

A Good Start: Alabama's 2006 Income Tax Reform

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NOTE: This fact sheet updates the information provided in "Pinching the Poor" (Feb. 22, 2006).

A highlight of the 2006 legislative session was the passage of a law that raises the Alabama income tax threshold to \$12,600 for a family of four, starting in 2007. Before the change, Alabama families owed income tax on earnings of \$4,600 a year, the lowest threshold in the country. This amount, based mostly on exemptions and deductions set in 1935, had gone unchanged for decades. The new threshold falls well short of the federal poverty line (\$19,961 for a family of four in 2005). By contrast, Mississippi's threshold of \$19,600 protects most families below the poverty line.

How does Alabama's income tax work?

An amendment to the Alabama Constitution in 1933 gave the state the authority to create a tax on personal income and set a limit of 5 percent for the tax rate. In 1935, the Legislature enacted the tax, establishing three different *income tax rates* that are still in place today:

- Yearly taxable income of less than \$500 (\$1,000/couple) is taxed at **2 percent**;
- Income from \$500 to \$2,999 (double for couples) is taxed at **4 percent**;
- Income of \$3,000 (\$6,000 for couples) and above is taxed at the top rate, **5 percent**.

Like most states, Alabama uses *exemptions and deductions* to exclude most basic costs of living from taxation. This is especially important to low-income taxpayers, for whom this small amount may be a large share of income. The 1935 law set *personal exemptions* that are still in place – \$1,500 for single adults, and \$3,000 for married couples. The law also set a *dependent deduction* that was raised in 2006 to \$1,000 per dependent for taxpayers earning \$20,000 or less and \$500 per dependent for taxpayers earning above \$20,000 and up to \$100,000. (For higher incomes, the 1935 deduction of \$300 per dependent still applies.) The *standard deduction*, for taxpayers who don't *itemize* deductions, was added in 1951 and raised in 2006 to \$7,500 for married taxpayers filing jointly at incomes of \$20,000 or less. The deduction phases down to \$4,000 for couples filing at \$30,000 and above.

A 1965 amendment allows a deduction for federal income tax paid. This gives higher-income earners a special break, because they can deduct more from their Alabama taxes than those who pay less federal tax. Of this \$430 million tax break, 80 percent goes to the top 20 percent of taxpayers.

Alabama also allows a deduction for Social Security contributions. In theory, this should help low-income people, who pay a higher share of their income toward Social Security. The catch is that the deduction is available only to those who itemize their deductions, which excludes many middle- and low-income people.

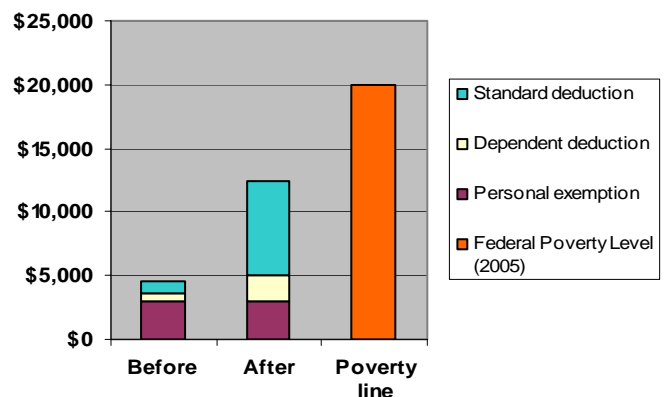
How does our income tax measure up?

Most states define their income tax in statutory law. Major parts of ours are written into our constitution, which is much harder to change.

Ideally, an income tax should be the most progressive tax in the system, because it's the easiest one to structure in a way that offsets more *regressive* taxes. When it was set in 1935, Alabama's *graduated* system of income tax rates *was* progressive. In that year, when the state began to tax annual incomes of \$3,600 or more, the average teacher salary was around \$500, and only about 7,000 Alabamians earned enough to be taxed.

How the threshold stacks up

The tax threshold – the income level at which one begins to pay income tax – is actually a sum of several parts of the income tax. Here's how the new 2007 threshold compares with the old one for a two-parent family of four:



Most states have made sure that people below the federal poverty line don't have to pay income taxes. Alabama's new threshold of \$12,600, while a great step forward, is still little more than halfway to the poverty line. This puts us ahead of just three other states – West Virginia, Montana and Hawaii.

In Alabama, low-income and high-income families pay at the same rate – 5 percent on taxable income of \$6,000 and above. More than 70 percent of Alabama families paid at the top rate in 2002.

The changes to our *standard deduction* will bring it closer to the 2007 federal level of \$10,500 for a married couple (\$5,250 for individuals). Unlike the federal standard deduction, ours will not be adjusted annually for inflation. Alabama's *dependent deduction* has improved with the new law, but it's still only at one-third of the federal level, with no adjustment for inflation. The *personal exemption* remains unchanged, at half of the federal level.

How could we improve our income tax?

The 2006 "Threshold Law" is a strong first step toward tax fairness. The new law makes statutory changes that do not require a constitutional amendment. The parts of our income tax system that are written into the constitution can be changed only by means of the amendment process or a new constitution. Below are two further statutory changes Arise supports, along with two changes that would require a vote of the people.

Statutory changes:

- **RAISE exemptions and deductions to federal levels;**
- **LINK exemptions and deductions to federal**

Keywords

adjusted gross income – total annual earnings after subtraction of allowed expenses but before subtraction of *deductions* and *exemptions*.

deduction – an expense that is subtracted from *adjusted gross income* in figuring *taxable income*.

dependent deduction – an amount excluded from *taxable income* to offset the cost of supporting another person.

earned income tax credit (EITC) – a tax credit for low-income taxpayers who work.

income tax – a tax on earned and unearned income.

itemized deduction – an individual expense (such as mortgage interest or charitable gifts or payments for medical services) that lowers taxable income. Taxpayers itemize if their deductions exceed the *standard deduction*.

personal exemption – an amount excluded from the

A break for low-income families

Here's how the new income tax law will affect two-parent families of four at different income levels, starting in tax year 2007:

Adjusted gross in-	2006 Ala. income tax	Under the new law	Change in tax owed
\$10,300 ¹	\$166 ²	\$0 ²	-\$166
\$15,000	\$340 ²	\$80 ²	-\$260
\$20,000	\$540 ²	\$345 ²	-\$195
\$30,000	\$1,040 ²	\$1,020 ²	-\$20
\$50,000	\$1,528 ³	\$1,508 ³	-\$20
\$75,000	\$2,420 ³	\$2,400 ³	-\$20
\$100,000	\$3,286 ³	\$3,286 ³	No change
\$200,000	\$6,604 ³	\$6,604 ³	No change

¹Annual income at minimum wage

²Calculated using the standard deduction

³Calculated using itemized deductions based on Alabama Statistics of Income

levels, so that Alabama's levels will keep pace with annual increases in the cost of living.

Constitutional changes:

- **ELIMINATE the deduction for federal income taxes paid**, an unfair tax break for high-income taxpayers that costs the state \$430 million a year;
- **CREATE a new rate structure:** 6 percent on income above \$150,000 per couple (\$75,000 for singles) and 5 percent below that level.

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taxable income of any taxpayer who cannot be claimed as a dependent by another taxpayer.

progressive tax – a tax that requires people who make more money to pay a bigger share of their income than those who make less.

regressive tax – a tax that requires people who make less money to pay a bigger share of their income than people who make more money.

standard deduction – a fixed amount that taxpayers who do not itemize deductions can subtract from their *adjusted gross income* to lower their *taxable income*.

tax threshold – the lowest income level affected by a particular tax.

taxable income – income subject to the income tax after subtraction of all allowable expenses, deductions and exemptions.