392 million in additional revenue to protect basic public services and investments needed for a strong economy.

This is a more balanced approach to resolving the state’s fiscal crisis than the cuts-only approach proposed by Gov. Jindal. Like the other revenue options proposed in this series, it would help ensure that the state can more fully participate in the economic recovery when it occurs.

Previous Research Notes in series

Itemized Deduction for State and Local Income Taxes Costs Money We Can’t Afford to Lose

http://www.labudget.org/lbp/wp-content/uploads/2011/03/Itemized-Deduction-for-State-and-Local-Income-Taxes.FINAL_.pdf

Two New Tax Brackets for High-Income Households Would Limit State Economic Damage

<http://www.labudget.org/lbp/wp-content/uploads/2011/03/Two-New-Tax-Brackets-for-High-Income-Households.Paper2-.pdf>

Raising Cigarette Taxes Will Increase Revenues, Lower Health Care Costs, and Reduce Smoking -- A Win, Win, Win

<http://www.labudget.org/lbp/wp-content/uploads/2011/03/Raising-Cigarette-Taxes-Will-Increase-Revenues-FINAL.pdf>

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About the Louisiana Budget Project

The Louisiana Budget Project (LBP) provides independent, nonpartisan research and analysis of Louisiana fiscal issues and their impact on Louisiana families and businesses. We seek to bring wider prosperity to Louisiana through a deeper understanding of the state budget, broadening fiscal policy debates, and increasing public participation in decision-making. As part of the State Fiscal Analysis Initiative's 40 state budget projects that are coordinated by the national Center on Budget and Policy Priorities, we uphold a commitment to issuing work that is Credible, Timely, and Accessible.

End Notes

¹ "Topsy-Turvy: State Income Tax Deductions for Federal Income Taxes Turn Tax Fairness on its Head." *Institute of Taxation and Economic Policy*. March, 2011.
http://www.itepnet.org/pdf/topsyturvy_0311.pdf