

**INFORMATION BRIEF**

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## 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. This information brief explains income tax deductions and credits.

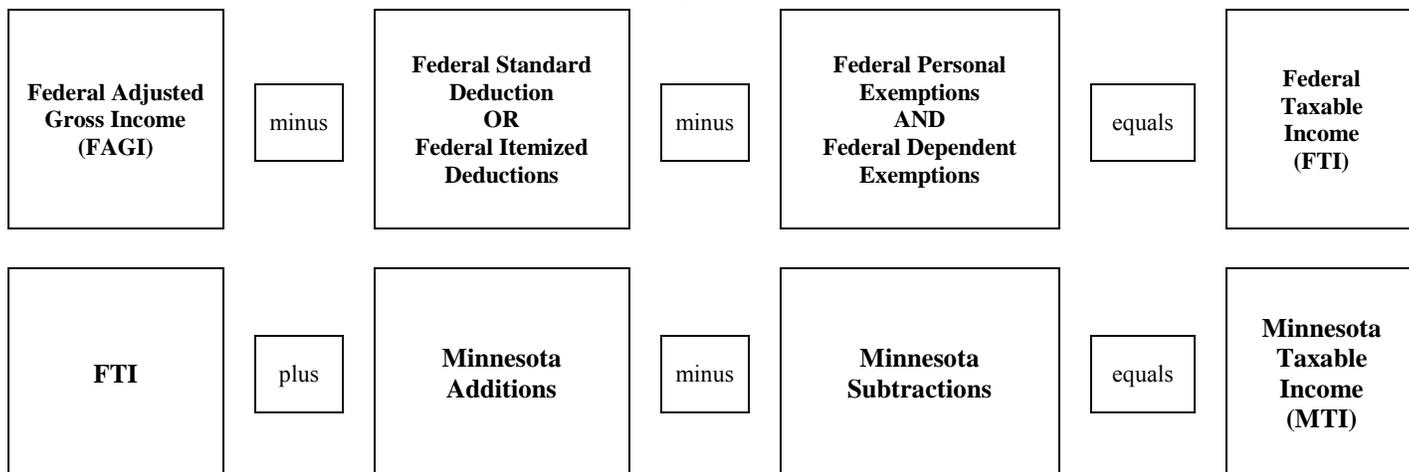
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### Deductions

**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**



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 Department of Revenue’s income tax booklet.

Table 1 shows Minnesota taxable income and tax liability for two families, each with children, filing a joint return, and claiming itemized deductions at the federal level. Because Minnesota did not conform to the increase in the federal standard deduction for married joint filers, both families must add \$1,950 to federal taxable income.<sup>1</sup> The second family claims a Minnesota dependent education expense subtraction of \$1,000,<sup>2</sup> while the first family does not.

Table 1  
**Calculation of Minnesota Income Tax for Two Example Families**

<b>Tax Year 2011</b>	<b>Family One</b>	<b>Family Two</b>
Federal Taxable Income	\$40,000	\$40,000
Minnesota Additions	\$1,950	\$1,950
Minnesota Subtractions	\$0	\$1,000
Minnesota Taxable Income	\$41,950	\$40,950
Minnesota Income Tax	\$2,383	\$2,313

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<sup>1</sup> In the [Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010](#) (Pub. L. No. 111-312, 124 Stat. 3296 et seq.), Congress extended an increase in the standard deduction for married filers first set in motion in 2001. The increased standard deduction is twice the amount allowed single filers, eliminating the marriage penalty otherwise imposed when the married joint standard deduction is less than twice the amount allowed for single filers.

In [Laws 2011, first special session, chapter 8](#), Minnesota chose not to conform to the increased standard deduction but instead required married taxpayers to add to state taxable income the difference between the old and new standard deduction amounts.

<sup>2</sup> 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.

**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 \$33,770 and under \$134,170.<sup>3</sup> The second family claims a state income tax deduction for dependent education expenses of \$1,000 and sees an income tax liability decrease of \$70.00—7.05 percent times the \$1,000 deduction.

**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 \$150,000. 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.

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

Tax Bracket	Minnesota Taxable Income*	Tax Decrease
	\$0	\$0
5.35%	\$1 to \$33,770	\$53.50
7.05%	\$33,771 to \$134,170	\$70.50
7.85%	Over \$134,170	\$78.50

\* Taxable income amounts are for brackets that apply to married joint filers. Smaller brackets apply for head of household, single, and married separate filers.

**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 children and claim itemized deductions at the federal level. The second family claims a

<sup>3</sup> The brackets shown are for tax year 2011. Minnesota tax brackets are indexed annually for inflation.

Minnesota K-12 education tax credit of \$1,000, while the first family does not.<sup>4</sup> Otherwise, the families' tax profiles are identical.

Table 3  
**Calculation of Minnesota Income Tax for Two Example Families**

<b>Tax Year 2011</b>	<b>Family One</b>	<b>Family Two</b>
Minnesota Taxable Income	\$30,000	\$30,000
Minnesota Income Tax	\$1,605	\$1,605
K-12 Education Tax Credit	\$0	\$1,000
Tax after Credits	\$1,605	\$605

The family that does not claim the credit has a Minnesota tax liability of \$1,605, while the family that claims the credit has a tax liability of only \$605. The \$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.<sup>5</sup> Two of Minnesota's major tax credits—the marriage credit and the long-term care insurance credit—are nonrefundable.

**Refundable** credits, in contrast, are refunded fully to taxpayers 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.**

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<sup>4</sup> 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*, November 2008.

<sup>5</sup> In 2011, a family of four will not have any state income tax liability until their gross income exceeds \$24,450, which equals the standard deduction of \$11,600, minus the \$1,950 add-back required at the state level (see footnote 1), and two personal and two dependent exemptions of \$3,700 each.

Minnesota's three major 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 or limit 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 website, [www.house.mn/hrd/hrd.htm](http://www.house.mn/hrd/hrd.htm).*