INFORMATION BRIEF
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Updated: July 2005

Income Tax Terms

Deductions and Credits

Both deductions and credits can decrease income tax liability. Deductions reduce taxable income, and decrease income tax liability because tax rates are applied to a lower income figure. Credits, in contrast, are subtracted directly from income tax liability.

Tax deductions reduce taxable income and tax liability.

Deductions reduce the income tax base against which liability is calculated. Minnesota's income tax base is called Minnesota taxable income (MTI). Figure 1 shows how MTI is calculated.

Figure 1
MTI Calculation

Federal Adjusted Gross Income (FAGI) minus **Federal Standard Deduction OR Federal Itemized Deductions** minus **Federal Personal Exemptions AND Federal Dependent Exemptions** equals **Federal Taxable Income (FTI)**

FTI plus **Minnesota Additions** minus **Minnesota Subtractions** equals **Minnesota Taxable Income (MTI)**

The MTI calculation starts with a federal taxable income (FTI), which equals federal adjusted gross income (FAGI) after subtraction of federal deductions—either the standard deduction or itemized deductions—and personal and dependent exemptions. Minnesota tax law requires taxpayers to add some items to FTI and allows taxpayers to subtract other items from FTI. The result—MTI—is then used to determine Minnesota income tax liability. Taxpayers typically use this income to look up their tax liability in a table included in the income tax booklet.

Table 1 shows Minnesota taxable income and tax liability for two families, each with two children and claiming itemized deductions at the federal level. Both families have to add $1,300 to their federal taxable income—this is the difference between the federal standard deduction ($10,000) and the standard deduction allowed in Minnesota ($8,700). The second family claims a Minnesota dependent education expense of $1,000,[1] which the first family does not.

Table 1
Calculation of Minnesota Income Tax for Two Example Families

Tax Year 2005	**Married Couple with Two Children**	
	Family One	**Family Two**
Federal Taxable Income	$30,000	$30,000
Minnesota Additions	$1,300	$1,300
Minnesota Subtractions	$0	$1,000
Minnesota Taxable Income	$31,300	$30,300
Minnesota Income Tax	$1,712	$1,642

The value of a state income tax deduction equals the taxpayer's marginal rate times the amount of the deduction.

Both families in Table 1 are in the 7.05 percent state tax bracket, which for married joint filers applies to incomes over $29,070 and under $115,510.[2] The second family claims a state income tax deduction of $1,000 and sees an income tax liability decrease of $70.50—7.05 percent times the $1,000 deduction.

[1] Minnesota allows taxpayers to deduct up to $1,625 in qualified education expenses for each child in grades K-6, and up to $2,500 of qualified expenses for each child in grades 7-12. Qualified expenses include: tuition; tutoring; academic summer camps and after-school enrichment programs; transportation costs paid to others; nonreligious textbooks; required items for courses such as shop, home economics, and art; clothing required for physical education classes; driver's education courses taken for school credit; music lessons; rental or purchase of musical instruments; and up to $200 for computer hardware and educational software.

[2] The brackets shown are for tax year 2005. Minnesota tax brackets are indexed annually for inflation.

Minnesota's graduated income tax makes deductions worth more to high-income taxpayers than to low-income taxpayers.

Suppose that the second family in Table 1 had Minnesota taxable income over $100,000. This would put them in the 7.85 percent income tax bracket. The $1,000 deduction would then result in a $78.50 decrease in tax liability, $8 more than that received by a family with a more modest income. Conversely, if the second family had MTI of only $20,000, the same $1,000 deduction would only result in a tax decrease of $53.50. Finally, a family with no taxable income does not receive any benefit from a tax deduction. Table 2 summarizes the value of a $1,000 income tax deduction by tax bracket for married couples filing joint returns.

Table 2
Tax Value of a $1,000 Deduction for Married Joint Filers

Minnesota Taxable Income	Tax Decrease
$0	$0
$1 to $29,070	$53.50
$29,071 to $115,510	$70.50
Over $115,510	$78.50

Credits

Tax credits are subtracted directly from tax liability.

After subtracting any allowable deductions to arrive at MTI, taxpayers apply Minnesota's income tax rates to determine Minnesota income tax liability. If the taxpayer qualifies for any of Minnesota's tax credits, the credits are subtracted directly from income tax liability.

Table 3 shows Minnesota taxable income and tax liability for two families, both of which have two children and claim itemized deductions at the federal level. The second family claims a Minnesota K-12 education tax credit of $1,000, while the first family does not.[3] Otherwise, the families' tax profiles are identical.

[3] The K-12 education tax credit equals 75 percent of qualifying expenses. The maximum credit is $1,000 per child, and families may claim the credit for each child enrolled in grades K-12. The credit begins to phase out when gross income equals $33,500, and is fully phased out for families with one or two children when income exceeds $37,500. The phaseout range extends by an additional $2,000 for each additional child for whom the credit is claimed—to $39,500 for three children, $41,500 for four children, and so on. The families in Table 3 have gross incomes low enough to qualify for the K-12 education credit. For more information on the K-12 education credit, see the House Research Information Brief, *Income Tax Deductions and Credits for Public and Nonpublic Education in Minnesota*, update forthcoming.

Table 3
Calculation of Minnesota Income Tax for Two Example Families

Tax Year 2005	**Married Couple with Two Children**	
	Family One	**Family Two**
Minnesota Taxable Income	$20,000	$20,000
Minnesota Income Tax	$1,070	$1,070
K-12 Education Tax Credit	$0	$1,000
Tax after Credits	$1,070	$70

The family that does not claim the credit has a Minnesota tax liability of $1,070, while the family that claims the credit has a tax liability of only $70. A $1,000 tax credit reduces tax liability by $1,000. This contrasts with a $1,000 tax deduction, which at most can reduce Minnesota tax liability by only $78.50.

Tax credits can be refundable or nonrefundable.

Nonrefundable credits only offset tax liability. Taxpayers with incomes too low to have any tax liability do not receive any benefit from nonrefundable tax credits.[4] Two of Minnesota's major tax credits—the marriage credit and the long-term care insurance credit—are nonrefundable.

A **refundable** credit, in contrast, is refunded fully to the taxpayer regardless of their tax liability. For example, a taxpayer with $500 in tax liability who qualifies for a $1,000 refundable credit would receive a refund of $500. If the credit was nonrefundable, that taxpayer would only be able to "use" the $500 of the tax credit that offset liability.

Because credits are subtracted directly from liability, they are worth the same to all taxpayers with liability, regardless of income.

All three of Minnesota's refundable credits—the dependent care credit, the working family credit, and the K-12 education credit—are subject to income-based phaseouts. However, an income-based phaseout is not an essential feature of a tax credit. If taxpayers were allowed a credit not subject to phase out, it would be worth the same to all taxpayers regardless of their income. A $1,000 refundable credit would be worth $1,000 to a taxpayer with $100,000 income and also worth $1,000 to a taxpayer with no taxable income.

For more information about income taxes, visit the income tax area of our web site, www.house.leg.state.mn.us/hrd/issinfo/tx_inc.htm.

[4] In 2005, a family of four will not have any state income tax liability until their gross income exceeds $21,500, which equals a state standard deduction of $8,700 and two personal and two dependent exemptions of $3,200 each.