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Income Tax Terms: Deductions and Credits

What is a deduction?

A deduction reduces income tax liability by reducing taxable income, the amount to which tax rates are applied to determine tax. Federal income tax deductions are commonly divided into two categories:

- Deductions that reduce adjusted gross income (sometimes called **"above-the-line" deductions**) that can be claimed in all cases
- **Itemized deductions** that can only be claimed if the taxpayer does not claim the standard deduction (a fixed dollar amount based on filing status)

What federal deductions are allowed?

For tax year 2015, federal above-the-line deductions include ordinary and necessary business expenses, various retirement account contributions, certain employee business expenses, student loan interest payments, Health Savings Account contributions, moving expenses, one-half of self-employment tax, health insurance premiums (for self-employed taxpayers only), penalty on early withdrawal of savings, and alimony paid by the taxpayer. Federal itemized deductions include state and local property taxes and either income or sales taxes, mortgage interest, charitable contributions, medical expenses in excess of 10 percent of income for taxpayers under age 65, and in excess of 7.5 percent for older taxpayers, casualty and theft losses in excess of 10 percent of income, and job expenses and miscellaneous expenses (most only allowed in excess of 2 percent of income).

Are federal deductions allowed at the state level?

Because Minnesota's income tax calculations start with federal taxable income, federal deductions are reflected in Minnesota taxable income. But Minnesota law may nullify some federal deductions by requiring them to be added back to state taxable income; for example, the itemized deduction for income or sales taxes.

What state subtractions are allowed?

Minnesota allows its own set of subtractions, including ones for K-12 dependent education expenses, military pay, 50 percent of charitable contributions over $500 (for filers who do not claim federal itemized deductions only), up to $12,000 for low-income elderly and disabled taxpayers with low amounts of Social Security and nontaxable pensions, Job Opportunity Building Zone (JOBZ) income, organ donation expenses, gain on sale of farm property for insolvent taxpayers, foreign subnational income taxes, and national service education awards.

Minnesota also allows subtractions for U.S. bond interest, railroad retirement benefits, and on-reservation earnings of enrolled tribal members, because federal law prohibits state taxation of these types of income.

Finally, Minnesota's income tax allows various subtractions to coordinate the calculation of taxable income with other features of the income tax. Minnesota requires itemizers to add back the amount of state income tax deducted at the federal level and allows a subtraction for amounts refunded in order to avoid twice taxing the same income. Also, Minnesota has not conformed in recent years to federal deductions for bonus depreciation, section 179 expensing, domestic production activities, income from the discharge of indebtedness, and net operating losses. As a result, Minnesota allows subtractions for amounts of these items that were included in Minnesota taxable income, but not federal taxable income, in earlier tax years.

How much are deductions worth?

The value of an income tax deduction equals the taxpayer's marginal rate times the amount of the deduction. A taxpayer whose income is too low to be subject to taxes does not benefit from a deduction, unless the law allows the unused deduction to be carried over to a later tax year.

In tax year 2015, federal marginal rates range from 10 percent to 39.6 percent, and state marginal rates from 5.35 percent to 9.85 percent. The graduated federal and state income tax rates make deductions worth more to high-income taxpayers than to low-income taxpayers. A taxpayer in the top federal and state brackets who claims a $1,000 deduction for moving expenses pays $396 less in federal taxes (39.6 percent of $1,000) and $98.50 less in state taxes (9.85 percent of $1,000). But a taxpayer in the bottom federal and state brackets who claims the same deduction pays $100 less in federal taxes (10 percent of $1,000), and $53.50 less in state taxes (5.35 percent of $1,000).

What is a credit?

Credits are subtracted directly from tax liability. Because credits are subtracted directly from liability, they are worth the same to all taxpayers with liability, regardless of income (i.e., it doesn't matter what tax rate bracket the taxpayer is in).

What is the difference between nonrefundable and refundable credits?

Nonrefundable credits only offset tax liability. Taxpayers with little or no tax liability do not benefit from nonrefundable tax credits.

Refundable credits, in contrast, fully benefit taxpayers regardless of their tax liability. For example, a taxpayer with $700 in tax liability who qualifies for a $1,000 refundable credit would receive a refund of $300. If the credit was nonrefundable, that taxpayer would only be able to "use" the $700 of the tax credit that offset liability.

What federal credits are allowed?

In tax year 2015, the federal income tax allows *nonrefundable* credits for adoption expenses, foreign taxes paid, child and dependent care expenses, and retirement contributions of low-income taxpayers. The federal income tax allows *refundable* credits for certain health care premiums and earned income of lower income filers. The federal child credit, for children younger than 17, and the American Opportunity credit, for postsecondary education expenses, are partially refundable.

What state credits are allowed?

In tax year 2015, Minnesota allows *nonrefundable* credits for marriage penalties resulting from the state's progressive rate structure (marriage credit), long-term care insurance premiums, and military retirement pay of low-income veterans. Minnesota also allows *refundable credits* for earned income of low-income filers (working family credit), dependent care expenses, and K-12 education expenses.

For more information: Contact legislative analyst Nina Manzi at 651-296-5204. Also see the income tax area on the House Research website for more information on tax credits.

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