

Surprises in state income taxes

Around the country, substantial income is treated very differently by state law

By Robert N. Gordon

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State taxes don't always follow the same rules used in calculating federal income taxes. This can cause problems for taxpayers in general, and investors in particular.

I was surprised to learn how different state and federal taxes are when I was dealing with my own taxes in New York.

If you make more than \$500,000 in the Empire State, only half of your federal deductions, excepting charitable deductions, are allowed as deductions in calculating state income tax. And if residents in that state make more than \$1 million a year, none of those deductions are deductible.

It is no wonder that the state taxes paid by high earners in New York are so high. And thanks to those high state taxes, residents are then catapulted into the federal alternative minimum tax.

Massachusetts's taxpayers have their own problems. Although the state allows some deductions, there is no deduction for interest expense.

Even more disturbing to a leveraged-margin-account investor is the fact that short-term gains are singled out and taxed at 12%, more than double the 5.3% regular income tax rate in Massachusetts. It seems unfair to tax income but not allow a deduction for the expenses incurred in producing that income. Even more surprising, Massachusetts, along with New Jersey and Pennsylvania, allows no deduction for contributions to individual retirement accounts.

New Jersey has other tax quirks. It doesn't allow capital loss carry-overs, for example. It also doesn't allow capital losses to be deducted against ordinary income.

Most states don't allow a foreign tax credit for money withheld.

For example, if an investor received a \$1 dividend from the United Kingdom, he or she would receive just 85 cents in cash because a 15% withholding tax would be deducted. In most states, however, the investor would pay state tax on the \$1, not the 85 cents received.

Facing hard times, states are in a bind, so there is no reason to think that state taxes aren't going to become a larger burden for investors.

Rhode Island was in the news last year because it trumpeted the fact that it was dropping its maximum tax rate on individuals to 5.99%, from 9.9%. However, what wasn't in the headlines was that this tax decrease actually was going to increase taxes for the top 19% of earners in Rhode Island.

How does a tax decrease create higher tax bills? Well, what the state didn't trumpet in its announcement about lower rates was that it redefined the tax base.

As of Jan. 1, Rhode Island no longer allows itemized deductions. That change made Rhode Island the ninth "gross income" tax state.

States that fall into this category generally allow no deductions in computing taxable income.

Most gross-income states don't even allow a standard deduction. Of the few such states that do allow a standard deduction, most phase out the standard deduction for high-income taxpayers.

As an example, Rhode Island denies its standard deduction if income exceeds \$200,000.

The other gross-income states are Connecticut, Illinois, Indiana, Michigan, New Jersey, Ohio, Pennsylvania and West Virginia. New Hampshire and Tennessee tax dividends and interest income but allow no deductions, bringing to 11 the number of states that tax income but allow no deductions for expenses.

Just seven states — Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming — have no income tax. But given the states' financial straits, I wouldn't be surprised to see that number dwindle.

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Treatment of Itemized Deductions by Category of Deductions by State

State	Itemized Deductions	Interest Expenses	Charitable Contributions
Alabama	Yes	Federal	Federal
Arizona	Yes	Federal	State
Arkansas	Yes	Federal	Federal
California	Yes	Federal	State
Colorado	Yes	Federal	Federal
Connecticut	No	None	None
Delaware	Yes	Federal	State
District of Columbia	Yes	Federal	Federal
Georgia	Yes	State	Federal
Hawaii	Yes	Federal	Federal
Idaho	Yes	Federal	Federal
Illinois	No	None	None
Indiana	No	None	None
Iowa	Yes	Federal	State
Kansas	Yes	Federal	Federal
Kentucky	Yes	Federal	Federal
Louisiana	Yes	State	State
Maine	Yes	State	Federal
Maryland	Yes	Federal	Federal
Massachusetts	Yes	None	None
Michigan	No	None	None
Minnesota	Yes	Federal	Federal
Mississippi	Yes	Federal	Federal
Missouri	Yes	Federal	State
Montana	Yes	Federal	Federal
Nebraska	Yes	Federal	Federal
New Hampshire	No	None	None
New Jersey	No	None	None
New Mexico	Yes	Federal	Federal
New York	Yes	Federal	Federal
North Carolina	Yes	Federal	Federal
North Dakota	Yes	Federal	Federal
Ohio	No	None	None
Oklahoma	Yes	Federal	Federal
Oregon	Yes	Federal	Federal
Pennsylvania	No	None	None
Rhode Island	No	None	None
South Carolina	Yes	Federal	Federal
Tennessee	No	None	None
Utah	Yes	Federal	Federal
Vermont	Yes	Federal	Federal
Virginia	Yes	Federal	Federal
West Virginia	No	None	None
Wisconsin	Yes	State	Federal

Source: *Individual Income Tax Provisions in the States, Wisconsin Legislative Fiscal Bureau, January 2011, Table 4, pg 11.*