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GEORGIA TAXPAYERS AND FEDERAL "PEASE" LIMITATIONS ON ITEMIZED DEDUCTIONS

The "fiscal cliff" bill passed by the U.S. Congress January 1, 2013—officially the American Taxpayer Relief Act of 2012 ("ATRA2012")—made permanent much of the Bush-era tax policy originally passed in 2001 and 2003, including the ordinary income tax rates for approximately 99 percent of Americans. However, in addition to raising rates for the other one percent, the bill also reimposed a relic of Clinton-era policy—the so-called Pease limitations on itemized deductions. The 2001 tax act phased out the Pease limitations, with complete elimination beginning in 2010, but they return under ATRA2012, effective this year. Because Georgia's personal income tax piggybacks on the federal tax in many respects, and in particular with regard to itemized deductions, the reimposition of the Pease limitations will result in higher state income taxes for some Georgians compared to what they would pay had the limits not been reimposed. This brief summarizes the likely effects for individuals in Georgia.

What are the new Pease limits and how do they affect Georgia income tax filers?

The Pease limitations, named after the Congressman who introduced them in 1990, reduced the amount of allowable itemized deductions for taxpayers with income above certain thresholds, which depended on filing status. Specifically, allowable itemized deductions were reduced by three percent of the amount by which a taxpayer's adjusted gross income exceeds the applicable threshold, up to a maximum reduction of 80 percent of the claimed itemized deductions. Under ATRA2012, the thresholds for the 2013 tax year are $250,000 for single filers, $275,000 for heads of households, and $300,000 for married couples ($150,000 each if filing separately).

A couple with $350,000 of adjusted gross income, for example, would see their itemized deductions reduced by three percent of $50,000, the amount over the threshold, or by $1,500. If the itemized deductions they could otherwise claim on their federal return total, say, $20,000, then they would only be allowed to take $18,500 of deductions after the Pease limitation. Under current Georgia law, the couple would report the same $18,500 of itemized deductions on their Georgia return, losing $1,500 of deductions here just as on their federal return. At Georgia's top marginal tax rate of six percent, the result is an additional $90 of Georgia tax liability for the couple compared to what they would owe had 2012 federal tax policy been extended.

The additional tax liability is, of course, higher the higher is the taxpayer's income, by $18 for every $10,000 of income over the applicable threshold. Figure 1 below shows the amount of additional

FIGURE 1. GA INCOME TAX COST OF PEASE LIMITATIONS BY FILING STATUS AND FEDERAL AGI

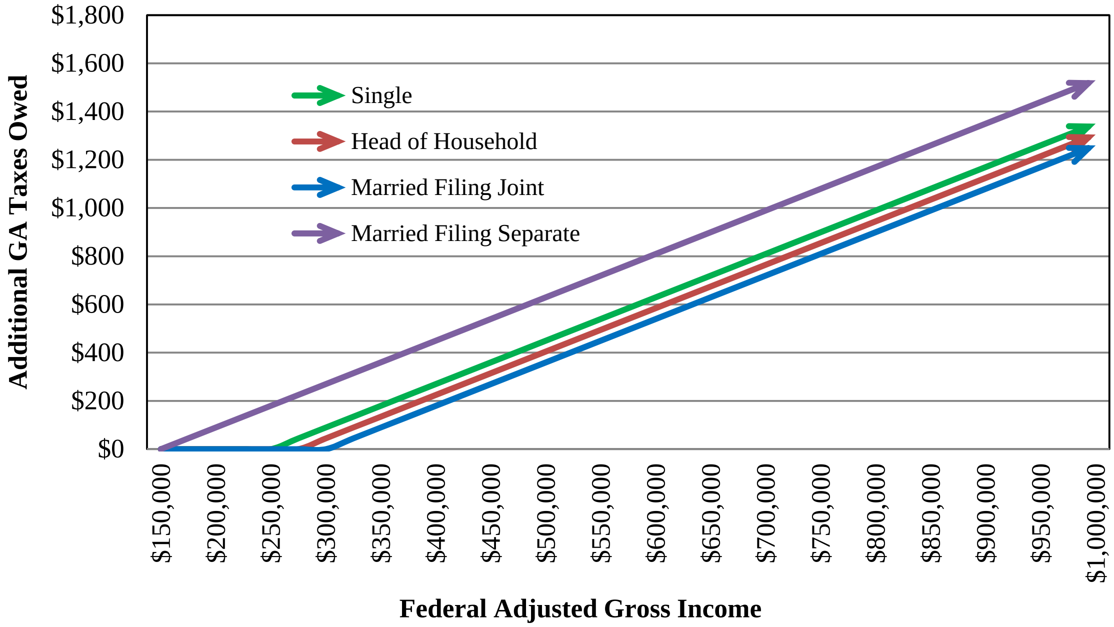

TABLE 1. SIMULATION RESULTS SUMMARY, 2010 FULL-YEAR RESIDENT FILERS

Filing Status	# Affected	-----Federal AGI---- Mean	Median	Actual State Tax -(before credits)- Mean	Median	Simulated Additional State ----------Tax Liability---------- Mean	Median	Sum
Single	5,803	$571,191	$339,249	$25,989	$15,829	$578	$185	$3,355,971
Head of Household	1,221	$601,541	$376,146	$27,144	$17,577	$600	$213	$733,023
Married Filing Joint	43,242	$619,180	$410,637	$28,083	$18,570	$590	$231	$25,533,249
Married Filing Separate	1,479	$398,378	$206,823	$17,918	$8,823	$411	$113	$608,142
All	51,745	$607,071	$398,324	$27,535	$18,027	$584	$221	$30,230,384

Georgia income taxes that filers would owe as their incomes rise above the threshold for their filing status.

The effect of the Pease limits on filers' 2014 tax returns is slightly more complex as there is a feedback effect from the filer's increased 2013 tax bill. Those subject to the limitation in 2013, and thus making larger final tax payments (or receiving smaller refunds) when they file, will claim higher itemized deductions (or report a smaller refund as income) on their 2014 federal and state returns as a result, and thus slightly reduce their 2014 tax liability. The amount of the 2014 tax savings for these filers would be as much as 6 percent—the top marginal rate—of the 2013 tax cost outlined above. For example, the hypothetical filer above with $90 of added tax liability for 2013 and thus receiving a $90 smaller refund upon filing, would then have $90 less of taxable income for 2014, saving $5.40 and bringing the two-year tax cost for this filer down to $84.60.

What are the statewide effects on taxpayers?

These limitations on itemized deductions clearly can increase the income tax bill of some filers by hundreds or thousands of dollars, but what does it add up to in terms of the numbers of filers affected and their average tax bill? To find these effects, we simulated the reimposition of the Pease limits using Georgia income tax data from 2010, recalculating taxes owed as if the limits were in affect at that time. The threshold used for each filing status was adjusted for inflation since then (just as they will be adjusted going forward after 2013), reducing them by about 6.2 percent from the 2013 levels.

Among the roughly 3.73 million Georgia full-year resident filers in 2010, approximately 52 thousand filers would be affected by the Pease limitations in the simulation, resulting in a mean tax increase for affected filers of about $584 (median increase of $221). Of those affected, the vast majority were married filers. Table 1 summarizes the simulation results by filing status.

In aggregate, full-year resident taxpayers would have experienced about a $30.2 million tax increase had the Pease limitations been in effect in 2010. The affected filers represent about 1.4 percent of 2010 full-year resident filers and the simulated tax change represents about a 2.1 percent increase over these filers' actual 2010 tax liability, on average.

In addition, it is estimated that over 2,400 part-year residents (about 2.1 percent of part-year filers) and almost 22 thousand non-residents (about 10.3 percent of non-resident filers) itemized deductions and had incomes over the inflation-adjusted Pease thresholds in 2010, and would thus be affected to some degree by the Pease limitations. Non-residents, in particular, tend to have significantly higher incomes than full-year residents, so they are more likely to be affected, but only a portion of their incomes are taxed in Georgia and their federal itemized deductions flow through to their Georgia returns in proportion to the Georgia share of their total income. Unfortunately, data limitations prevent simulating tax changes for part-year and non-resident filers, so absent precise estimates, it is assumed that the effect on their Georgia tax liabilities would be similar to that of full-year residents, or about a 2.1 percent increase. For the roughly 24 thousand part-year and non-resident filers who would apparently be affected, a 2.1 percent increase in Georgia tax liability would amount to about $3.1 million or $129 each, on average.

Conclusion

Overall, based on 2010 tax return data, an estimated 1.9 percent of Georgia taxpayers will be affected by the reimposition of the Pease limitations on itemized deductions, realizing an increase in their Georgia tax liability of about 2.1 percent, or about $33.3 million in 2010 dollars. Allowing for population growth (assumed to be about 3.6 percent, cumulatively, based on Census estimates) and inflation (6.6 percent, cumulatively), the effect for the 2013 tax year will likely be approximately $36.8 million. To the extent the numbers or incomes of affected filers grow faster than general population growth or inflation, respectively, the aggregate effects will be larger.

Applying the Pease limitations to 2014 returns will have a similar effect, growing with population and incomes, but the feedback effect described above from filers' higher 2013 tax bills will partially offset the 2014 effect. The estimated $36.8 million of added 2013 liability would reduce filers' 2014 taxes by as much as $2.2 million. Assuming 2013-2014 population growth and inflation similar to recent years, or about 3.4% together, the effect on taxpayers for the 2014 tax year, net of the feedback effect, would be about $35.8 million.

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