

The Price for Simplification

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The Chair of the House Ways and Means Committee, the principal federal tax legislative committee of the House of Representatives, announced a plan for income tax reform and simplification that would, among many other changes, eliminate one important deduction for individuals and modify an exemption from tax (noted below). The overall intent of the proposed reform package is to be revenue neutral and yet to make the Internal Revenue Code more manageable by eliminating a host of provisions, by providing fewer individual income tax rates and by reducing the maximum rate to 25%.

One of the blockbuster provisions to be eliminated would be the individual deduction for state and local income tax. That is already eliminated under the existing alternative minimum tax and one reason why middle income taxpayers in high income tax states, such as California and New York, find themselves in AMT or struggling to avoid it. The elimination of the deduction under the regular income tax would permit the repeal of the AMT which would occur under the plan.

The second blockbuster proposal would be to impose a 10% surtax on previously exempt state and municipal bond interest for taxpayers with income (presumably adjusted gross income) in the \$400,000 (single filers) and \$450,000 (married filers) levels and above.

These two changes would have serious effects on the revenue of the states by putting pressure on the state income tax rates and by increasing the cost of borrowing.

The state and municipal bond surtax would raise a serious constitutional issue. Interest on state and municipal bonds issued for governmental activities has long been regarded as protected from federal tax under an implied limitation on the power of the federal government based on the sovereignty of each of the state governments in its sphere. The existing tax regime applicable to municipal bond interest under Section 103 of the IRC makes a distinction between governmental activities bonds, the interest on which is not taxed, and other types of state and municipal bonds which may be taxed in certain circumstances.