# 2004 Optional State and Local Sales Tax Tables
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## 1. Why did the IRS produce these tables for Tax Year 2004?

Congress passed (and the president signed into law) the *American Jobs Creation Act of 2004*, which included a provision to allow individuals who itemize deductions on their Form 1040 to choose to deduct the amount of state and local general sales tax they paid in lieu of deducting the amount of state and local income tax that they paid. Sales taxes had not been deductible since the enactment of the *Tax Reform Act of 1986*. Prior to Tax Year 1987, individuals could deduct *both* their income taxes and their sales taxes. The 2004 Act required the Secretary of the Treasury to publish tables that taxpayers could use in lieu of totaling up their receipts, and specified that these optional tables take into account the taxpayer's state of residence, income, and family size. The IRS developed tables of this sort routinely prior to Tax Year 1987.

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## 2. Why were they issued in a separate publication, rather than in the Form 1040 instructions?

Congress passed the new law on October 11, 2004, to take effect for Tax Years 2004 and 2005. Unfortunately, this became law right around the time when the Tax Year 2004 Form 1040 instructions were about to be sent to the printers. IRS and Treasury officials decided to

proceed with the Form 1040 instructions in order to meet longstanding deadlines, making reference in them to a separate publication (Publication 600, *Optional State Sales Tax Tables*) to be issued in early January that would include the optional sales tax tables and related instructions.

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**3. Why did the tables not include local sales taxes?**

Local sales tax rules vary widely across the states, and in many cases within a state. Through 1986, an IRS research analyst devoted his entire time to keeping up with the many laws and changes to them so that he could produce accurate tables each year. Since he retired many years ago, no one at IRS had kept up to date on state and local sales taxes. Given that the law was passed so late in 2004, Congress anticipated that producing the tables in time for the Tax Year 2004 filing season would be a major undertaking, so they included the following language in the conference report on the bill:

> The IRS is currently in the process of finalizing tax forms for 2004. The Code has not contained an itemized deduction for State and local sales taxes for a number of years. Developing the tables required by the provision will in general require a significant amount of time and effort. The conferees anticipate that IRS will do the best they can to reasonably and accurately implement this statutory provision in order to effectuate the deduction for the 2005 filing season.

By mid-October 2004, IRS set a deadline of December 15 by which the tables would have to be completed in order for there to be enough time to print and mail out the separate sales tax table publication by the time taxpayers would need it in mid-January 2005. When the deadline was set, it was clear that there was no hope of learning all that would be necessary to include detailed guidance with the tables on the subject of local sales taxes. It was agreed to restrict the tables to state sales taxes, and to provide more general (approximate) guidance about local sales taxes.

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**4. Why were taxpayers in all states offered the same methodology for deriving their local sale tax deduction, while different methodologies were employed in different states in 1986, the last year the IRS produced Optional Sales Tax Tables?**

The 1986 Optional Sales Tax Tables handled local sales taxes in three general ways, depending on the relationship between the state and local sales tax rules:

(1) Included in the Tables: The local sales tax amount was included in the table with the state sales tax for those states in which the tax base (what is taxed) in all of the localities was identical to the state sales tax base **and** there was just one local sales tax rate throughout the state, which applied to *all* localities. This was true for the District of Columbia and 14 of the states (Hawaii, Idaho, Indiana, Kentucky, Maryland, Michigan, Mississippi, New Jersey, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, and West Virginia) in 1986. Local sales tax amounts were also included for 8 additional states (California, Connecticut,

Illinois, Maine, Massachusetts, North Carolina, Utah, and Washington), but under some circumstances (explained in footnotes to the tables), taxpayers in these states had to adjust the table amount to account for particular purchases.

(2) Ratio Method: Taxpayers who lived in states in which the tax base in all of the localities was identical to the state sales tax base **but** there was more than one local sales tax rate throughout the state were allowed to derive their local sales tax deduction as a fraction of the state amount given in the table (see footnote #1 to the 1986 tables). The fraction was merely the ratio of their local sales tax rate to their state sales tax rate. In 1986, 18 states (Alabama, Arkansas, Florida, Georgia, Iowa, Kansas, Minnesota, Missouri, Nebraska, Nevada, New Mexico, North Dakota, Ohio, Oklahoma, Tennessee, Texas, Wisconsin, and Wyoming) fell into this category. Two additional states (Louisiana and New York) were given variants of this method.

(3) Receipts Method: In 1986, there were three states (Arizona, Colorado, and South Dakota) in which the tax base (and tax rate) varied across the localities. Taxpayers in these states were required to keep their receipts as a basis for determining their local sales tax deduction (see footnote #2 to the 1986 tables).

Since we didn't have enough time to learn all the current local sales tax rules in order to follow a similar approach for 2004, and since taxpayers could not be expected to have kept their receipts in 2004, which they could use to derive their local sales tax deduction, Treasury and IRS decided to allow taxpayers in *all* states to use the ratio method as an alternative to using receipts for deriving their local sales tax deduction. This approach certainly required more effort than would have been necessary for taxpayers in some states, and was more approximate for others than was the case in 1986, but it was the best compromise possible between accuracy and simplicity given the time constraints.

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**5. How were the state sales tax table amounts derived?**

As in 1986 and earlier, the optional sales tax tables were based on the most recent national expenditure patterns captured in the Consumer Expenditure Survey (CE) conducted annually by the Bureau of Labor Statistics (BLS). This survey has two components, each with its own questionnaire and independent sample of consumer units: (1) An **interview** panel survey in which each consumer unit in the sample is interviewed once every 3 months over 5 consecutive quarters to obtain a year's worth of data. New panels are initiated every month of the year. (2) A **diary** or recordkeeping survey completed by the sample consumer units for two consecutive 1-week periods; the sample is surveyed across a 12-month period. These two approaches overlap substantially in the kinds of expenditures they record. However, the interview format tends to be more representative in the purchases of "big-ticket" items that it includes, and the diary format tends to do a better job of reflecting routine purchases. Like many users of these surveys, we used data only from whichever of the two components BLS judged contained the better data, so that we included all expenditure categories (other than those, like motor vehicle purchases or leases, which were to be excluded from the tables), but without any overlap in categories across the two components.

BLS provided IRS with two special datasets derived from the 2002 CE Survey—one from the interview data, and one from the diary data. Each dataset contained for each state separately the annualized total amount of sales tax each consumer unit in the national sample would have paid had it lived in that state. That is, the same national expenditure pattern was used for each state, but each state's specific tax rules were applied, in turn, to the national data. This was necessary because the CE Survey is not designed to be representative at the state level. The raw CE expenditure amounts generally include sales tax where applicable, so BLS first removed the actual sales tax paid (if any) from these expenditures, so that the 2004 state sales tax rules for each state could be applied to the before-tax expenditure amounts. For each consumer unit and for each state, BLS included in the datasets the total sales tax that would have been paid had they lived in that state, the total income of the consumer unit, the family size, and a state indicator.

After analyzing the data, IRS decided to eliminate "outliers" from the dataset, including consumer units having less than $3,100 in income (the lowest filing threshold for 2004), those with no tax expenditure, and those with more than $3,500 of tax paid. This latter restriction eliminated the effect of those who made a large purchase of an item covered by the diary data, the corresponding annualized amount for which (52 times the actual purchase price) was very unrepresentative of anyone's annual purchases. The diary dataset that IRS received from BLS included 11,065 consumer units, of which 247 were eliminated because they had income under the $3,100 threshold. The number eliminated by the other two rules varied from state to state, because those rules depended on the state sales tax rules, which differed by state. On average, 387 consumer units were eliminated because they paid no sales tax, and 195 consumer units were eliminated because they paid more than $3,500 of tax. The interview dataset that IRS received from BLS included 25,888 consumer units, of which 717 were eliminated because they had income under the $3,100 threshold. The average numbers eliminated by the other two rules were 8,190 and 12 respectively.

IRS used these two unweighted datasets containing the information for each consumer unit in the CE surveys in two parallel analyses (one using the diary data, and the other using the interview data) to determine the table amounts. For each state and each dataset separately, IRS first estimated the average sales tax paid as a nonlinear function of both income and family size using a standard nonlinear regression procedure. The curve that was fit to the data took the following form:

$$T = a\,Y^{b}\,F^{c} + u$$

Where: T = sales tax paid; Y=family income; F=family size; a, b, and c are the parameters estimated by the regression procedure that define the location and curvature of the function; and u is term that represents the unexplained (assumed random) difference between the actual observations and the estimated function. The overall estimated average tax paid, then, was the sum of the amount estimated from the diary curve and the amount estimated from the interview curve, since together they represented all of the relevant expenditure categories.

Given these estimated curves for each state, IRS was able to compute an estimate of the average sales tax paid for different combinations of income and family size for each state. The tables in Publication 600 for 2004 were designed with 15 income ranges, as in the 1986

tables, except that the ranges for the 2004 tables were double the size of the 1986 ranges, to account for the growth in incomes over that period. IRS computed the sales tax amount at the median income of all itemizers in each range, based on the Statistics of Income sample of individual returns for Tax Year 2002. For the column related to taxpayers with more than 5 exemptions, IRS used the average family size among this group in the BLS data, which was 6.7.

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6. **What state sales tax rates were used to produce the 2004 tables?**

The following rates were generally in effect in 2004, and were used to produce the tables.

| *State* | *State Sales Tax Rate* | *State* | *State Sales Tax Rate* | *State* | *State Sales Tax Rate* |
|---|---|---|---|---|---|
| Alabama | 4.000% | Louisiana | 4.000% | Oklahoma | 4.500% |
| Arizona | 5.600% | Maine | 5.000% | Pennsylvania | 6.000% |
| Arkansas | 5.854% | Maryland | 5.000% | Rhode Island | 7.000% |
| California | 6.125% | Massachusetts | 5.000% | South Carolina | 5.000% |
| Colorado | 2.900% | Michigan | 6.000% | South Dakota | 4.000% |
| Connecticut | 6.000% | Minnesota | 6.500% | Tennessee | 7.000% |
| District of Columbia | 5.750% | Mississippi | 7.000% | Texas | 6.250% |
| Florida | 6.000% | Missouri | 4.250% | Utah | 4.750% |
| Georgia | 4.000% | Nebraska | 5.500% | Vermont | 6.000% |
| Hawaii | 4.000% | Nevada | 6.500% | Virginia | 3.667% |
| Idaho | 6.000% | New Jersey | 6.000% | Washington | 6.500% |
| Illinois | 6.250% | New Mexico | 5.000% | West Virginia | 6.000% |
| Indiana | 6.000% | New York | 4.250% | Wisconsin | 5.000% |
| Iowa | 5.000% | North Carolina | 4.500% | Wyoming | 4.000% |
| Kansas | 5.300% | North Dakota | 5.000% | | |
| Kentucky | 6.000% | Ohio | 6.000% | | |

Note: The state sales tax rates changed during 2004 in Arkansas, California, and Virginia. The rates used were blended to account for the two rates in effect during the year, and how long they were in effect.

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7. **Why wasn't a table for Alaska included in the original Publication 600?**

Alaska does not have a state sales tax, though some of its localities do have local sales taxes. Also, these local sales taxes vary widely across the taxing jurisdictions in Alaska (both in what is taxed and at what rate, putting Alaska in the third category of states explained in FAQ #4 above). We could not produce a single table for Alaska comparable to the other states—particularly in the time available for 2004. Therefore, Publication 600 advised Alaska residents to base their local sales tax deduction, if any, on their actual receipts for 2004 (since they couldn't use the ratio method offered to the other states). This was the same advice given to similar states in 1986. However, given that taxpayers could not be expected to have kept their receipts for 2004 (since the law was passed in October), an alternative was developed for Alaska in January 2005—Publication 600-A, *Optional Local Sales Tax Table for Certain Alaska Boroughs and Cities.*

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**8. How was the Alaska table derived for Publication 600-A?**

The Alaska table was produced in exactly the same way as the optional state sales tax tables for the other states, with two exceptions: (1) the rules as to what items are taxed were blended across the largest 12 taxing jurisdictions in Alaska (with size based on either population or sales tax revenue); and (2) a tax rate of one percent was used for all jurisdictions. The first exception was an approximation to be applied to all jurisdictions in the interest of time and simplicity. The second exception allows the table to apply to all Alaska localities, but requires that taxpayers in a given locality multiply the relevant table amount by their particular local sales tax rate (e.g., those with a 7% local sales tax rate would multiply by 7).

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**9. Why were some expenditure types (e.g., motor vehicle purchases and leases) excluded from the tables, requiring taxpayers to use actual receipts for these items?**

The new law anticipated such exclusions (based on earlier experience with optional sales tax tables), and specifically identified motor vehicle purchases as an example of the type of exclusions the Secretary could make, as appropriate. There are several reasons why excluding some items makes sense, but the overriding reason is that "big ticket" items like this generally are not purchased annually, and they often carry a significant amount of sales tax. If they were included in the optional tables, then taxpayers would, in effect, be taking these large purchases into account annually, but spread over many years. In the long run, there's nothing wrong with that, except that in the year when a taxpayer actually purchased such a large item, it would be in his interest to base his sales tax deduction on his actual receipts, rather than on the optional tables—perhaps even if the only receipt he used was the one for this large purchase. If taxpayers used their receipts when they made large purchases, but used the optional tables in all other years (and those tables included the large types of purchases), then they would be getting double the benefit for the tax they paid on the "big ticket" items. Since it is a fairly routine matter to keep receipts for these large purchases, the easiest solution is to exclude them from the optional tables.

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**10. Will the 2005 Optional Sales Tax Tables be derived the same way as the 2004 tables?**

We expect that the methodology will be essentially the same. However, with the longer lead-time available to develop them, we anticipate being able to compile more detailed information about the sales tax rules in each state and locality, and to provide more accurate guidance to taxpayers in computing an optional local sales tax deduction amount.

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**11. Will Publication 600 continue to be used to disseminate the sales tax tables?**

No. Since there is enough lead time available for the development of the 2005 sales tax tables, the Schedule A (Form 1040), Itemized Deductions, instructions will contain the

information that would otherwise have been in Publication 600. The Schedule A instructions are in all Form 1040 tax packages.

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**12. Are the formulas for deriving the sales tax tables available to the public?**

No, but IRS has released the tables electronically in both PDF and spreadsheet formats.

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**13. Who should I contact if I have more detailed questions on how the table amounts were derived?**

The Director, IRS National Headquarters Office of Research at (202) 874-6118.

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