

Itemized Deductions

Prepared for discussion on November 3, 2009

Four main purposes of itemized deductions: (The Encyclopedia of Taxation and Tax Policy)

- to ease the burden of catastrophic expenditures
- to encourage certain types of activities
- to reduce the cost of taxes paid to state and local governments
- to reduce the cost of some business expenses

Arguments against itemized deductions:

- itemized deductions complicate the tax code
- create a difference in tax liability between taxpayers with similar incomes and filing status
- provide opportunities for tax avoidance/aggressive tax preparation (??)
- because itemizers are generally higher-income individuals, deductibility reduces the overall progressivity of the federal-state-local tax system
- deductions are always more advantageous for taxpayers in higher tax brackets than those in lower tax brackets (e.g. the same charitable contribution has a larger benefit for a high-income taxpayer)
- many of the policy reasons for itemized deductions are related to national issues, not state issues (in addition, many of these deductions are for activities that do not occur in Vermont, and therefore providing the deduction may have no direct returns/benefits for the state)

Vermont Statistics (TY 2006)

- 94,739 resident taxpayers itemized their deductions or 33% of all resident taxpayers

Major Groups of Itemized Deductions

Medical and Dental Expenses (Schedule A Lines 1-4)

Brief Description: Limited only to non-reimbursed expenses that exceed 7.5% of the taxpayer's adjusted gross income. This deduction is likely taken by taxpayers without health insurance, with high-deductible insurance plans, or unusual medical expenses not covered by traditional health insurance. Because of the AGI limitation, this deduction is taken more frequently by lower-income taxpayers. *Note: At least one of the Congressional health care proposals included changes to this deduction – increasing the amount from 7.5% to 10%.*

Purpose: to ease the burden of catastrophic medical and dental expenditures

Vermont Statistics:

- Of the \$2.0 billion of itemized deductions taken by Vermont taxpayers, medical and dental expenses account for \$128.3 million or 6% of the total
- 17,445 taxpayers claimed this exemption –18% of those that itemized
- 91% of those taking this exemption had AGI of \$100,000 or less
- the average amount claimed was \$7,353 per return

Taxes You Paid (Schedule A Lines 5 – 9)

Brief Description: These taxes include State and Local Income OR Sales Taxes; Real Estate Taxes; Personal Property Taxes (includes the new motor vehicle tax deduction); and Other Taxes (income taxes paid to a foreign country, war profits or excess profits taxes, generation-skipping transfer taxes and environmental taxes). *NOTE: Beginning in TY 2009 and thereafter, the amount of state and local income taxes deducted in Vermont is limited to \$5,000.*

Purpose: to reduce the cost of taxes paid to state and local governments

Debate:

Proponents:

- Allowing tax deductibility is a means of aiding state and local government budgets by reducing the price of state and local government goods. At the state level of taxation, the local tax deduction is an additional benefit to local governments, and to the itemizer.
- The deductibility of taxes serves to level the playing field among higher and lower taxing states. Taxpayers in higher taxing states will receive more federal tax savings through deductibility, thereby reducing their total federal, state, and local tax liability relatively more than for those taxpayers in lower taxing states.

Opponents:

- It would be more efficient to provide assistance to state and local governments directly with federal aid than allow these deductions.
- Why should the federal government subsidize higher taxing states? Taxpayers in higher taxing states receive more federal tax savings through deductibility, thereby reducing their total federal, state, and local tax liability relatively more than for those taxpayers in lower taxing states.
- At the state level, allowing a deduction for state taxes is inefficient.

Vermont Statistics for State and Local Income Taxes and Real Estate Taxes ONLY

State and Local Income Taxes

- state and local income taxes are the second largest deduction for \$464.7 million or 23% of the total
- Almost all 93,530 taxpayers who itemize claimed this exemption – 99% of itemizers
- this deduction is taken by all levels of AGI, the amount increase as the AGI increases
- the average amount claimed was \$4,968 per return; with the most unequal distribution, lowest average amount was \$741 – highest \$171,064

Real Estate Taxes

- real estate taxes deducted were \$383.9 million or 19% of the total
- 88,567 taxpayers who itemize claimed this exemption – 93% of itemizers
- the average amount claimed was \$4,335 per return

Interest You Paid (Schedule A Lines 10 – 15)

Brief Description: This is predominantly home mortgage interest, but may also include investment interest.

Purpose: to encourage home ownership and reduce the cost of doing business (investment interest)

Debate on Mortgage Interest:

Opponents:

- homeownership may not be advantageous for all types of taxpayers
- the deduction may encourage homebuyers to take on larger mortgages than they would otherwise
- this deduction gives homeowners a significant benefit over renters

- this deduction is inefficient because it provides a bigger benefit to taxpayers who are able to take on larger mortgages and likely have higher incomes (e.g. it is not targeted)
- the deduction is allowed for second homes

Vermont Statistics:

- at \$645.4 million, home mortgage interest is the largest deduction or 32% of the total claimed
- 78,171 taxpayers who itemize claimed this exemption, or 83%
- The number of taxpayers and the amount claimed is concentrated – 65% of the claims and 60% of the amount deducted is taken by taxpayers with AGI between \$25,000 and \$100,000
- the average amount of \$8,256 is also the highest

Gifts to Charity (Schedule A Lines 16 – 19)

Brief Description: Charitable contributions may be made to organizations that are religious, charitable, educational, scientific or literary in purpose as well as those that prevent cruelty to children or animals. Contributions may be cash, property, or out-of-pocket expenses paid to do volunteer work. There are some limits on the amounts that can be deducted. In general, taxpayers can deduct an amount equivalent to up to 50 percent of their adjusted gross income. A limit of 30 percent of adjusted gross income applies to gifts to some types of foundations and organizations. Because charitable contributions are deductible, the federal government in effect pays part of the individual taxpayer's contributions.

Purpose: to encourage charitable giving; to subsidize the activities of private organizations that provide viable alternatives to direct government programs

Debate:

Proponents:

- the good done by these charitable organizations is worth the federal government's support
- Some donations substitute for activities the government might otherwise undertake. Some complement those activities, and still others support an adversarial relationship with government. Nonprofits, for instance, may seek, further government funding for a given activity or its members may engage in debates with government officials. Many believe these multiple types of charitable activity add to the efficient functioning of a democracy even when particular efforts fail.

Opponents:

- allowing such deductions is a violation of the separation between church and state
- although the deduction likely induces additional giving, estimates of the size of this effect vary, and there is considerable debate over whether the increase in giving exceeds the loss of revenue.

For or Against?

- Donors choose which charitable activities to support. Because part of the cost of their donations is borne by the government through reduced revenue, donors effectively have a say in which activities the government supports.

Vermont Statistics:

- at \$239.1 million of charitable giving was deducted in Vermont, or 12% of the total claimed
- 73,464 taxpayers who itemize claimed this exemption, or 78%
- 29% of the charitable contributions deducted was claimed by 1,240 taxpayers, just over 1% of those that itemized
- the average amount deducted was \$3,255

Casualty and Theft Losses (Schedule A Lines 20)

Brief Description: The amount of losses claimed must be more than \$500 (for each separate claim) and must be more than 10% of the taxpayers' AGI.

Purpose: to ease the burden of catastrophic expenditures

Job Expenses and Certain Miscellaneous Deductions (Schedule A Lines 21-27)

Brief Description: This includes three major types of expenses (not personal expenses) and must exceed 2% of the taxpayers' AGI:

- unreimbursed employee expenses (job travel, dues to professional organizations, safety and protective equipment, certain educational expenses)
- tax preparation fees
- other expenses (legal and accounting fees, clerical help and office rent, trust custodial fees, investment expenses) not deductible in other areas of the tax code

Purpose: to reduce the cost of some business expenses

Other Miscellaneous Deductions (Schedule A Lines 28)

Brief Description: Miscellaneous!

- Gambling Losses (net of winnings)
- Casualty and theft losses
- Losses from K-1 activities (business)
- Estate tax
- Premiums on bonds acquired before 1986
- Impairment related work expenses of a disabled person

Purpose: different for each type of item claimed

Vermont Statistics for ALL Other Deductions:

- \$150.3 of other deductions amounted to 7% of the total claimed
- 31,412 taxpayers who itemize claimed this exemption, or 33%