1. What changes in data or methodology did IRS employ relative to the 2004 tables?

Unlike for the 2004 tables, we had the time in 2005 to engage a contractor to compile for us data on what is taxable (the “tax base”) at what rate under the various sales tax laws of each state and the largest localities in the U.S. This gave us detailed data on over 500 expenditure categories as opposed to the 70 broader categories used for the 2004 tables (the data for which were already included in the expenditure data we relied upon from the Bureau of Labor Statistics). This made the tables more accurate in 2005 than in 2004. Moreover, this tax base and rate information was compiled for localities in 2005, whereas in 2004 there wasn’t enough time to conduct that level of research. As in 2004, we used the latest Consumer Expenditure (CE) Survey from the Bureau of Labor Statistics. However, in 2005 we used the 2003 CE data, one year more recent than was available for the 2004 tables. As in 2004, the tax base and rate rules for a given jurisdiction were applied to the national CE data since the CE Survey does not include enough observations to be statistically valid for each state, let alone for each locality. As in 2004, we fit nonlinear curves (of the same form) through the micro data to estimate how sales tax expenditures vary as a function of income and family size for each state (and in 2005, each local jurisdiction) separately. We used the same method for computing the table values from these formulas, except that we used updated median incomes (from SOI) for the income ranges used in the tables. The only methodological change we employed in 2005 was that we did not exclude “outlier” cases from our curve-fitting analysis. We excluded about 2 percent of the cases in the 2004 analysis because their estimated total tax paid seemed to be well above the norm due to the way the BLS survey data were annualized. After comparing various alternatives in 2005, we concluded that such exclusions were not necessary this year, and attributed the change to having better taxability data this year.
2. Why do the 2005 state tables tend to have larger amounts for high incomes and lower amounts for low incomes relative to the 2004 tables?

The estimated amount of state sales tax paid is generally more sensitive to differences in income in 2005 compared with 2004 largely because of the vast improvement in the level of detail as to what is taxable and what is not in each state and locality (see Question 1). That is, the 2004 tables were much more approximate due to the speed with which they had to be prepared. (The law was passed and made retroactive in October 2004, so the tables needed to be derived, printed, and mailed in roughly two months.) If the law is extended beyond 2005, we expect that the future tables would look much more like the 2005 tables than they would the 2004 tables.

3. Why isn’t the ratio method used for all localities, as in 2004?

The states that have local sales taxes fall into three general categories: (a) all localities in the state tax the exact same things as the state (i.e., they have the same tax base), and they all have the same local sales tax rate; (b) all the localities have the same base as the state, but they have different rates; and (c) there is variety within the state both as to the local base and the local rate. The ratio method is appropriate for the middle category; the local sales tax amount is proportional to the state sales tax amount, with the proportion being the ratio of the local rate to the state rate. This method was allowed for all states in 2004 because we did not have the time necessary to research all local sales tax laws to determine which states should have used which method, or (more importantly) what to do if they were in the third category. (In the first category, the local amounts could easily be included in the state table.) We did develop a separate local sales tax table for Alaska for 2004, since Alaska does not have a state sales tax, making the ratio method not only inappropriate, but impossible. Alaska is in the third category, so we developed a table for Alaska using an average tax base and a one percent rate; taxpayers were to multiply the appropriate amount in the table by their actual local sales tax rate to derive their local sales tax amount. For 2005, we used this same one-percent table approach for all localities in category (c), since that was more accurate than the simple ratio method. However, we divided all such localities into three groups—with a unique one-percent table for each group. This allowed us to take into account significant differences in what these localities tax (see Question 4, below).

4. How did you determine which localities would use which method?

The states fell into the three general categories based on a straightforward interpretation of the tax base and tax rate data compiled in 2005 (refer to the instructions accompanying the 2005 state tables to see which state is in which category). In fact, the contractor who compiled the data for us was already familiar enough with the state laws to know how most of them would be categorized before compiling the details. That allowed them to focus much of their attention on researching the localities in the handful of states in category (c). Since there are obviously thousands of localities even in a subset of states, we prioritized their research to include just the largest cities and/or counties in these states. That list eventually included 81 distinct localities. The contractor compiled detailed tax base data for each one, and we developed a separate one-percent table for each. As we anticipated, the differences in tax base across many of these 81 localities were fairly minor when applied to national expenditure patterns. Therefore, we were able to approximate the 81 distinct localities by
just 3 one-percent tables, balancing accuracy with simplicity (in fact, some of the 81 tax bases were identical to each other). In most of these states, it was clear that the smaller localities that were not included among these 81 conformed to one or more of the larger localities that were included. In the few states where there were many different local tax bases (e.g., Colorado and Illinois), we assumed that the tax bases in the smaller jurisdictions (not included among the 81) conformed to the most common base among the larger jurisdictions (which were included in our detailed research). The instructions accompanying the three local tables indicate which localities should use which of the three one-percent tables.

5. **Why are the residents of Salem County, New Jersey entitled to deduct only half of that state’s table amount?**

   By virtue of New Jersey law, the state sales tax rate in Salem County is half of the statewide rate.