

June 1997

Nina Manzi, Legislative Analyst, 296-5204

Lisa Larson, Attorney/Legislative Analyst, 296-8036

Information Brief

RECEIVED

JUL 11 1997

LEGISLATIVE REFERENCE LIBRARY
STATE OFFICE BUILDING
ST. PAUL, MN 55155

Income Tax Deductions and Credits for Public and Nonpublic Education in Minnesota

An unresolved debate of the 1997 legislative session focused on income tax deductions and credits for public and nonpublic education-related expenses. Minnesota has had a dependent education expense deduction since 1955, and had an education tax credit in effect from 1971 to 1973. The Minnesota Supreme Court found the education credit unconstitutional in 1974. The U.S. Supreme Court found the education deduction constitutional in 1983. This information brief outlines the legislative and legal history of the deduction and the credit, and their effects on tax liability.

Contents

Page

Executive Summary	2
Dependent Education Expense Deduction	2
Education Tax Credit	2
Dependent Education Deduction	3
Description	3
Legal History	5
Effect on Tax Liability	7
Education Tax Credit	8
Description	8
Legal History	10
Effect on Tax Liability	12

Executive Summary

Dependent Education Expense Deduction

Minnesota has allowed a deduction for dependent education expenses paid to others since 1955. The current maximum deduction is \$1,000 for students in grades 7 to 12 and \$650 for students in grades kindergarten to 6. The benefit a taxpayer receives under the deduction equals the taxpayer's marginal tax rate times the amount of the deduction. Most Minnesota taxpayers are in the 8 percent bracket, where a \$1,000 deduction decreases taxes by \$80. The Department of Revenue's preliminary reports show that in 1995 over 90,000 Minnesota taxpayers deducted about \$63 million. The U.S. Supreme Court upheld Minnesota's deduction in 1983. The Court reasoned that the deduction was:

- ▶ one of many available deductions;
- ▶ a result of the legislature's broad latitude in creating tax classifications;
- ▶ available to public and nonpublic school parents alike;
- ▶ available only as a result of private choices by individual parents; and
- ▶ a neutrally available tax benefit that did not violate the federal constitution.

Education Tax Credit

Minnesota allowed a refundable tax credit for nonpublic school tuition from 1971 to 1973. The credit equaled \$100 per pupil unit, making it worth \$50 for kindergarten students, \$100 for students in grades 1 to 6, and \$140 for students in grades 7 to 12 as a result of pupil unit weighting. Because credits directly offset tax liability, a \$100 credit decreased a taxpayer's liability by \$100. In 1973, the U.S. Supreme Court struck down similar New York tax provisions, including a tuition credit. The Court found the New York credit had the effect of providing financial support to nonpublic sectarian institutions, and neither restricted the uses of public funds, nor offered ways to ensure that schools complied with any restrictions. The Minnesota Supreme Court followed the U.S. Supreme Court decision and struck down the Minnesota credit in 1974.

Dependent Education Deduction

Description

Minnesota allows a deduction for education-related expenses of up to \$1,000 for each dependent in grades 7 to 12, and up to \$650 for each dependent in grades K-6.¹ When first enacted in 1955, the deduction was limited to \$200 per dependent, regardless of grade.² If the deduction had been indexed for inflation beginning in 1985, in tax year 1997 it would have been worth \$1,510 for each dependent in grades 7-12, and \$980 for those in K-6. The box to the right shows the history of the deduction.

The deduction is allowed for tuition, textbooks, and transportation. The statute defines "textbooks" to include other instructional materials and equipment, but not books and materials used in the teaching of religious tenets, doctrines, or worship. The deduction also does not include materials for or transportation to extracurricular activities such as sporting events, musical or dramatic events, and speech activities.

The Department of Revenue provides information on what expenses qualify for the deduction. Table 1 reproduces a list published in the income tax instructions, giving examples of expenses that do and do not qualify. The department uses three guidelines for determining deductibility:³

Timeline: Dependent Education Expense Deduction

1955	\$200 per dependent, for tuition and transportation expenses paid to others
1975	Amount increased to \$500 for grades K-6 and \$700 for grades 7-12. Deduction allowed for nonreligious textbooks, instructional materials, and equipment
1978	Deduction not allowed for transportation to or materials for extracurricular activities Federal district court in Minnesota upholds deduction in <i>Minnesota Civil Liberties Union v. Roemer</i> *
1983	U.S. Supreme Court upholds deduction in <i>Mueller v. Allen</i> .
1985	Deduction increased to \$650 for grades K-6, and \$1,000 for grades 7-12

* 452 F. Supp. 1316 (D. Minn. 1978).

¹ A deduction reduces tax liability by an amount equal to the taxpayer's marginal tax rate times the amount of the deduction. The greatest tax reduction possible for the maximum \$1,000 deduction is \$85, which goes to higher-income taxpayers in the 8.5 percent bracket. Taxpayers in the 6 percent bracket receive a tax decrease of \$60 for a \$1,000 deduction. Those with no tax liability receive no benefit from a deduction.

² Minn. Laws 1955, ch. 471, § 1.

³ Memorandum, Gerome T. Caulfied, Director, Income Tax Division, Minnesota Department of Revenue, March 27, 1979.

- ▶ Material must be primarily used for the class and not for personal use.
- ▶ Only the basic minimum required expense can be deducted.
- ▶ Material must be consumed in the normal course of the class.

Table 1
Expenses Allowed for Dependent Education Deduction

Expenses allowed	Expenses not allowed
Tuition for grades K-12 Tuition for summer school classes*	Tuition for nursery schools or pre-kindergarten classes Education expenses after the student has left high school
Transportation costs paid to others	Cost of driving children to school
Clothing required for physical education classes	Uniforms for school, including choir robes
Rental fees for musical instruments	Purchase of musical instruments
Driver's education courses if for school credit	School hot lunches
Nonreligious textbooks	Class trips* Student exchange programs
Items required for courses such as shop, home economics, and art	Expenses for after-school activities, such as sports, music, and drama.
<p>* Based on the M-1 instructions alone, taxpayers may believe that all summer school expenses qualify and that no class trip expenses qualify for the deduction. This belief appears to contradict an internal Department of Revenue memo that states that tuition for summer school is deductible only if it is for remedial classes or for a student to keep up with classmates, and that expenses for class trips are deductible if the trips are required. (Memorandum, Gerome T. Caulfield, Director, Income Tax Division, Minnesota Department of Revenue, March 27, 1979.)</p>	

House Research

Source: Instructions for 1996 Form M-1, the standard Minnesota income tax form, Minnesota Department of Revenue.

Preliminary Department of Revenue reports show that in 1995 over 90,000 Minnesota taxpayers claimed almost \$63 million in dependent education expenses. Assuming an average marginal tax rate of 7 percent, the deduction decreased tax payments to the state by \$4.4 million. The amount deducted has increased in recent years. Minnesotans claimed \$49 million in 1992; \$46 million in 1993; and \$54 million in 1994.

Legal History

Taxpayers challenged the constitutionality of the deduction in *Mueller v. Allen* in 1983.⁴ Minnesota taxpayers claimed that the deduction amounted to an establishment of religion because almost all of the taxpayers using the deduction had children in parochial schools.⁵ The plaintiffs argued that this fact, in addition to the fact that Minnesota public schools were largely tuition free to most residents, showed that the statute advanced religion by providing tax relief for tuition expenditures for religiously affiliated education.

The U.S. Supreme Court, in a five-to-four decision, upheld the Minnesota statute giving tax deductions to parents for tuition and other costs they incurred in educating their children at public and nonpublic schools.

The Court's majority found that the deduction met all three parts of the *Lemon* test.⁶ Justice Marshall dissented, arguing that the tuition deduction had the effect of advancing religion.

The Court found several valid secular purposes for the law under the first part of the *Lemon* test. First, by offsetting parents' educational expenses the deduction helped ensure an educated populace and thereby protected the community's political and economic health. Second, assuring the continued financial health of private schools helped to relieve the financial burden on public schools. Finally, promoting "wholesome competition" between public and private schools promoted the state's interest in providing the highest quality education to all children.

Under the three-part test the U.S. Supreme Court announced in *Lemon v. Kurtzman*, 403 U.S. 602 (1971), a government action violates the first amendment establishment clause, which forbids laws that establish religion, if it:

- (1) has a nonsecular purpose;
- (2) exerts nonsecular primary effects; or
- (3) creates excessive church-state entanglement.

⁴ 463 U.S. 388 (1983). The tax deduction statute was first challenged in *Minnesota Civil Liberties Union v. Roemer* in 1978. The federal district court in Minnesota upheld the statute because it was designed to benefit public and nonpublic school children and it provided a true tax deduction.

⁵ The plaintiffs showed that more than 95 percent of Minnesota's 91,000 nonpublic school students attended parochial schools during the 1979-1980 school year. Plaintiffs also showed that while the 87,000 parochial school students represented about 10 percent of the state's total elementary and secondary school population, 71 percent of the \$2,400,000 state revenue lost through the tuition deduction was due to taxpayers with children in parochial schools.

⁶ Some Supreme Court justices have questioned the *Lemon* test and suggested alternative establishment clause tests, including a coercion test and an endorsement test. In *Lee v. Weisman*, 112 S.Ct. 2649 (1992), the U.S. Supreme Court held that a nonsectarian prayer at a public school graduation ceremony violated the establishment clause by coercing students to participate in the prayer. The majority opinion defined coercion to include social and psychological pressure. The dissent defined coercion as that which is supported by the force of law. In *Lynch v. Donnelly*, 465 U.S. 668 (1984), Justice O'Connor suggested modifying the *Lemon* test to say that the establishment clause is violated when government endorses or disapproves of a religion. Currently, the *Lemon* test is the applicable law.

The Supreme Court looked at several important features of the deduction statute in deciding whether or not it had the primary effect of advancing the sectarian aims of nonpublic schools under the second part of the *Lemon* test. The Court found that:

- ▶ the deduction was merely one of many deductions available to Minnesota taxpayers;
- ▶ the legislature had “broad latitude” in creating tax classifications and distinctions;
- ▶ the deduction was available to all parents, regardless of whether their children attended public or private schools;
- ▶ public funds became available only as a result of “numerous, private choices of individual parents;” and
- ▶ the financial benefits flowing to parochial schools from a neutrally available tax benefit were sufficiently attenuated to avoid violating the federal constitution.

The Court suggested that any statutory benefit sectarian schools received could be seen as a “rough return” for the benefits these schools conferred upon the state and its taxpayers.

The Court found that the statute’s potential for excessive government entanglement under the third part of the *Lemon* test might come only from state officials’ need to decide whether or not a textbook qualified for the deduction.⁷ The Court observed that the administrative involvement implicated in the statute was sufficiently similar to the government’s involvement in other programs the Court had already approved⁸ and that the Minnesota statute would not excessively entangle the state in religion.

Justice Marshall wrote the dissent in *Mueller*, arguing that the tuition deduction had the primary effect of advancing religion. He reasoned that “any generally available financial assistance for elementary and secondary school tuition expenses mainly will further religious education because the majority of schools charging tuition are sectarian.” Marshall charged that the textbooks and instructional materials subsidized under the textbook deduction could be used to inculcate religious values and beliefs, since the statute permitted a deduction for books chosen by the parochial schools. He found the majority’s opinion “flatly at odds with the fundamental principle that a state may provide no financial support whatsoever to promote religion.” He wrote that the statute provided no effective means for restricting state aid to the secular functions of private schools.

⁷ Instructional books and materials used in teaching religious tenets, doctrines or worship do not qualify for a deduction.

⁸ The Supreme Court had already authorized the government to loan textbooks to public and private school students.

Effect on Tax Liability

The tax reduction a taxpayer sees from claiming the deduction depends on the taxpayer's income and the total amount deducted.⁹ The value of a state income tax deduction equals the taxpayer's marginal income tax rate times the amount of the deduction. Minnesota has a progressive rate structure, with higher marginal rates for higher income taxpayers. Table 2 shows the income ranges, or brackets, and tax rates for tax year 1997 by filing status. The income ranges shown are Minnesota taxable income, which equals income after federal deductions and exemptions, and after Minnesota additions and subtractions. Taxable income is significantly lower than gross income. For example, in tax year 1997 a married couple with two dependents can have up to \$17,500 in gross income before having any taxable income.

Table 2
Income Tax Rates and Brackets
Tax Year 1997

Filing Status	6 percent	8 percent	8.5 percent
Married joint*	\$0 to \$24,140	\$24,141 to \$95,920	over \$95,920
Single	0 to 16,510	16,511 to 54,250	over 54,250
Head of household**	0 to 20,330	20,331 to 81,700	over 81,700
* Brackets for married separate filers are half the brackets for married joint filers. ** Head of household filers are typically single parents.			

Tax deductions under a progressive income tax provide greater benefits to taxpayers in higher tax brackets than to those in lower tax brackets, and no benefits to taxpayers who do not have taxable income. A taxpayer who claims a \$1,000 deduction and has income in the 6 percent tax bracket will see a tax decrease of \$60, or 6 percent of \$1,000. If the taxpayer's income is in the 8.5 percent bracket, the tax decrease will be \$85.¹⁰ If the taxpayer's income is low enough to be totally offset by deductions and exemptions (\$17,500 for a family of four in 1997), a deduction provides no benefit at all.

⁹ For more information on tax deductions, **Income Tax Terms: Deductions and Credits**, December 1996, House Research Department.

¹⁰ Because the deduction is currently only available to taxpayers who itemize, the tax decrease realized at the state level will be offset in part in the following year by a tax increase at the federal level. This is because itemizers must add back any current year state tax refunds in determining their federal taxable income for the following tax year. The amount of the federal offset will equal the tax value of the state deduction, multiplied by the taxpayer's federal marginal tax rate. Federal marginal rates range from 15 percent to 39.6 percent, depending on income.

Only filers who claim itemized deductions at the federal level may claim the dependent education expense deduction. When the deduction was enacted in 1955, Minnesota's income tax was not as closely tied to the federal income tax as it is today. For many years Minnesota allowed taxpayers to claim either a state standard deduction amount or state itemized deductions. The dependent education expense deduction was allowed as state deduction, but was not allowed for taxpayers who claimed the Minnesota standard deduction amount. In the 1987 legislative session Minnesota responded to the federal tax reform act of 1986 by conforming to the federal definition of income after deductions, but continued to allow the dependent education expense deduction as a subtraction.

Education Tax Credit

Description

Minnesota enacted a nonpublic education tax credit in 1971.¹¹ The credit was allowed for "education costs", defined to include tuition, classroom instructional fees, and textbooks. The statute followed language used for the deduction in specifying that the credit was not allowed for purchase of textbooks used in the teaching of religious tenets, doctrines, or worship.

The credit was set at \$100 per pupil unit for 1971 and 1972. The way Minnesota weights pupil units made the credit worth \$50 for kindergarten students, \$100 for students in grades 1 to 6, and \$140 for students in grades 7 to 12. For 1973 and following years, the credit was adjusted by the percentage growth in school foundation aid.

Taxpayers claiming the credit had to submit documents verifying their eligibility with their income tax returns. The return had to include a receipt from the nonpublic school that listed:

- ▶ the name and location of the nonpublic school;
- ▶ the amount paid for education costs and textbooks, and the date of payment;
- ▶ the grade in which the student was enrolled; and
- ▶ the student's name, and name of the person who paid for tuition and textbooks.

¹¹ Minn. Laws 1971, chapter 944.

The legislation also required taxpayers to include certification from the nonpublic school indicating:

- ▶ that the school satisfied the requirements of compulsory attendance;
- ▶ the restricted maintenance cost of education per pupil;¹²
- ▶ the total amount paid by the taxpayer for education costs;
- ▶ the maximum allowable tax credit for each month of enrollment;¹³ and
- ▶ the student's name, and the number of months the student was enrolled.

The tax credit was refundable, with any amount in excess of tax liability refunded to the taxpayer. In addition, there was no limit on the number of students for whom a taxpayer could claim the credit. However, only one credit could be claimed for each student, and taxpayers had to choose between claiming the credit and claiming the already existing dependent education expense deduction.

Department of Revenue records show that between 44,000 and 45,000 taxpayers claimed the credit in each of the three years it was available. Taxpayers claimed \$7.4 million in credits in 1971; \$8.6 million in 1972; and \$10.6 million in 1973. The average credit claimed increased from about \$170 in 1971 to about \$240 in 1973.¹⁴

Timeline: Education Tax Credit

1971	\$100 per pupil unit tax credit enacted
1972	Ramsey County district court finds state tax credit permissible under then-existing law Plaintiffs appeal district court judgment
1973	Legislation restricts credit to Minnesota residents. U.S. Supreme Court finds similar New York credit unconstitutional in <i>Nyquist</i> .
1974	Minnesota Supreme Court follows precedent set in <i>Nyquist</i> and strikes down the Minnesota credit. State Department of Revenue disallows the credit for tax year 1974 and following years.
1980	Repeal of credit included in Revenue Department technical legislation.

¹² The statute defined "restricted maintenance cost" as 80 percent of the levy portion of school expenses.

¹³ The statute specified that the total claim for the credit be based on a ten-month school year, so that a taxpayer could claim ten percent of the full credit amount for each month of student enrollment.

¹⁴ Available data on tuition costs suggests that the increase in amount claimed per family resulted from increased tuition at nonpublic schools.

Legal History

New York taxpayers asked the U.S. Supreme Court to determine whether state tax programs designed to help children in nonpublic schools, including sectarian schools, violated the establishment clause of the federal constitution in the 1973 case *Committee for Public Education and Religious Liberty v. Nyquist*. The programs provided partial tuition reimbursement and tax credits to low income parents who sent their children to nonpublic schools by:

- ▶ reimbursing low income parents for private school tuition,¹⁵ and
- ▶ allowing a private school tuition deduction for parents who were not entitled to the tuition reimbursement.¹⁶

A third program provided direct money grants to private schools for maintaining and repairing school facilities and equipment.

The Court found that New York's tuition reimbursement and tax deduction programs advanced religion because the programs neither restricted the uses of public funds, nor offered ways to ensure that schools complied with any restrictions.¹⁷ The state argued that the tax programs removed the state's ability to directly fund nonpublic schools because it was only through parents' individual choices, and not state action, that state money flowed to nonpublic schools. The Court rejected the argument, indicating that parental choice was just one of many factors in deciding whether state funds had the effect of promoting religion.¹⁸

¹⁵ The New York tuition reimbursement statute allowed a parent who had an annual taxable income of less than \$5,000 to receive a tuition reimbursement of up to \$50 for each elementary school child and up to \$100 for each secondary school child.

¹⁶ The New York tax deduction statute allowed taxpayers who had dependent children attending nonpublic elementary or secondary school to subtract from their gross income a defined amount for up to three children. The amount that taxpayers could subtract was based on taxpayers' income and not actual tuition expenses. For example, if a taxpayer's income was less than \$9,000, they could subtract \$1,000; once income reached \$15,000, the deduction decreased to \$400; and once income reached \$25,000 or more, no deduction was allowed.

¹⁷ The Court stated "Nothing in the statute. . .bars a qualifying school from paying out of state funds the salaries of employees who maintain the school chapel."

¹⁸ The Court permitted aid to parents with parochial school children in those instances where there was no threat that the funds could be used for sectarian purposes. For example, in *Everson v. Board of Education*, 330 U.S. 1, (1946), the Court upheld a New Jersey statute permitting parochial school children to use state-funded buses to reach their schools safely. In *Board of Education v. Allen*, 392 U.S. 236 (1968), the Court upheld a New York statute that lent secular textbooks to children in public and private school. In such cases, state benefits had no sectarian characteristics and could not be put to secular uses.

The Court, in a 6 to 3 decision,¹⁹ found that all three programs had the effect of promoting religion and were unconstitutional under the second part of the *Lemon* test.²⁰ The Court found that the effect of the tuition reimbursement was “unmistakably to provide financial support for nonpublic sectarian institutions” because the payments gave parents a financial incentive to send their children to sectarian schools and the financial ability to do so. The Court struck down the tax deduction because it rewarded parents for sending their children to nonpublic schools and operated, in effect, as a tax credit by allowing a fixed amount of “tax forgiveness” to those parents who did what the state encouraged.²¹ The Court used a similar analysis for the program directing money grants to private schools for maintenance and repairs, concluding that the state could not ensure that direct money grants to private schools went for secular purposes.²²

In 1974, the Minnesota Supreme Court, following the law interpreted by the U.S. Supreme Court in *Nyquist*, found Minnesota’s tax credit unconstitutional in *Minnesota Civil Liberties Union and Others v. State and Others*.²³ In 1971, the Minnesota Civil Liberties Union, Americans United for Separation of Church and State and seven Minnesota taxpayers challenged in Ramsey County district court the 1971 state statute providing tax credits to parents whose children attended nonpublic schools²⁴ on the grounds that it violated the U.S. Constitution and the Minnesota Constitution. In 1972, the trial court found the statute to be constitutional under the law as then interpreted by the U.S. Supreme Court and the Minnesota Supreme Court. The trial court reasoned that the statute had a valid secular purpose, that it survived entanglement challenges, and that the primary effect of the statute was not to promote the establishment of religion. The plaintiffs appealed the decision to the Minnesota Supreme Court.

While the appeal was pending, the U.S. Supreme Court announced a series of decisions, including *Committee for Public Education v. Nyquist*, that, according to the Minnesota Supreme Court, “effectively changed the course and standard of measurement of establishment questions.” The

¹⁹ Chief Justice Burger dissented in part, Justice Rehnquist dissented in part, and Justice White dissented from the entire opinion.

²⁰ The Court concluded that the statutes had a secular purpose, which satisfied the first part of the *Lemon* test, and stated in dicta that it was unlikely the statutes would pass the excessive entanglement test, the third part of the *Lemon* test.

²¹ The Court specifically reserved a decision as to the constitutionality of a genuine tax deduction.

²² The statute limited grants to nonpublic schools to 50 percent of the amount expended for comparable services in public schools. The Court observed that “a mere statistical judgment will not suffice as a guarantee that state funds will not be used to finance religious education.”

²³ 302 Minn. 216, 224 N.W.2d 344 (1974), cert. denied, 421 U.S. 988 (1975).

²⁴ The Court’s opinion states that the Minnesota Legislature intended the tax credit statute to reduce the financial plight of parents exercising their constitutional right to send their children to nonpublic schools; promote the state’s interest in maintaining the plurality of educational opportunity; and prevent the demise of nonpublic schools by imposing an obligation on state taxpayers.

state supreme court discussed the *Nyquist* opinion at length and declared its intent to follow the precedent set in *Nyquist* in evaluating the tax credit statute before it. In applying the three-part *Lemon* test, the court had no difficulty in finding a secular purpose for the statute. The court found the “primary effects” part of the test problematic because it believed that the result in *Nyquist* obligated it to use an “any effects” test instead. Under such a standard, where the first amendment establishment clause received clear preference over the free exercise clause,²⁵ the court found that the tax credit statute could not pass constitutional muster under federal law.²⁶ The court rejected the argument that Minnesota’s tax credit statute could be distinguished from *Nyquist*.

Taxpayers were allowed to keep credits issued from 1971 to 1973. The Court did not consider the constitutionality of 1974 legislation prohibiting the commissioner of revenue from recovering credits paid in previous years.²⁷ The credit was not allowed for 1974 and following years, however, because it was found unconstitutional before the end of the 1974 tax year. The tax credit remained in statute until 1980, when it was repealed as part of a Department of Revenue technical bill.

Effect on Tax Liability

Tax credits directly offset tax liability, unlike deductions, which reduce taxable income. In the case of refundable credits, the benefit to the taxpayer exactly equals the amount of the credit claimed. If a refundable credit exceeds a taxpayer’s income tax liability, the excess is refunded to the taxpayer. This is accomplished by providing an open appropriation to the commissioner of revenue to pay refunds allowed under the credit.

A refundable credit provides the same benefit to all claimants, regardless of income. As a result, filers who claimed an education tax credit of \$140 for a secondary student received a \$140 benefit. For those with tax liability, the benefit came in the form of reduced taxes. Filers without tax liability received a \$140 refund check.

This publication can be made available in alternative formats upon request. Please call Karin Johnson at (612) 296-5038 (voice); or the Minnesota State Relay Service at 1-800-627-3529 (TTY).

²⁵ The establishment clause forbids laws that establish religion and the free exercise clause forbids laws that prohibit the free exercise of religion.

²⁶ Although the Minnesota Supreme Court disposed of the constitutional challenge on federal constitutional grounds, it specifically commented on the validity of the statute in the context of the state constitution. The court quoted those sections of the state constitution providing for “a thorough and efficient system of public schools” and prohibiting the use of public moneys for the support of religious schools. The court also commented upon the failure of the courts and the litigants in the case to recognize that the major problem at issue was “society’s concern for the children involved.”

²⁷ Minn. Laws 1974, chapter 556, § 20.