

**Building a Better Income Tax:  
Options for Enacting a Statewide Personal Income Tax  
in Washington**

Institute on Taxation and Economic Policy  
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## Executive Summary

Washington is one of seven states with no personal income tax—and some lawmakers see this as part of what makes Washington unique. But over the past decade, Washington's fiscal situation has become increasingly turbulent. As a decade-long property tax battle heats up and projected budget deficits loom, Washington policymakers must critically evaluate whether a statewide personal income tax could help create a fairer and more sustainable tax structure for the state.

This report provides a basic overview of the state personal income tax as a policy tool. The report discusses the rationale for taxing personal income, and takes a comparative look at the universe of choices facing lawmakers who seek to enact a personal income tax in Washington. Readers of the report are given a walking tour of how the personal income tax works, with helpful hints on how to avoid the pitfalls encountered by some existing state income taxes.

The report also provides hard data that can help lawmakers and advocates to pinpoint the likely impact of enacting a personal income tax on Washington tax revenues. The report assesses the impact of six separate income tax options, with an eye towards illustrating the effect of important parameters such as exemptions, deductions, graduated rates and tax credits on the fairness and yield of the tax.

The appendix to the report includes model statutory language that can serve as a helpful template for lawmakers and legislative fiscal officers seeking to assemble legislative language that accurately describes the intent of a broad-based personal income tax.

ITEP views this report as an introduction to an important frontier in Washington tax policy. When state lawmakers draft legislative proposals along the basic outlines described in this paper, ITEP's technical resources will be made available on a *pro bono* basis to help lawmakers and legislative fiscal officers to determine the best way to structure such a proposal. We hope this report will help inspire policymakers to investigate this important tool for progressive tax reform.

The personal income tax has been described as the “third rail” of Washington politics. For decades, many important policymakers have taken “the pledge” not to enact a broad-based income tax. Yet behind this quixotic effort to avoid enacting an income tax is a basic truth: the personal income tax can be—and usually is—the fairest tax available to state policymakers. 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.

This paper provides an overview of the options available to Washington lawmakers seeking to draft legislation enacting a personal income tax. The report explains the basic workings of the income tax and discusses important issues that should be addressed in order to ensure that a Washington income tax is both fair and sustainable. The report also provides revenue estimates for an array of possible approaches to enacting an income tax, and assesses the impact of each option on Washington tax fairness. Finally, the report’s appendix includes model statutory language for a simple personal income tax.

## How The Income Tax 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.<sup>1</sup> 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

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<sup>1</sup>New Hampshire is one of two states (the other is Tennessee) that tax only interest and dividend income, and half a dozen states have local income taxes that apply only to wages.

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. 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.<sup>2</sup> 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.

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<sup>2</sup>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.

- **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 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.

A basic benchmark for achieving a simple Washington income tax is reducing the number of ways in which Washington Adjusted Gross Income departs from the federal definition of Adjusted Gross Income. The fewer departures from federal rules, the simpler tax filing will be for Granite State residents.

## Computing Taxable Income

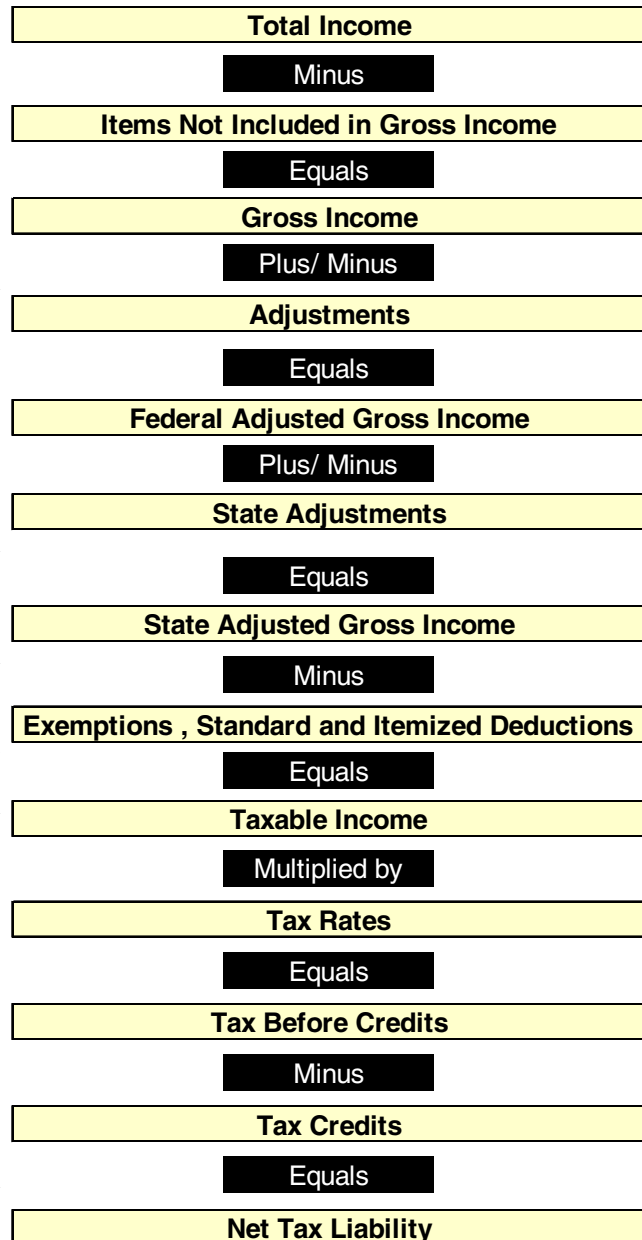
**Taxable income** is the amount of income that is subject to tax after subtracting deductions and exemptions from AGI. This is the amount to which the income tax rate(s) are applied.

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 contrast, 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

### How the Personal Income Tax Works



—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 \$10,300 for couples, \$7,850 for unmarried parents and \$5,350 for single filers in 2007. (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 \$3,400 for each taxpayer and dependent (indexed each year for inflation). Thus, in 2007 a family of four gets a total of \$13,600 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

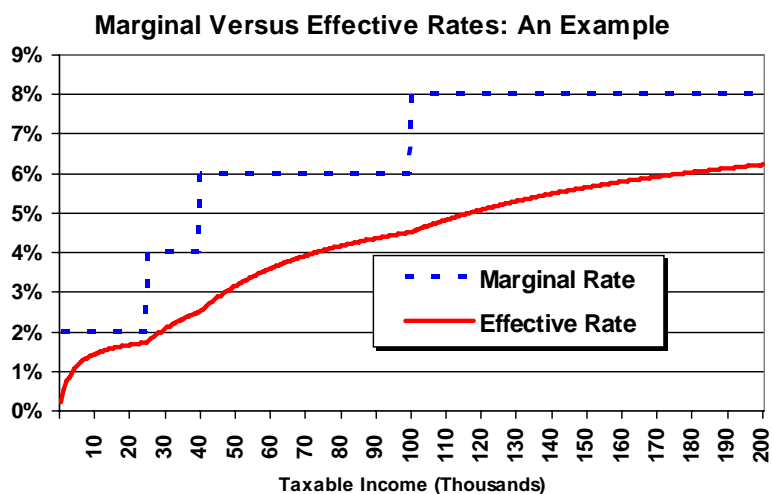
<b>Taxable Income Bracket</b>	<b>Marginal Rate</b>
0 - \$25,000	2%
\$25,000 - \$40,000	4%
\$40,000 - \$100,000	6%
Over \$100,000	8%

percent, income from \$40,000 to \$100,000 is taxed at 6 percent and income over \$100,000 is taxed at 8 percent.

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.<sup>3</sup> 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

<sup>3</sup>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.

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 2007, 22 states allow earned income tax credits modeled after the federal credit.

## Local Income Taxes

**I**n 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

**B**ecause 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.

## What Makes a Fair Personal Income Tax?

Unlike most states, Washington policymakers are starting from scratch in designing a personal income tax: such a tax can be designed to be as fair, and as broad-based, as Washington lawmakers want it to be. In practice, almost every state 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 non-working 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.

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.

#### "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
<b>Inflation-Adjusted Income</b>	<b>\$19,500</b>	<b>19,500</b>

### 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.

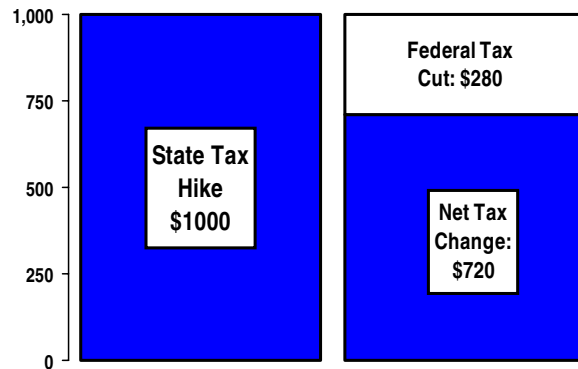
## Options for a Washington Income Tax

This section describes six distinct options for enacting a broad-based personal income tax in Washington. Each option is designed to illustrate the impact of the important design choices that must be made in constructing a state income tax. For each option, estimates of the annual revenue yield and the impact on tax fairness are given.

For each option described below, the accompanying bar charts show the impact of these options on each Washington income group, expressed as a percentage of personal income. The solid portion of each bar represents the net tax change (after taking federal tax changes into account) for each income group. The transparent part of the bar shows each proposal's effect on the federal income taxes paid by each group of Washington residents. The entire bar, including both the solid and transparent part, shows the state tax change, before taking account of federal tax changes, for each income group. We have presented our data in this way because for those Washington residents who itemize deductions on their federal tax returns, changes in state and local income or property taxes can produce partially offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of state tax proposals on the *overall* taxes paid by Washington residents, including federal taxes. The simplified graph on the following page shows how to interpret these charts.

Suppose an itemizing Washington taxpayer in the 28 percent federal tax bracket is subject to a \$1,000 increase in a hypothetical Washington income tax. The value of her federal itemized deductions will increase by \$1,000. This means that \$1,000 *less* of this taxpayer's income will be subject to federal tax after the Washington tax increase. Since this last increment of income was originally taxed at 28 percent, this person's federal tax liability decreases by \$280. So the net *overall* tax hike for this itemizing Washington taxpayer from a \$1,000 hike in state tax liability is actually \$720, not \$1000. Our distributional analysis of this proposal (the second column in the chart on the previous page) shows that taxpayers do not pay the full \$1,000 tax hike, since \$280 of that hike is directly offset by federal tax cuts. An analysis that looked only at the *state* tax impact of the proposal (the first column in the chart) would overestimate the real tax hike on Washington residents from the proposal.

How Increases in Federally Deductible Taxes Reduce Federal Tax Burdens:  
An Example

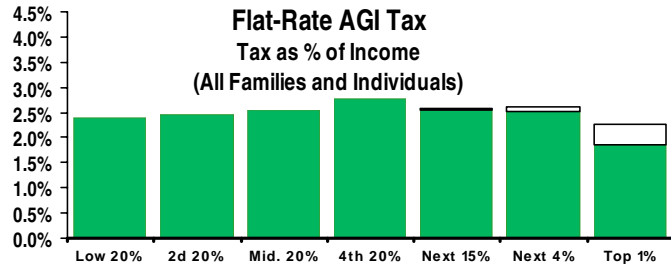


### 1. Flat-Rate 3% Tax on Adjusted Gross Income: No Exemptions, No Credits

The simplest income tax base available to state lawmakers is federal Adjusted Gross Income. The advantage of this approach is twofold: first, because the income definition is tied closely to federal rules, state tax administrators can piggyback on federal income

tax enforcement efforts. Since federal auditors have already verified reported income for Washington filers, the additional burden on state tax administrators is minimized. A second advantage of this approach is that for taxpayers, the process of filing income tax returns is greatly simplified. The main disadvantage of this approach is that it offers no low-income shelters from tax liability. Under a pure AGI tax with no exemptions, deductions or credits, the first dollar of every taxpayer's AGI is subject to a 3 percent income tax rate.

- The impact on low-and middle-income families would be progressive, although low-income families would face a substantial tax liability under this approach.



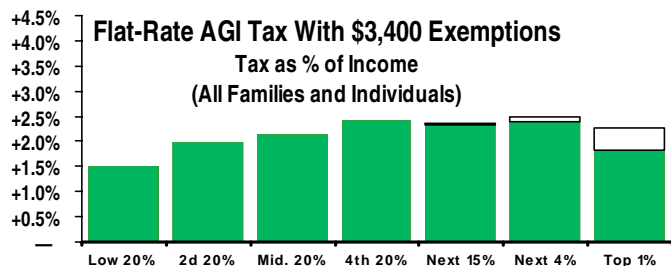
- Upper-income families would actually pay less of their income in tax than would middle-income Washington residents. This is because proportionately less of upper-income families' income is included in federal AGI.

Washington residents. This is because proportionately less of upper-income families' income is included in federal AGI.

- This proposal would have increased Washington state tax collections by \$5.65 billion if fully implemented in tax year 2007.
- Federal taxes paid by Washington families would fall by \$233 million under this proposal—offsetting 4.1 percent of the state tax increase that would result from enacting this income tax. This is because federal itemizers would be able to deduct the Washington income tax on their federal tax returns.

## 2. Flat-Rate 3% Tax on Adjusted Gross Income With \$3,400 Exemption

Most states, and the federal government, shelter a basic amount of each family's income from tax using personal and dependent exemptions. In 2007, federal law gives an exemption of \$3,400 for each parent and each dependent. This means that for a family of four, the first \$13,600 of income will be exempt from tax. Otherwise, this option is identical to option #1.



- Allowing personal and dependent exemptions provides tax cuts for all families, but reserves the largest cuts, as a share of income, for low-and middle-income taxpayers.

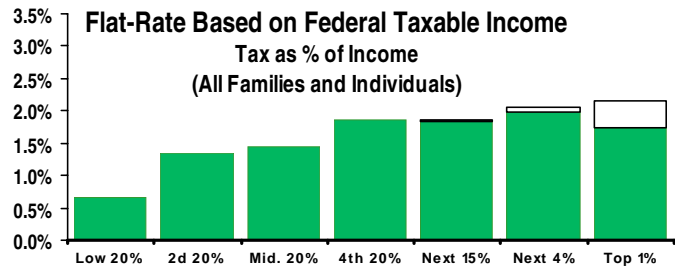
- This proposal would have increased Washington state tax collections by \$5.1 billion if fully implemented in tax year 2007.
- Federal taxes paid by Washington families would fall by \$227 million under this

proposal—offsetting 4.5 percent of the state tax increase that would result from enacting this income tax. Because this plan is more progressive than options 1 and 2, the federal government offsets a higher percentage of this plan’s state tax hike.

### 3. Flat-Rate 3% Tax on Federal Taxable Income

Like options 1 and 2, this proposal starts with federal AGI. But in addition to the personal exemptions offered in option 2, this plan also allows standard and itemized deductions identical to federal law. Put another way, this tax is based on federal taxable income.

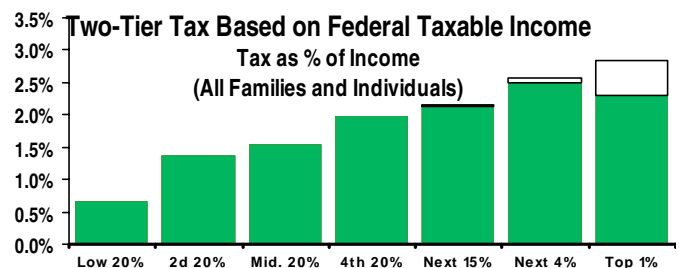
- The use of standard and itemized deductions provides an extra tax shelter for all families, and makes the tax somewhat more progressive because deductions are worth most, as a share of income, for low-income families.
- Allowing deductions dramatically reduces the yield of the tax to \$4.0 billion.
- Federal taxes paid by Washington families would fall by \$211 million under this proposal—offsetting 5.2 percent of the state tax increase that would result from enacting this income tax. Because this plan is more progressive than options 1 and 2, the federal government offsets a higher percentage of this plan’s state tax hike.



### 4. Two-Tier Tax Based on Federal Taxable Income

Each of the options presented so far use a single-rate tax. But the vast majority of the state currently levying income taxes use more than one tax rate, applying a lower rate to lower-income families. This option uses the same tax base (federal taxable income) used in option 3, but adds a second tax rate of 3 percent on taxable income over \$25,000 for single taxpayers (\$50,000 for married couples).

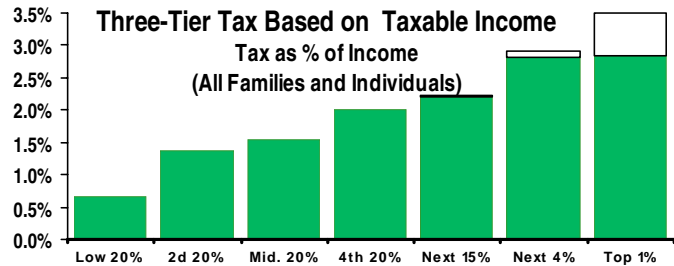
- The use of a higher top tax rate makes the income tax more progressive, without affecting most low- and middle-income taxpayers at all.
- The higher top rate increases the yield of the tax to \$4.06 billion.
- Federal taxes paid by Washington families would fall by \$280 million under this proposal—offsetting 5.8 percent of the state tax increase that would result from



enacting this income tax. Because this plan is more progressive than options 1 through 3, the federal government offsets a higher percentage of this plan's state tax hike.

### 5. Three-Tier Tax Based on Federal Taxable Income

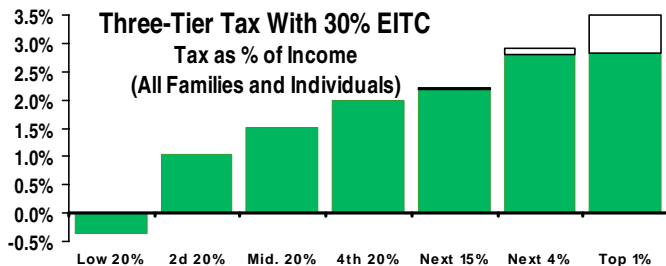
This option differs from option 4 only in the use of a third tax rate of 5 percent above \$50,000 of taxable income for singles (\$100,000 for married couples).



- The third top tax rate makes the income tax even more progressive, without affecting most low- and middle-income taxpayers at all.
- The higher top rate increases the yield of the tax to \$5.3 billion.
- Federal taxes paid by Washington families would fall by \$500 million under this proposal—offsetting 6.4 percent of the state tax increase that would result from enacting this income tax. Because this plan is more progressive than options 1 through 4, the federal government offsets a higher percentage of this plan's state tax hike.

### 6. Three-Tier Tax Based on Federal Taxable Income, Federal EITC

This option differs from option 5 only in the use of an Earned Income Tax Credit calculated as 30 percent of the federal credit.



- The EITC provides targeted tax relief to low-income families, making the tax more progressive and actually reducing income taxes below zero for the poorest quintile of Washington families.
- The EITC reduces the annual yield of the tax to \$5.0 billion.
- Federal taxes paid by Washington families would fall by \$500 million under this proposal—offsetting 6.6 percent of the state tax increase that would result from enacting this income tax. This plan has the same federal tax impact as option 5, despite costing less, because those families claiming the EITC are unlikely to itemize their federal income taxes.

## Conclusion

All too often, discussions of personal income tax legislation generate more heat than light in Washington. The desire of some lawmakers to preserve the state's unique tax heritage short-circuits efforts to rationally discuss the pros and cons of enacting this sensible approach to tax reform. This paper has, we hope, helped to bridge this gap by providing basic talking points on the benefits of a progressive personal income tax, along with hard data on the likely impact of such a tax on the fairness and sustainability of Washington's tax system.

We hope this report will be helpful to state policymakers.

### STATE INCOME TAX

Definitions. In this chapter:

I. “Consumer price index” means the consumer price index for all urban consumers published by the United States Department of Labor.

II. “Department” means the department of revenue administration.

III. “Education trust fund” means the education trust fund established in RSA 198:39.

IV. “Individual” means a natural person.

V. “Washington modified gross income” means Washington modified gross income as determined in RSA 76-A:3.

VI. “Washington taxable income” means Washington taxable income as determined in RSA 76-A:3.

VII. “Nonresident individual” means an individual who receives wages, self-employment income, or unearned income for the taxable year from sources in this state, who maintains his or her domicile outside the state.

IX. “Resident individual” means:

(a) An individual domiciled in the state; or

(b) An individual who maintains a permanent place of abode within the state and spends more than 183 days of the taxable year within the state.

X. “Taxable year” means the calendar or fiscal year or portion thereof which the taxpayer uses for federal income tax purposes under the United States Internal Revenue Code.

XI. “Taxpayer” means any individual or fiduciary subject to the provisions of this chapter.

XII. “Unearned income” means any income which is not wage or self-employment income, including but not limited to capital gains, allocations of income from S corporations, partnerships, limited liability companies or other similar entities, dividends, interests, rents, and royalties.

XIII. “United States Internal Revenue Code” means the United States Internal Revenue Code of 1986 as amended. The forms, procedures, and regulations of the United States Internal Revenue Service may be used by the commissioner of revenue administration in formulating rules for adoption under RSA 541-A. This definition shall be operative unless and until a specific statutory exception to its adoption is provided in this chapter, or until the application of one of its provisions is held to violate the Washington constitution.

76-A:2 Imposition of Tax. A tax is imposed upon every resident and nonresident individual and upon every resident fiduciary at the rate of 4 percent of Washington taxable income as determined in RSA 76-A:3.

76-A:3 Washington Taxable Income.

I. "Washington taxable income" means, for any taxable year:

(a) In the case of a resident or nonresident individual, the individual's Washington modified gross income, as defined in paragraph II of this section, less the following:

(1) An exemption of \$15,000 for the taxpayer and an additional exemption of \$15,000 for the taxpayer's spouse if a joint return is made, provided that the taxpayer or spouse is not claimed as a dependent on another taxpayer's federal income tax return or Washington income tax return; and

(2) An additional exemption of \$5,000 for each dependent to which the taxpayer is entitled for federal tax purposes under the United States Internal Revenue Code, provided that the dependent is not claimed as a dependent on another person's federal income tax return or Washington income tax return.

(3) A person who is claimed as a dependent under subparagraph (2) and who has earned income from wages, self-employment income, or farm income which is taxable under this chapter, shall be entitled to a separate exemption of \$5,000 of such earned income on that person's Washington income tax return; and

(4) An additional exemption of \$5,000 for a taxpayer entitled to a head of household status for federal tax purposes under the United States Internal Revenue Code.

(b)(1) In the case of a resident fiduciary, the amount shown as total taxable income on the fiduciary's United States fiduciary income tax return:

(A) Increased by:

(I) Any interest or dividend income on obligations or securities of another state of the United States; and

(ii) Any interest or dividend income on obligations or securities of any authority, commission, or instrumentality of the United States to the extent exempted from the federal income tax; and

(B) Decreased by interest on, and dividends on securities attributable to the interest on, the direct obligations of the United States government.

(2) For a resident fiduciary with at least one beneficiary that is not either a resident individual or another resident fiduciary, the amount of income derived by application of subparagraph (1) shall be multiplied by a fraction, the numerator of which is income properly accumulated for the benefit of resident individuals or resident fiduciaries and the denominator of which is all income property accumulated.

(c) The amount of the exemptions allowed under this paragraph shall be in place for

the first year of the tax only. The commissioner of revenue administration shall increase the exemption amounts allowed in each succeeding year by an amount which equals the percentage increase in the consumer price index for a recent prior annual period established by rule by the commissioner, and rounded to the nearest \$10.

II. “Washington modified gross income” means, for any taxable year, the amount of the taxpayer’s adjusted gross income for federal income tax purposes under the United States Internal Revenue Code:

(a) Decreased by:

(1) Interest on, and dividends on securities attributable to interest on, the direct obligations of the United States government;

(2) Interest and dividend income received from funds invested in the college tuition savings plan under RSA 195-H if used in accordance with RSA 195-H;

(3) The amount of income taxable under this chapter which is also taxed as business profits under RSA 77-A;

(4) The amount of capital gains income directly derived from sales of timber subject to taxation under RSA 79;

(5) The amount of any social security income that is included the taxpayers’ adjusted gross income for federal income tax purposes;

(6) The amount of income attributable to pension or retirement income that the taxpayer receives in lieu of social security income (due to employment where the employer was obligated to contribute to a pension plan in lieu of social security contributions), which amount when combined with any social security income shall not exceed the maximum potential regular social security benefit per beneficiary for that year might have otherwise been available to such taxpayer, all as determined by rules adopted by the commissioner; and

(7) The amount of income attributable to pension payments where the taxpayer’s contributions to the pension fund were previously subject to federal personal income taxation, as determined by rules adopted by the commissioner.

(b) Increased by:

(1) Any interest or dividend income on obligations or securities of any authority, commission, or instrumentality of the United States to the extent exempted from the federal income tax; and

(2) Any interest or dividend income on obligations or securities of another state of the United States.

76-A:4 Tax; When Due. Subject to the provisions of this chapter concerning the withholding of tax and estimated tax declarations, the tax imposed by this chapter shall be deemed to be assessed and due and payable on the fifteenth day of the fourth month following the close of the taxpayer’s taxable year.

## Returns

### 76-A:6 Returns.

I. Every resident individual and nonresident individual having Washington modified gross income greater than the exemption amounts provided in RSA 76-A:3, I and every resident fiduciary shall make a return to the department of revenue administration under such rules and in such form or manner as the commissioner may prescribe, on or before the due date of the tax as provided in RSA 76-A:4.

II. A husband and wife who are both residents or who both earn wages or self-employment income from sources within Washington shall file a joint return for any taxable year for which such a joint return is filed for United States income tax purposes.

III. Whenever any return shows that overpayment allowable to the taxpayer exceeds the amount of tax due, the department shall certify the amount of overpayment to the state treasurer for refund from the education trust fund created by RSA 198:39 or shall allow the taxpayer a credit against taxes due for a subsequent year, to the extent of the overpayment, at the taxpayer's option.

76-A:7 Information Returns. Each individual, partnership, limited liability partnership corporation, limited liability corporation, proprietorship, joint stock company, association, insurance company, business trust, real estate trust, or other form of organization, organized for gain or profit, being a resident or having a place of business in this state or being a nonresident having income derived from sources subject to tax under this chapter, in whatever capacity acting, including lessors or mortgagors of personal property, fiduciaries, employers, and all officers and employees of the state or of any political subdivision of the state, having the control, receipt, custody, disposal, or payment of salaries, wages, rentals, or other compensation or income subject to the provisions of this chapter paid or payable during any year to any taxpayer subject to a tax under this chapter shall on such date or dates as the department shall from time to time designate, make complete return thereof to the department, in such form as the department may prescribe.

## Withholding of Tax

76-A:8 Who Must Withhold. Every employer as defined by section 3401(d) of the United States Internal Revenue Code of 1986, as amended, employing any person within this state shall deduct and withhold upon wages paid to said employee, a tax equal to 4 percent of such wages less claimed exemptions, subject, however, to the provisions of RSA 76-A:11.

### 79-A:9 Time for Payment of Withheld Taxes and Filing Withheld Taxes Returns.

I. Every employer required to deduct and withhold any tax under RSA 76-A:8 shall make a quarterly return thereof to the department on or before the fifteenth day of the first calendar month following the calendar quarter for which the return is made. However, a return may be filed on or before the last day of the first calendar month following such quarter if timely deposits have been made in full payment of such taxes due for the quarter.

II. Every employer shall pay over to the department, or to a depository designated by the department, the taxes so required to be deducted and withheld at the same time that such employer is required, under federal income tax law and regulations, to pay over federal taxes that are required to be deducted and withheld from wages to employees.

III. The department may, if such action is necessary in any emergency where collection of the tax may be in jeopardy, require such employer to make such return and pay such tax at any time, or from time to time.

## APPENDIX II : ITEP TAX MODEL METHODOLOGY

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The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of current law and proposed changes. ITEP's research is frequently used by other groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

### What the ITEP Model Does

The ITEP model is a tool for calculating the yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed changes. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

The ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the Joint Committee on Taxation, the U.S. Treasury and the Congressional Budget Office (although each of these models differs as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and its capabilities:

***The Personal Income Tax Model*** analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemptions and standard deductions,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care\ credits.

***The Consumption Tax Model*** analyzes the yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in consumption taxes. There are more than 250 base items available to amend in the model.

***The Property Tax Model*** analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

***The Corporate Income Tax Model*** analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

**Local taxes:** The model can analyze the statewide revenue and incidence of aggregate

local taxes (not, however, broken down by individual localities).

### **Data Sources**

The ITEP model is a “microsimulation model.” That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

#### *Micro-Data Sets:*

IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey; Consumer Expenditure Survey; U.S. Census, 1990.

#### *Partial List of Aggregated Data Sources:*

Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

A more detailed description of the ITEP Microsimulation Tax Model can be found on ITEP’s website at [www.itepnet.org](http://www.itepnet.org).