

ahead of three other states – West Virginia, Montana and Hawaii. By contrast, Mississippi doesn't start taxing such a family until they make \$19,600 per year.

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* (see previous section) 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. And unlike the federal version, it's not adjusted for inflation. The new law doesn't change the *personal exemption*, which remains at half of the federal level.

How could we improve our income tax?

The 2006 "Threshold Bill" 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 that would make the income tax fairer, 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 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.

Important 2006 update!

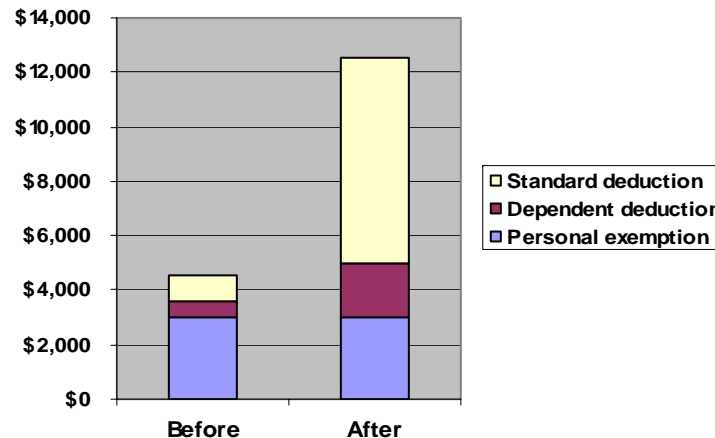
New law makes income tax threshold fairer

When we published *The Alabama Tax & Budget Handbook* in August 2005, Alabama families were paying income tax on earnings of \$4,600 a year, the lowest *income tax threshold* in the country. This amount, based mostly on exemptions and deductions set in 1935, had gone unchanged for decades. We hoped the handbook would help voters and lawmakers understand the need for a higher threshold, but we didn't expect a change to come this soon!

On April 12, 2006, Governor Riley signed a law that raises the threshold to \$12,600 for a family of four, starting in 2007. This important first step in tax reform makes the income tax section of the handbook out-of-date. *Please use this insert in place of pages 20-25.*

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:



2006 update!

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.

Effect of new income tax law			
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 income	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

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 Alabama's 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.

Most states have made sure that people below the federal poverty line don't have to pay income taxes. Up through 2006, Alabama began taxing a family of four at an income of \$4,600, less than one-quarter of "poverty line" wages (\$19,961 in 2005). Our income tax *threshold* was the lowest in the nation. This year, the Legislature passed a law that will raise the threshold in 2007 to \$12,600, still little more than halfway to the poverty line. This puts us