Federal Tax Reform and State Taxes

President's Advisory Panel on Federal Tax Reform

Harley T. Duncan
Federation of Tax Administrators
April 18, 2005

Purpose

- Overview of the state tax impacts of various federal tax reform/change proposals
  - Framework for analysis
  - Overview of key proposals
- Not advocating for or against any particular proposal
- Discussion of the issues marks an important first step

Punchline

- Fundamental reform could substantially alter state tax bases and state tax authority
- Certain proposals also present opportunities for improving state tax structures
- Need for structured dialogue
  - Develop context for dealing with issues
  - Take advantage of opportunities for improvement

Operating Premise

- State base must necessarily follow federal base
  - Taxpayer compliance and burden
  - Required for reliance on federal compliance systems
  - No 3rd party reporting systems
- With no federal income tax, there can be no state income tax [broad-based]
  - Possibility of wage-based tax

Analytic Framework

- Conformity Impacts
  - What are structural impacts on state tax base?
- "Crowding Out" Impacts
  - To what degree does federal taxation move into traditional state tax base and limit flexibility?
- Sovereignty Impacts
  - What is the effect on tax authority/prerogatives and what range of options does it leave states?
- Opportunity Impacts
  - Does it create avenues for improving state tax structures?

Reform Options

- Broadened income tax
  - Broaden base, lower rates
- Consumed income tax
  - Exclude capital income
- National retail sales tax
  - Retail tax on all goods and services
- Value-added tax
  - Transaction, European style
- "Flat" tax
  - Integrated personal/business income tax

Reform Current Income Tax

- Conformity
  - Broadening of the base is likely
- Crowding
  - Standing alone would be neutral [See caveat.]
- Sovereignty
  - Broader base retains or increases state options for rate reductions and comprehensive income base
- Opportunities
  - Base broadening would improve horizontal equity and affect compliance positively

Caveat : State/Local Deduction

- Repeal of deduction has crowding out effect
  - Increases “price” of state and local government
  - Impact is more severe if it is only deduction repealed since relative “price” of other services are not affected
- Some offset with AMT reform
  - One of primary determinants of AMT liability

National Sales Tax and VAT

- Conformity
  - Opportunities for improvement/coordination are maximized with conformity
  - Differing federal/state bases (and type of tax) would be complex for businesses
- Crowding
  - Would move federal government into traditional state/local area
  - Question is one of degree

NST and VAT [Cont.]

- Sovereignty
  - Design must accommodate state/local rate flexibility
  - Requires recognition that base is being shared
- Opportunities
  - Improved consumption tax -- services, business inputs and interstate sales
  - Issues of rates, compliance, coordinated administration require examination
  - If the federal income tax is replaced (and states are required to abandon income taxes), the combined federal and state revenue-neutral rate would need to be at least 50 percent higher than the federal revenue-neutral rate to replace state and local income and sales taxes

Consumed Income Tax

- Conformity
  - Narrowing of base; decoupling,if possible, dependent on type of federal change and information reporting systems
  - Constrains choices and complicates administration
- Crowding
  - Shifts federal taxation to traditional state base, albeit not as directly as an RST or VAT
- Sovereignty
  - Effectively precludes comprehensive income tax if reporting/compliance system is eliminated
- Opportunities
  - From intergovernmental perspective, improvements are minimal

Flat Income Tax

- Conformity
  - Some potential broadening of base even with integration
- Crowding
  - Neutral relative to current system
- Sovereignty
  - State ability to retain current approach is dependent on information reporting system
- Opportunities
  - Some base broadening
  - Improved business tax base

Conclusion

- Federal changes likely to occasion similar state-level changes
- Certain reforms pose difficult conformity issues, but offer opportunity to improve tax systems as well
- Repeal of state and local deductibility raises fiscal federalism issues
- Eliminating federal income tax is problematic
- Need a structured dialogue to assess impacts and maximize opportunities for improvement

Appendix: Summary Evaluation of Federal Reform Proposals

	Reform Income Tax	RST or VAT	Consumed Income Tax	Flat (Integrated) Tax
Conformity	Broader base creates rate flexibility Reduced preferences improve compliance	Significant taxpayer burden unless state conforms to federal Conformity improves compliance and creates opportunities for improvement VAT, as new tax, creates greater challenges	Narrowing of income tax base compared to current State options to decouple constrained dependent on type of federal change and reporting systems Decoupling adds complexity and reduces compliance	Some potential broadening of base is possible even with integration Pressure to conform, but options would exist with retention of information reporting systems
Crowding	By itself has neutral impact Repealing state/local tax deduction increases "price" of services and constrains options	Shifts some portion of federal financing to traditional state tax base Question of degree dependent on retention (or not) of income tax	Shifts federal financing to base used by state Less direct than with RST or VAT	Neutral relative to the current system
Sovereignty	Broader base improves state flexibility Repeal of state/local tax deduction reduces flexibility	State control of base is likely diminished Design must accommodate rate flexibility Need recognition that tax base is being shared Repeal of income tax would constrain state choices	Ability to retain comprehensive state income tax is dependent on information reporting State choices likely restricted	Retention of comprehensive income tax base is dependent on information reporting systems State choices potentially constrained
Opportunities	Broader base improves horizontal equity Reduced preferences improves compliance	Could improve design and administration of state consumption taxes Improvements maximized if state base conforms to federal	From intergovernmental perspective, improvements are minimal	Potential for broader base with fewer preferences Potentially improved business income tax base Compliance improvements and burden reduction possible

SOURCE: Federation of Tax Administrators

Relationships Between Federal and State Income Taxes

Submitted to

President's Advisory Panel on Federal Tax Reform

April 2005

Harley T. Duncan
Federation of Tax Administrators
444 North Capitol St., NW, #348
Washington, D.C. 20001
Ph. 202/624-5891
harley.duncan@taxadmin.org

Relationships Between Federal and State Income Taxes

Harley T. Duncan
Federation of Tax Administrators
April 2005

1. Purpose

1.1. The purpose of this outline is to explain the nature of the relationships that exist between state and federal income taxes at both the individual and corporation level. It looks at the structural relationships as well as the administrative connections between the state and federal systems. It also examines the rationale supporting "conformity" between the two systems and the consequences of non-conformity for taxpayers and for states.

2. Prevalence of Personal and Corporation Income Taxes

2.1. Forty-one states and D.C. impose a broad-based personal income tax. In addition, New Hampshire and Tennessee impose a tax on income from interest and dividends only. Those states not imposing a personal income tax include Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

2.2. Forty-six states and D.C. impose a tax at the corporate or business entity level that uses net income as at least part of the base. Those states that do not have such a tax include Nevada, South Dakota, Washington and Wyoming.

2.3. In 2003, state personal income tax collections totaled about $182 billion or roughly one-third of total state tax collections of $549 billion. Corporation income tax collections amounted to just over 5 percent of the total or $28.4 billion. For comparison purposes, federal income taxes in FY 2003 were $793.7 billion at the individual level and $131.8 billion at the corporate level.[1]

2.4. Unlike the sales and use tax, local governments do not make extensive use of the income tax. Local income taxes are generally limited to Pennsylvania, Ohio, Indiana, and Kentucky and selected larger cities in certain states like New York and Missouri. Most local income taxes are imposed primarily on wage income.

3. Structural Relationships

3.1. State income taxes, for both individuals and corporations, are heavily reliant on the structure of the federal income tax, and to a large degree, conform to many features of the federal tax base such as definitions of items of income and deduction as well as the treatment of various types of transactions.

---

[1] Data from U.S. Bureau of the Census and U.S. Treasury Department Monthly Treasury Statement.

3.2. **Individual Income Taxes.** Thirty-seven of the 42 states[2] with a broad-based individual income tax conform to the federal tax base in some fashion in that they base the calculation of state tax on a federal "starting point," meaning that the first entry on the state return is a computed federal number to which various "addition and subtraction modifications[3]" are made.

3.2.1. As shown in Table I, 27 states use federal adjusted gross income (AGI) as the state starting point, and 10 states begin the state calculation with federal taxable income. In the five states that do not use a federal starting point – Alabama, Arkansas, Mississippi, New Jersey and Pennsylvania – the various items of income used to develop the state base are commonly defined with reference to the Internal Revenue Code.[4]

3.2.2. Most states also base state deductions on the federal tax. Of the 34 states that allow itemized deductions, computation of state deductions generally follows federal law. The most common modification is to "add back" or eliminate the deduction for state income taxes paid.[5]

3.2.3. Conformity to the federal tax is prevalent in other areas as well. For example, all but three states (New Jersey, Massachusetts and Pennsylvania) generally follow federal treatment of Individual Retirement Arrangements.[6]

3.2.4. Unless a state uses federal taxable income as a starting point, it usually sets it own standard deduction and personal exemption amounts. [See Table II.] These are generally lower than the comparable federal provisions, given the lower personal income tax rates.

3.2.5. In short, then, the computation of state individual income taxes generally proceeds in this fashion:

---

[2] The District of Columbia is treated as a state for purposes of this analysis since its personal and corporate income taxes operate identical to those of a state government.

[3] The modifications are designed to do three things: (a) subtract items in the federal base that the state cannot constitutionally tax (e.g. interest on federal obligations); (b) add items to the state base that the federal government is constitutionally prohibited from taxing (e.g., interest on state/local obligations); and (c) providing special treatment of certain types of income as the state may choose.

[4] As recently as 2001, North Dakota, Rhode Island and Vermont computed the state income tax as a percentage of the federal tax. The prospect of annual reductions in federal liability that were beyond their control and the magnitude of which was not certain caused each of the states change their tax to one based on taxable income or AGI. This allowed them to establish their own rate structure and stabilize their revenue stream.

[5] In several states such as Illinois, Indiana, Michigan, New Jersey and Pennsylvania, the personal income tax is essentially a flat tax in which itemized deductions are not allowed. The only deductions from the base are generally a personal exemption allowance and possibly a standard deduction. For further discussion, see "Individual Income Tax Provisions in the States," Information Paper No. 4, Wisconsin Legislative Fiscal Bureau, January 2001.

[6] David Baer, "State Taxation of Social Security and Pensions in 2000," Issue Brief No. 55, AARP Public Policy Institute, Washington, D.C., 2001.

Federal Tax Base
Plus or Minus: State modifications
Minus: State personal exemptions
Minus: State standard deduction or itemized deductions (based on federal)
Equals: State taxable income

Multiplied by: State Tax Rates
Equals: Tentative State Tax Liability

Minus: State Tax Credits
Equals: Final State Liability

3.2.6. Federal tax base plus/minus state modifications less state personal exemptions less state standard deduction or state itemized deductions (based on federal itemized deductions) yielding state taxable income that is then run through state income tax rate brackets.

3.3. **Corporation Income Taxes.** There is also a substantial degree of conformity between state corporation income taxes and the federal corporate income tax, albeit the degree of similarity has declined in recent years as many states have refrained from adopting certain recent federal tax law changes. [See below.]

3.3.1. Of the 46 states that levy a tax based on corporate income, all of them effectively use federal taxable income as the starting point for state tax computations.[7] This conformity to federal taxable income may be by statutory adoption of the Internal Revenue Code provisions by reference, identification of federal taxable income as the state starting point, or a presumption that beginning with federal taxable income reflects entire net income for tax purposes (New Jersey.)[8]

3.3.2. As with the personal income tax, certain modifications are made to federal taxable income in order to arrive at state taxable income. Generally, the corporate modifications are driven by constitutional considerations or areas of nonconformity with federal law.[9]

3.4. **Types of Conformity.** State conformity with the federal tax code can be broken into two categories – rolling conformity and fixed-date conformity.

---

[7] About 60 percent of the states start with Line 28 of Form 1120 (taxable income before net operating losses), and the remainder start with Line 30 which includes net operating losses.

[8] Compiled from information available through Commerce Clearing House, Inc. Available upon request.

[9] Taxpayers would also modify their taxable income to deal with a category of income called "nonbusiness income," but the issue of non-business income is not relevant to this discussion.

3.4.1. Under rolling conformity, stat law is written such that the state code is tied to the federal code on an automatic or current law basis, and additional state legislative action is not necessary to incorporate new enactments at the federal level. Instead, a state enactment would be necessary to not incorporate federal changes at the state level.

3.4.2. Under fixed date conformity, state law is tied to the federal code as of a particular date. State legislation is necessary to incorporate new federal provisions when enacted. States with this type of conformity commonly consider legislation updating their code references annually.

3.4.3. As shown in Table I, twenty states have a rolling conformity date for personal income taxes (designated as having "Current" conformity in the table.) Seventeen states have fixed-date conformity, and five states do not incorporate a federal starting point that is tied to the federal code for individual income tax purposes.

3.4.4. At the corporate level, 20 states use fixed date conformity, and 26 incorporate some form of rolling or automatic conformity into the state tax law.

3.5. **Recent Federal Changes.** Since 2001, Congress has enacted several tax law changes that have reduced the degree of conformity, particularly on the corporation income tax side. The most important of the federal changes were the bonus depreciation provisions enacted in 2002 as part of the Job Creation and Worker Assistance Act and extended and expanded in the Jobs and Growth Tax Relief Reconciliation Act in 2003.[10]

3.5.1. The effect of these Acts was to reduce the tax base (corporate base in particular), since the deduction for depreciation (increased under these bills) is taken prior to the computation of taxable income. Moreover, the change occurred at a time when states were experiencing serious fiscal difficulties due to a recession and what is commonly called the "burst of the Internet bubble."[11] The choice presented to states was to conform to the federal base or to protect their revenue base by not conforming to the bonus depreciation provisions. Protection of the revenue base was determined by most states to be paramount, given the balanced budget requirements facing them.

3.5.2. Prior to the enactment of bonus depreciation, all but two states conformed to federal depreciation allowances. Only 12 states maintained their conformity after the bonus depreciation provisions. Twenty-nine states chose not to conform to either the 2002 or the 2003 Acts, and four states conformed to one, but not the

---

[10] Public Law 107-147 and P.L. 108-27, respectively.

[11] From the 2nd quarter of 2002 through the 2nd quarter of 20003, total state tax receipts were about 6 percent below the prior year. Research of data back to World War II did not yield another 12-month period in which tax receipts fell below the prior year.

other.[12] In short, we went from nearly total conformity to one in which two-thirds of the states deviate from federal rules.

3.5.3. There has been a similar, but not as large, movement to decouple from other recent changes affecting the federal, and consequently, state tax base. Twelve states have chosen to not to conform to the expansion of the Section 179 expensing provisions available to small businesses.[13] While states are still making their choices, it seems that at least 1/2 of the states are likely to not conform to the recently enacted Sec. 199 deduction for Qualified Production Activity Income.[14]

3.5.4. The tax law changes at the individual level, particularly the Economic Growth and Tax Relief Reconciliation Act of 2001, have not had as profound an effect since the bulk of the federal revenue impacts were associated with the marginal tax rate reductions and the child tax credit, neither of which have an impact on states from a conformity standpoint.

3.5.5. The congressional passage of the 2001, 2002 and 2003 tax bills demonstrates a strong natural tension in federal-state conformity relationships. The federal government often uses tax cuts (particularly depreciation changes) to combat economic slowdowns and promote investment. States are forced to consider not conforming to such changes because of revenue and balanced budget considerations.

4. Compliance Relationships

4.1. States also rely extensively on the Internal Revenue Service and its activities as a part of and a complement to their enforcement and compliance programs.[15]

4.2. With respect to the corporation income tax, states are extremely reliant on federal determinations of taxable income. While states devote substantial resources to the audit of corporation tax returns, their audit activities are focused primarily on verifying the apportionment of income across states, examining the taxpayer's treatment of certain types of transactions, and determining the membership of the unitary group if the state employs combined reporting.

---

12 Commerce Clearinghouse, Inc., "Special Report: Corporate Income Tax and 'Bonus' Depreciation," December 4, 2003.

13 FTA compilation based on data from Commerce Clearing House, Inc.

14 Estimate based on information provided to the author by individual state tax agencies. Available on request.

15 Currently, all states but one have entered into an exchange of information agreement with the Internal Revenue Service under I.R.C. § 6103. Through the agreement, they can receive, at their option, a variety of reports and abstracts on a regular basis. Some of the information available includes revenue agent reports for businesses and individuals, adjustments based on information return matching programs, and extracts from both the business and individual master files and the information returns master file.

4.3. On the individual side, states also rely heavily on federal examinations and adjustments (particularly those involving the matching of information returns) as primary enforcement tools. In addition, states use federal income tax return data for a wide range of individual, independent enforcement programs.

4.4. If federal compliance efforts were to cease, equivalent compliance efforts simply are not within the reach of most individual states, particularly given that, on average, state personal and corporation income tax rates are roughly 20-25 percent of the federal tax rates.

5. Information Reporting

5.1. States are also reliant on the federal information reporting mechanisms for state income tax administration. To a very considerable degree, states simply mirror federal requirements [and forms, formats, etc.] for third-party information reporting. Seldom, does a state attempt to impose requirements in excess of the federal duties; some states do, however, rely only on federal information reports and do not require separate filings at the state level. Attempting to replicate these systems individually would likely result in non-uniformity and increased burdens on taxpayers, not to mention additional expense at the state level.

5.2. Moreover, states would likely encounter legal challenges to their ability to require certain entities that may not be physically present in a state to file information reports on transactions with residents of the state. Such reports are necessary for a full accounting of income and for insuring the taxpayer has the information necessary to prepare his/her return. Use of the federal reporting infrastructure eliminates the question.

6. Reasons for Conformity

6.1. States conform to the federal tax code primarily as a means to simplify matters for taxpayers and to promote compliance with the state income tax. Conformity is of benefit to both taxpayers and tax agencies.

6.2. Conformity makes it simpler for taxpayers to comply with state taxes because they do not have to deal with two separate sets of tax laws, rules and definitions and do not have to maintain two sets of accounts and books. Conformity reduces the complexity especially for firms and individuals operating on an interstate basis because it promotes one set of rules instead of potentially multiple sets.

6.3. Conformity also serves the interests of states in that the reduced complexity promotes voluntary compliance. Moreover, with conformity, states can rely on federal compliance efforts to also assist and complement their efforts. It also improves the ability of states and the IRS to undertake cooperative and joint efforts to improve tax administration and compliance.

7. Consequences of Nonconformity

7.1. Not conforming to federal law increases complexity for taxpayers and consequently reduces voluntary compliance. Certain types of nonconformity present greater complexity than others.

7.2. Nonconformity on issues that do not involve "timing" can be relatively straightforward from a compliance perspective. That is, such nonconformity generally involves either subtraction or addition of an amount that is probably easily known to the taxpayer, and there are no consequences for future years.[16] Excluding a category of income entirely from taxation at the federal level, however, could present issues for states if the information reporting system providing taxpayers with the information necessary to comply with state law are also eliminated.

7.3. Not conforming to issues involving timing (e.g., deferral of income, depreciation, etc.) is quite a different manner. Not conforming to changes in depreciation, for example, requires a taxpayer to maintain two (or more) sets of asset accounts and to track the different federal and state basis in each asset and to recognize different amounts upon disposition. Tracking differences over time imposes significant burdens on taxpayers. Taxpayer accuracy in such matters can usually be verified only on audit, an expensive proposition for both taxpayers and tax agencies alike.

7.4. The complexity associated with timing issues makes it such that there are certain types of federal provisions that make it effectively impossible for states to not conform, particularly as it relates to individual income taxation. Individual Retirement Arrangements are an example. If, for example, IRA contributions are deductible or excluded at the federal level, but taxed at the state level, a taxpayer would have a different basis in the account when withdrawn and have differing amounts taxable at the federal and state level each year. The recordkeeping requirements would be substantial, and compliance would likely be stressed.[17]

8. Conclusion

8.1. Conformity between state and federal tax systems serves the interests of taxpayers, state tax agencies and the overall health of the intergovernmental fiscal system. It promotes simplification for the taxpayer and increases voluntary compliance with the tax law.

8.2. The interrelationships between federal and state systems are extensive. To a considerable degree, the federal tax base effectively defines the state tax base. In addition, states are heavily reliant on federal compliance and information reporting mechanisms for the administration of their income taxes.

8.3. As a result of these interrelationships, federal tax law changes can have both transitory and permanent structural and revenue impacts on state tax systems. At the same time, a

---

[16] The issue is more complex for multistate taxpayers that must track state treatment in which they operate.

[17] The Retirement Savings Accounts and Lifetime Savings Accounts proposed in the Administration's FY 2006 budget present similar issues.

number of potential federal reforms under consideration could improve state tax systems and their administration.

8.4. State reliance on the federal income tax structure and its infrastructure is so extensive that we believe it is appropriate to operate from a premise that state income tax bases must necessarily following federal income tax bases. Moreover, we believe that if the federal income tax is eliminated, it would not be possible for states to maintain and administer their own broad-based income tax over the long term. Without a federal tax to tie to, taxpayer costs and burdens of compliance are likely to prove too burdensome, not to mention the administrative issues and burdens states would face.

Table I

STATE PERSONAL INCOME TAXES: FEDERAL STARTING POINTS

(as of January 1, 2005)

STATE	Relation to Internal Revenue Code	Tax Base
ALABAMA	---	---
ALASKA	no state income tax	
ARIZONA	1/1/04	federal adjusted gross income
ARKANSAS	---	---
CALIFORNIA	11/11/03	federal adjusted gross income
COLORADO	Current	federal taxable income
CONNECTICUT	Current	federal adjusted gross income
DELAWARE	Current	federal adjusted gross income
FLORIDA	no state income tax	
GEORGIA	1/1/04	federal adjusted gross income
HAWAII	12/31/03	federal taxable income
IDAHO	1/1/04	federal taxable income
ILLINOIS	Current	federal adjusted gross income
INDIANA	1/1/03	federal adjusted gross income
IOWA	1/1/04	federal adjusted gross income
KANSAS	Current	federal adjusted gross income
KENTUCKY	12/31/01	federal adjusted gross income
LOUISIANA	Current	federal adjusted gross income
MAINE	5/28/03	federal adjusted gross income
MARYLAND	Current	federal adjusted gross income
MASSACHUSETTS	Current	federal adjusted gross income
MICHIGAN	Current (a)	federal adjusted gross income
MINNESOTA	6/15/03	federal taxable income
MISSISSIPPI	---	---
MISSOURI	Current	federal adjusted gross income
MONTANA	Current	federal adjusted gross income
NEBRASKA	4/15/04	federal adjusted gross income
NEVADA	no state income tax	
NEW HAMPSHIRE	on interest & dividends only	
NEW JERSEY	---	---
NEW MEXICO	Current	federal adjusted gross income
NEW YORK	Current	federal adjusted gross income
NORTH CAROLINA	5/1/04	federal taxable income
NORTH DAKOTA	Current	federal taxable income
OHIO	Current	federal adjusted gross income
OKLAHOMA	Current	federal adjusted gross income
OREGON	Current	federal taxable income
PENNSYLVANIA	---	---
RHODE ISLAND	6/3/01	federal adjusted gross income
SOUTH CAROLINA	12/31/02	federal taxable income
SOUTH DAKOTA	no state income tax	
TENNESSEE	on interest & dividends only	
TEXAS	no state income tax	
UTAH	Current	federal taxable income
VERMONT	1/1/02	federal taxable income
VIRGINIA	12/31/03	federal adjusted gross income
WASHINGTON	no state income tax	
WEST VIRGINIA	1/1/04	federal adjusted gross income
WISCONSIN	12/31/02	federal adjusted gross income
WYOMING	no state income tax	
DIST. OF COLUMBIA	Current	federal adjusted gross income

Source: Compiled by the Federation of Tax Administrators from various sources.
--- state does not employ a federal starting point. Current indicates state has adopted IRC as currently in effect. Dates indicate state has adopted IRC as ammended to that date.
(a) or 1/1/99, taxpayer's option.

STATE INDIVIDUAL INCOME TAXES

(Tax rates for tax year 2005 -- as of January 1, 2005)

	TAX RATE RANGE (in percents) Low	TAX RATE RANGE (in percents) High	Number of Brackets	INCOME BRACKETS Lowest	INCOME BRACKETS Highest	PERSONAL EXEMPTIONS Single	PERSONAL EXEMPTIONS Married	PERSONAL EXEMPTIONS Dependents	FEDERAL INCOME TAX DEDUCTIBLE
ALABAMA	2.0	5.0	3	500 (b)	3,000 (b)	1,500	3,000	300	*
ALASKA	No State Income Tax								
ARIZONA	2.87	5.04	5	10,000 (b)	150,000 (b)	2,100	4,200	2,300	
ARKANSAS (a)	1.0	7.0 (e)	6	3,299	27,500	20 (c)	40 (c)	20 (c)	
CALIFORNIA (a)	1.0	9.3	6	6,147 (b)	40,346 (b)	85 (c)	170 (c)	265 (c)	
COLORADO	4.63		1	-----Flat rate-----		-----------None-----------			
CONNECTICUT	3.0	5.0	2	10,000 (b)	10,000 (b)	12,750 (f)	24,500 (f)	0	
DELAWARE	2.2	5.95	6	5,000	60,000	110 (c)	220 (c)	110 (c)	
FLORIDA	No State Income Tax								
GEORGIA	1.0	6.0	6	750 (g)	7,000 (g)	2,700	5,400	2,700	
HAWAII	1.4	8.25	9	2,000 (b)	40,000 (b)	1,040	2,080	1,040	
IDAHO (a)	1.6	7.8	8	1,129 (h)	22,577 (h)	3,200 (d)	6,400 (d)	3,200 (d)	
ILLINOIS	3.0		1	-----Flat rate-----		2,000	4,000	2,000	
INDIANA	3.4		1	-----Flat rate-----		1,000	2,000	1,000	
IOWA (a)	0.36	8.98	9	1,242	55,890	40 (c)	80 (c)	40 (c)	*
KANSAS	3.5	6.45	3	15,000 (b)	30,000 (b)	2,250	4,500	2,250	
KENTUCKY	2.0	6.0	5	3,000	8,000	20 (c)	40 (c)	20 (c)	
LOUISIANA	2.0	6.0	3	12,500 (b)	25,000 (b)	4,500 (i)	9,000 (i)	1,000 (i)	*
MAINE (a)	2.0	8.5	4	4,350 (b)	17,350 (b)	2,850	5,700	2,850	
MARYLAND	2.0	4.75	4	1,000	3,000	2,400	4,800	2,400	
MASSACHUSETTS (a)	5.3		1	-----Flat rate-----		3,575	7,150	1,000	
MICHIGAN (a)	3.9		1	-----Flat rate-----		3,100	6,200	3,100	
MINNESOTA (a)	5.35	7.85	3	19,890 (j)	65,330 (j)	3,200 (d)	6,400 (d)	3,200 (d)	
MISSISSIPPI	3.0	5.0	3	5,000	10,000	6,000	12,000	1,500	
MISSOURI	1.5	6.0	10	1,000	9,000	2,100	4,200	1,200	* (s)
MONTANA (a)	1.0	6.9	7	2,300	13,900	1,900	3,800	1,900	*
NEBRASKA (a)	2.56	6.84	4	2,400 (k)	26,500 (k)	101 (c)	202 (c)	101 (c)	
NEVADA	No State Income Tax								
NEW HAMPSHIRE	State Income Tax is Limited to Dividends and Interest Income Only.								
NEW JERSEY	1.4	6.37	6	20,000 (l)	75,000 (l)	1,000	2,000	1,500	
NEW MEXICO	1.7	6.0	5	5,500 (m)	16,000 (m)	3,200 (d)	6,400 (d)	3,200 (d)	
NEW YORK	4.0	7.70	7	8,000 (n)	500,000 (n)	0	0	1,000	
NORTH CAROLINA (o)	6.0	8.25	4	12,750 (o)	120,000 (o)	3,200 (d)	6,400 (d)	3,200 (d)	
NORTH DAKOTA (a)	2.1	5.54 (p)	5	29,050 (p)	319,100 (p)	3,200 (d)	6,400 (d)	3,200 (d)	
OHIO (a)	0.743	7.5	9	5,000	200,000	1,300 (q)	2,600 (q)	1,300 (q)	
OKLAHOMA	0.5	6.65 (r)	8	1,000 (b)	10,000 (b)	1,000	2,000	1,000	* (r)
OREGON (a)	5.0	9.0	3	2,650 (b)	6,550 (b)	154 (c)	308 (c)	154 (c)	* (s)
PENNSYLVANIA	3.07		1	-----Flat rate-----		-----------None-----------			
RHODE ISLAND	25.0% Federal tax rates (t)				---	---	---	---	
SOUTH CAROLINA (a)	2.5	7.0	6	2,460	12,300	3,200 (d)	6,400 (d)	3,200 (d)	
SOUTH DAKOTA	No State Income Tax								
TENNESSEE	State Income Tax is Limited to Dividends and Interest Income Only.								
TEXAS	No State Income Tax								
UTAH	2.30	7.0	6	700 (b)	3,750 (b)	2,400 (d)	4,800 (d)	2,400 (d)	* (u)
VERMONT (a)	3.6	9.5	5	29,900 (v)	326,450 (v)	3,200 (d)	6,400 (d)	3,200 (d)	
VIRGINIA	2.0	5.75	4	3,000	17,000	800	1,600	800	
WASHINGTON	No State Income Tax								
WEST VIRGINIA	3.0	6.5	5	10,000	60,000	2,000	4,000	2,000	
WISCONSIN (a)	4.6	6.75	4	8,840 (w)	132,580 (w)	700	1,400	400	
WYOMING	No State Income Tax								
DIST. OF COLUMBIA	5.0	9.0 (x)	3	10,000	30,000	1,370	2,740	1,370	

STATE INDIVIDUAL INCOME TAXES (footnotes)

Source: The Federation of Tax Administrators from various sources.
(a) 15 states have statutory provision for automatic adjustment of tax brackets, personal exemption or standard deductions to the rate of inflation. Massachusetts, Michigan, Nebraska and Ohio indexes the personal exemption amounts only.
(b) For joint returns, the taxes are twice the tax imposed on half the income.
(c) tax credits.
(d) These states allow personal exemption or standard deductions as provided in the IRC. Utah allows a personal exemption equal to three-fourths the federal exemptions.
(e) A special tax table is available for low income taxpayers reducing their tax payments.
(f) Combined personal exemptions and standard deduction. An additional tax credit is allowed ranging from 75% to 0% based on state adjusted gross income. Exemption amounts are phased out for higher income taxpayers until they are eliminated for households earning over $55,500.
(g) The tax brackets reported are for single individuals. For married households filing separately, the same rates apply to income brackets ranging from $500 to $5,000; and the income brackets range from $1,000 to $10,000 for joint filers.
(h) For joint returns, the tax is twice the tax imposed on half the income. A $10 filing tax is charge for each return and a $15 credit is allowed for each exemption.
(i) Combined personal exemption and standard deduction.
(j) The tax brackets reported are for single individual. For married couples filing jointly, the same rates apply for income under $29,070 to over $115,510.
(k) The tax brackets reported are for single individual. For married couples filing jointly, the same rates apply for income under $4,000 to over $46,750.
(l) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply for income under $20,000 to over $150,000.
(m) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply for income under $8,000 to over $24,000. Married households filing separately pay the tax imposed on half the income.
(n) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $16,000 to $500,000.
(o) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $21,250 to $200,000. Lower exemption amounts allowed for high income taxpayers. Tax rate scheduled to decrease after tax year 2005.
(p) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $48,500 to $319,100. An additional $300 personal exemption is allowed for joint returns or unmarried head of households.
(q) Plus an additional $20 per exemption tax credit.
(r) The rate range reported is for single persons not deducting federal income tax. For married persons filing jointly, the same rates apply to income brackets that are twice the dollar amounts. Separate schedules, with rates ranging from 0.5% to 10%, apply to taxpayers deducting federal income taxes.
(s) Deduction is limited to $10,000 for joint returns and $5,000 for individuals in Missouri and to $5,000 in Oregon.
(t) Federal Tax Liability prior to the enactment of Economic Growth and Tax Relief Act of 2001.
(u) One half of the federal income taxes are deductible.
(v) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply for income under $49,650 to over $326,450.
(w) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $11,780 to $176,770. An additional $250 exemption is provided for each taxpayer or spouse age 65 or over.
(x) Tax rate decreases are scheduled for tax years 2006.

State and Local Retail Sales Taxes

Submitted to the
President's Advisory Panel on Federal Tax Reform

April 2005

Harley T. Duncan
Federation of Tax Administrators
444 North Capitol St., NW, #348
Washington, D.C.
Ph. 202/624-5891
harley.duncan@taxadmin.org

State and Local Retail Sales Taxes

Harley T. Duncan
Federation of Tax Administrators
April 2005

1. Purpose

1.1. The purpose of this outline is to provide an overview of state and local retail sales and use taxes in the U.S. and their administration.

1.2. It examines such issues as the use of the tax among states and localities, general characteristics of the state tax base, tax rates, and common tax policy criticisms of the tax.

2. Prevalence of the Tax at the State and Local Level

2.1. Forty-five states and the District of Columbia impose a broad-based general retail sales and use tax at the state level.[1] Those states not levying the tax include Alaska, Delaware, Montana, New Hampshire, and Oregon.[2]

2.2. In FY 2003, states collected about $185 billion in general retail sales taxes, about 37 percent of total state general tax collections of roughly $497 billion.[3]

2.3. Local governments in 34 states also impose a sales tax.[4] In all but four states, local taxes are imposed as an add-on to the state tax and are collected and administered by the state tax administration agency.[5] In addition, local tax bases as a general matter conform to the state sales tax base. In some states, the local tax is levied in all jurisdictions of a certain type, but the norm is to allow a "local option" tax in which a locality (or certain types of localities) can choose whether or not to impose a tax. This results in quite a patchwork of sales tax utilization and sales tax rates. Approximately 7,500 separate local jurisdictions impose a sales tax in the U.S.

---

[1] From this point forward, D.C. is treated as a state since its retail sales tax operates identical to those of the other states.

[2] A number of Alaska local governments are authorized to, and do, impose a sales tax. In addition, Delaware imposes a low-rate gross receipts tax and New Hampshire imposes excise taxes (that operate like sales taxes) on transient lodging, certain restaurant meals and a broad range of communications services.

[3] Data from U.S. Bureau of Census. Total tax figure does not include "License Taxes" as categorized by the Census Bureau. For comparison purposes, individual income taxes ($181 billion) account for 36.6 percent of total taxes, and corporate taxes account for 5.7 percent.

[4] Those states in which localities do not levy a sales tax include Hawaii, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Jersey, Rhode Island, and West Virginia.

[5] In Alabama, Arizona, Colorado and Louisiana, some local governments are authorized to administer their own sales tax. In these states, there is also somewhat more divergence between the state and local tax base.

2.4. For the large part, local sales taxes are levied by general purpose local governments (cities and counties) as opposed to special purpose districts such as school districts. The use of sales taxes for certain special purposes (e.g., transit) is becoming more common.

2.5. In FY 2002, general local sales accounted for $43.3 billion in revenue out of a total of $369.7 billion in local tax receipts (11.7 percent)[6]

3. State and Local Tax Bases

3.1. **Exemptions from the Base.** State and local sales taxes have three types of exemptions: (a) Product-based exemptions in which a product or service is exempt regardless of who purchases it or for what purpose;[7] (b) Use-based exemptions in which the exemption is dependent on the use to which it is to be put; (For example, a product purchased to be used in producing a subsequent product to be sold at retail may be exempt, but it would not be if purchased for final consumption.); and (c) Entity-based exemptions in which all or certain purchases by particular types of entities (e.g., schools, charities) are exempt.

3.1.1. States vary widely in their exemption practices, but all of them have a variety of exemptions aimed at eliminating the tax on intermediate or wholesale transactions and imposing the tax only on final consumption, e.g., exemptions of sales for resale, ingredient and component parts and the like. Still, states apply their taxes to a wide range of business inputs and intermediate goods, particularly in the service sector where few services are taxed on final consumption. See discussion below.

3.1.2. The most common product-based exemptions are aimed at excluding the tax on what are considered items of necessity, e.g., food for home consumption and prescription drugs. As shown in Table I, every sales tax state exempts prescription drugs from the tax, and about thirty states exempt (or are phasing in an exemption) food for home consumption from the tax. Several others subject food to a rate that is lower than the general sales tax rate.

3.2. **Taxation of Services.** State sales and use taxes came into prominence in the Great Depression. More than half of state sales taxes were enacted during the 1930s.[8] Since the economy was largely one of trade in tangible goods at that time and there was an aversion to imposing tax on personal labor services, most sales taxes were originally applied only to sales of tangible personal property and not services.

3.2.1. Despite the significant change in the U.S. economy and the increasing proportion of economic output that is attributable to services, states have not, for the large part, extended the reach of the tax to services. Only three states – Hawaii, New Mexico and South Dakota – impose their tax generally on transactions involving services.

---

[6] Data from the U.S. Bureau of the Census. Property taxes, by contrast, accounted for over 70 percent of all local tax revenue.

[7] State and local sales taxes are generally imposed on all sales of tangible personal property unless specifically exempted, but only on specifically enumerated service transactions. Thus, most services would be deemed to be excluded, rather than exempted, from the tax. See further discussion below.

[8] A second wave of adoptions occurred after World War II as state governments expanded their activities. There were also several adopted in the 1960s as states expanded their financing of elementary and secondary education.

3.2.2. Another group of about 10 states impose their tax on a fairly wide range of utility, admissions and amusement and labor repair services (when applied to tangible personal property.) These states, however, tend not to impose the tax on professional services (e.g., lawyers, accountants or medical), and they exhibit a mixed patter in terms of applying the tax to other business and personal services.

3.2.3. At the other end of the spectrum, there are a number of states that impose the tax on few, if any, services including utilities, admissions or labor services. In a 1996 survey, there were 16 states that taxed fewer than 30 services from a list of over 160 specific services. Fewer than one-half of the states impose the tax widely on labor and repair services.[9]

3.2.4. States have encountered a variety of political, economic and administrative obstacles when they have attempted to extend the sales tax to services. Massachusetts and Florida undertook such efforts in 1990 and 1987, respectively, and repealed the enactments within six months of the time they were passed. Among the reasons for repeal (that also influenced decisions in other states) were extreme opposition among providers of some services being subjected to tax, concern about the taxation of business inputs, and difficulties in effectively and efficiently sourcing transactions where services are provided or consumed on a multistate basis.

3.3. **Breadth of Sales Tax Bases.** States vary widely in terms of the breadth of their sales tax base. Factors contributing to differences across states include the exemption of various household goods such as food, clothing and drugs, treatment of service transactions and the treatment of various business inputs.

3.3.1. One recent study found that the implicit state sales tax base (calculated from actual collections) when expressed as a percentage of state personal income ranged from 109 percent in Hawaii (that taxes services and has heavy tourist purchases) to 24.8 percent in Illinois. The median implicit tax base expressed relative to personal income was 43.3 percent.[10]

3.3.2. There is a fairly strong regional pattern to the breadth of state sales tax bases (and reliance on the tax). States in the Northeast and Mid-Atlantic states rely relatively less on the tax, while those in the Plains, Mountain and Western states rely relatively more heavily on the tax.[11]

---

[9] All data regarding the taxation of services is taken from "Sales Taxation of Services: 1996 Update," Research Report No. 147, published by the Federation of Tax Administrators in April 1997. The survey is currently being updated to 2004 and will be available by June 2005. The details may vary, but the general conclusions remain the same as in the earlier work. The 1996 report is available at http://www.taxadmin.org/fta/pub/services/services.html.

[10] John Mikesell, "States of Mind: State Retail Sales Tax Burdens, Reliance and Breadth in Fiscal 2003," State Tax Notes, July 12, 2004, pp. 126-131.

[11] *Ibid.* See also, John Mikesell, "States of Mind: A Quality Index for States Sales Tax Structure – Measuring the States Against an Ideal Standard," State Tax Notes, Jan. 26, 2005, pp. 129-136.

4. State and Local Sales Tax Rates

4.1. As shown in Table I, state sales tax rates range from a low of 4 percent in several states to a high of 7 percent in Mississippi, Rhode Island and Tennessee. The median rate is 5.75 percent.

4.2. Local sales tax rates vary rather widely among the states, but generally fall within a range of 1.0-3.0 percent. As shown in Table II, however, the maximum local rate can exceed that level significantly. The highest maximum combined state and local rate exceeds 8 percent in 16 states; it is greater than 10 percent in 5 states.

4.3. The weighted average current state and local sales tax rate in the U.S. is estimated at 6.5 percent.[12]

5. Criticisms of State and Local Retail Sales Taxes

5.1. State and local sales taxes as they exist today are generally subjected to three criticisms on tax policy grounds when compared to the normative standard for broad-based consumption taxes. First, the ideal consumption tax would tax all (or nearly all) household consumption which current sales taxes do not. Second, the ideal consumption tax would not tax purchases by business, another area in which current sales taxes fall short. Finally, as a result of these shortcomings and for other reasons, the tax is administratively complex, particularly for a seller operating in multiple states.[13]

5.2. **Household Consumption.** As noted, most states do not impose the sales tax on a wide range of service transactions when purchased by households. In addition, a number of states have exempted a variety of "household necessities" from the sales tax as a means of improving the vertical equity of the tax. The consequence of this approach is to make tax rates higher than they would otherwise be and to introduce some distortions into household decisions as untaxed purchases may be preferred over taxed items. In addition, the pattern of exclusions and exemptions introduces administrative complexity for both taxpayers (sellers collecting the tax) and tax administration agencies. The exclusions and exemptions make it necessary to determine whether all or a portion of a transaction is taxable or not and to make judgments as to how tax should be applied to mixed transactions, among other matters.

5.3. **Business Purchases.** The ideal consumption tax would not impose tax on business purchases and would instead tax all final household consumption. States deviate from this norm in that they tax many business purchases when the business is the final consumer of the product or service and it is not being incorporated into another product or service that will be sold at retail or used for another exempt purpose. For example, purchases of paper, computers and desks by lawyers, accountants and other businesses

[12] See, Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004," University of Tennessee, Center for Business and Economic Research, July 2004, p. 4.

[13] For a more complete description, see either of the Mikesell articles cited earlier. Also, Charles McLure has written widely and well on this topic. See, for example, Charles E. McLure, Jr., "How – and How Not – to Tax Business," State Tax Notes, April 4, 2005, pp. 29-34.

would be taxable, but the flour, eggs and other ingredients used in making bread would not. The lines are not always easily drawn.

5.3.1. Taxation of business inputs leads to a pyramiding of the sales tax which, in turn, decreases the ability to control the actual incidence of the tax. It can also discriminate against smaller firms that cannot provide taxable services on an "in house" basis. Determining which transactions are taxable and which are not also introduces complexity for all parties.

5.3.2. Estimates are that taxation of business purchases accounts for about 43 percent of all state sale tax collections on average.[14]

5.4. **Other Complexities**. Beyond the administrative complexities driven by the above, much of the remaining complexity derives from the existence of multiple sales tax regimes, the large number of local taxing jurisdictions, and certain restrictions on state taxation.

5.4.1. Each of the 45 states and D.C. administer its sales tax independently of other states.[15] Thus, a retailer is obligated to track laws, file returns and make payments to each state in which it operates. A retailer is also subject to potential audit by each state in which it does business.

5.4.2. The existence of 46 sales tax regimes adds complexity for multistate sellers in that the procedures, rules, tax bases and tax rates vary from state-to-state, but the seller is liable for knowledge of the practice in all states.

5.4.3. The existence of over 7,500 localities that impose tax also creates issues for sellers delivering goods into or performing taxable services in multiple local jurisdictions. A seller is responsible for determining the appropriate jurisdiction to which a sale should be sourced and for determining the appropriate tax rate in each jurisdiction.

5.4.4. The U.S. Supreme Court has ruled that states may not require a seller that does not have a physical presence in a state (by virtue of its own activities or those of a representative) to collect tax on goods and services sold into a state. This adds another layer of complexity in that it becomes necessary to determine who is liable for collection in a state.

5.4.5. For the past five years, states have worked with the business community through the Streamlined Sales Tax Project to develop ways that the administration of state and local sales taxes can be simplified and much of this complexity eliminated.[16] The project is intended to reduce complexity for sellers as well as to persuade

---

[14] Robert Cline, John Mikesell etal., "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," Published by the Council on State Taxation, Washington, D.C., January 25, 2005.

[15] The Multistate Tax Commission to performs joint audits as a service to a number of states. The joint audits supplement the regular state audit staff.

[16] For a complete discussion, see Walter Hellerstein and John A. Swain, "Streamlined Sales and Use Tax," Research Institute of American, 2004.

Congress to authorize states to require those sellers that do not have a collection responsibility under current law to collect on goods and services sold into a state.

6. Observations on a National Sales Tax

6.1. Some of the criticisms and complexities associated with state and local sales taxes would not be relevant to a national sales tax (e.g,, multiple regimes and conflicting rules.) In addition, others criticisms and complexities could be overcome with the proper design of a national-level consumption tax, particularly the proper designation of the tax base.

6.2. Still, there are certain lessons that can be drawn from the state experience. Primary among these is that each instance in which the base deviates from taxing all final consumption at a single rate will introduce complexity (for sellers and the tax agency) as well as present opportunities and incentives for noncompliance. Put simply, someone has to decide what qualifies for the preferred treatment and people will try to take advantage of the preferred treatment.

6.3. Issues of compliance will not be inconsequential in a national sales tax. States devote substantial audit and collection resources to state sales tax administration, and the same will be necessary at the national level. Exempting business purchases (while the right policy) will introduce substantial compliance issues as will the mere fact that there will be a large number of sellers responsible for collecting tax and remitting it to the government.

6.4. There are a number of areas in which the coordination of federal and state activities in the administration of a sales tax (or other consumption tax) could be explored. The degree to which they can be coordinated will likely be dependent on the degree of similarity between the federal and state consumption tax bases.[17]

7. Conclusion

7.1. Despite some sizeable policy flaws and substantial complexity, the retail sales tax has been a workhorse in the state and local tax system for nearly 75 years. It was the single largest source of state tax revenue in 2004 and is often seen as the most widely accepted tax by the general public.

7.2. The state experience could be instructive in designing a potential federal consumption tax.

[17] The Federation, along with several other organizations, is sponsoring a forum to examine the implications of federal tax reform for state tax systems on May 18 in Washington, D.C. As part of that effort, we have commissioned several papers that will look at various federal reforms and what they might mean for states and for coordination of federal and state tax administration.

Table I
STATE SALES TAX RATES AND FOOD & DRUG EXEMPTIONS
(As of January 1, 2005)

		EXEMPTIONS		
STATE	Tax Rate (percentage)	Food (1)	Prescription Drugs	Nonprescription Drugs
ALABAMA	4		*	
ALASKA	none			
ARIZONA	5.6	*	*	
ARKANSAS	6		*	
CALIFORNIA (3)	7.25 (2)	*	*	
COLORADO	2.9	*	*	
CONNECTICUT	6	*	*	*
DELAWARE	none			
FLORIDA	6	*	*	*
GEORGIA	4	*	*	
HAWAII	4		*	
IDAHO	6		*	
ILLINOIS	6.25	1%	1%	1%
INDIANA	6	*	*	
IOWA	5	*	*	
KANSAS (6)	5.3		*	
KENTUCKY	6	*	*	
LOUISIANA	4	* (4)	*	
MAINE	5	*	*	
MARYLAND	5	*	*	*
MASSACHUSETTS	5	*	*	
MICHIGAN	6	*	*	
MINNESOTA	6.5	*	*	*
MISSISSIPPI	7		*	
MISSOURI	4.225	1.225	*	
MONTANA	none			
NEBRASKA	5.5	*	*	
NEVADA	6.5	*	*	
NEW HAMPSHIRE	none			
NEW JERSEY	6	*	*	*
NEW MEXICO	5	*	*	
NEW YORK	4.25	*	*	*
NORTH CAROLINA	4.5	* (4)	*	
NORTH DAKOTA	5	*	*	
OHIO	6	*	*	
OKLAHOMA	4.5		*	
OREGON	none			
PENNSYLVANIA	6	*	*	*
RHODE ISLAND	7	*	*	*
SOUTH CAROLINA	5		*	
SOUTH DAKOTA	4		*	
TENNESSEE	7	6%	*	
TEXAS	6.25	*	*	*
UTAH	4.75		*	
VERMONT	6	*	*	*
VIRGINIA	5.0 (2)	4.0% (5)	*	*
WASHINGTON	6.5	*	*	
WEST VIRGINIA	6		*	
WISCONSIN	5	*	*	
WYOMING	4		*	
DIST. OF COLUMBIA	5.75	*	*	*

** -- indicates exempt from tax, blank indicates subject to general sales tax rate.*
Source: Compiled by FTA from various sources.
(1) Some state tax food, but allow an (income) tax credit to compensate poor households. They are: ID, KS, SD, VT, and WY.
(2) Includes statewide local tax of 1.25% in California and 1.0% in Virginia .
(3) Tax rate may be adjusted annually according to a formula based on balances in the unappropriated general fund and the school foundation fund.
(4) Food sales are subject to local sales taxes.
(5) Tax rate on food is scheduled to decrease to 3.5% on 7/1/05. Statewide local tax is included.

Table II

Comparison of State and Local Retail Sales Taxes

January, 2004

	Food Items [1] Taxable (T) Exempt (E)	State Rate	Maximum Local Rate [2]	Maximum State/Local Rate [2]
Alabama	T	4.00	7.00	11.00
Alaska	T	0.00	7.00 [3]	7.00
Arizona	E	5.60	4.50	10.10
Arkansas	T	5.125	5.500	10.625
California	E	6.00	2.75	8.75
Colorado	E	2.90	7.00	9.90
Connecticut	E	6.00	---	6.00
District of Columbia	E	5.75	---	5.75
Florida	E	6.00	1.50	7.50
Georgia	E	4.00	3.00	7.00
Hawaii	T *	4.00	---	4.00
Idaho	T *	6.00	3.00	9.00
Illinois	T **	6.25	3.00	9.25
Indiana	E	6.00	---	6.00
Iowa	E	5.00	2.00	7.00
Kansas	T *	5.30	3.00	8.30
Kentucky	E	6.00	---	6.00
Louisiana	E [4]	4.00	6.25	10.25
Maine	E	5.00	---	5.00
Maryland	E	5.00	---	5.00
Massachusetts	E	5.00	---	5.00
Michigan	E	6.00	---	6.00
Minnesota	E	6.50	1.00	7.50
Mississippi	T	7.00	0.25	7.25
Missouri	T	4.225	4.125	8.350
Nebraska	E	5.50	1.50	7.00
Nevada	E	6.50	1.00	7.50
New Jersey	E	6.00	---	6.00
New Mexico	T	5.00	2.25	7.25
New York	E	4.25	4.50	8.75
North Carolina	E [4]	4.50	3.00	7.50
North Dakota	E	5.00	2.50	7.50
Ohio	E	6.00	2.00	8.00
Oklahoma	T	4.50	6.00	10.50
Pennsylvania	E	6.00	1.00	7.00
Rhode Island	E	7.00	---	7.00
South Carolina	T **	5.00	2.00	7.00
South Dakota	T *	4.00	2.00	6.00
Tennessee	T	7.00	2.75	9.75
Texas	E	6.25	2.00	8.25
Utah	T	4.75	2.25	7.00
Vermont	E	6.00	1.00	7.00
Virginia	T **	3.50	1.00	4.50
Washington	E	6.50	2.40	8.90
West Virginia	T	6.00	---	6.00
Wisconsin	E	5.00	1.00	6.00
Wyoming	T *	4.00	2.00	6.00

[1] Food purchased for consumption off-premises.
[2] Highest local rate known to be actually levied by at least one jurisdiction. Includes local taxes for general purposes and those earmarked for specific purposes (e.g. transit). Taxes applying only to specified sales (e.g. lodging or meals) are excluded.
[3] Alaskan cities and boroughs may levy local sales taxes from 1% to 7%.
[4] Food exempt from state tax, but subject to local taxes.
** Food taxed at lower rate.
* Income tax credit allowed to offset sales tax on food.

Source: Compiled by the Federation of Tax Administrators from various sources.