**HOUSE RESEARCH** | **Short Subjects**

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# Sunset of 2001 Federal Tax Law Provisions and Effects on Minnesota Income Tax Revenues

In 2001, Congress passed a federal tax act (the Economic Growth and Tax Relief Reconciliation Act of 2001, or EGTRRA) that included several tax provisions that sunset in 2010. In 2010, Congress extended these provisions for two years, to 2012, in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, or TRUIRJCA.

***Why do provisions of the 2001 federal tax law expire after 2012?***

EGTRRA was passed under the congressional budget reconciliation process. The reconciliation process allows any senator to require a three-fifths majority vote for revenue reductions that extend beyond a ten-year time period. To avoid this possibility, EGTRRA's sponsors chose to sunset its revenue reductions after ten years. Thus, the law included a "sunset" under which all changes expired after tax year 2010. TRUIRJCA extended the EGTRRA sunset by two years, through tax year 2012. Since 2001 Congress has made some of the EGTRRA provisions permanent, most notably the modifications made to pension and IRA provisions.

***How does the federal sunset affect Minnesota's income tax calculation and revenues?***

Federal sunset provisions can affect Minnesota's income tax in several ways.

- Since Minnesota's income tax calculation starts with federal taxable income, the expiration of federal deductions or exemptions results in larger federal taxable income, larger Minnesota taxable income, and higher Minnesota income tax revenues.
- EGTRRA included marriage penalty relief in the federal earned income tax credit, providing for the credit to phase out at higher income levels for married filers than for single parents.
- EGTRRA increased the maximum qualifying expenses and rates for the federal dependent care credit. Minnesota continued to tie the phaseout of the state credit to the federal credit amounts, resulting in higher state credits for some claimants subject to the income phaseout.

***Which expiring federal provisions affect federal taxable income and what is the impact on Minnesota income tax revenues?***

Minnesota did not conform to the TRUIRJCA extension of the three provisions that affect the most taxpayers and would have had the largest state revenue impact: marriage penalty relief in the standard deduction, and the elimination of both the limit on itemized deductions and the phaseout of personal and dependent exemptions. Because Minnesota did not conform to extension of these three items, Minnesota income tax revenues will not be affected when the provisions sunset after tax year 2012. Instead, affected Minnesota taxpayers are required to adjust their state taxable income in tax years 2011 and 2012 for these three items.

- *Marriage penalty relief in federal standard deduction.* Married filers who claim the standard deduction must add to taxable income the additional standard deduction amount allowed at the federal level. Over 500,000 Minnesota taxpayers will pay about $59 million more in taxes in 2011 and about $62 million more in 2012.

- *Limit on itemized deductions.* Higher income taxpayers will have up to 80 percent of their itemized deductions disallowed. Over 100,000 Minnesota taxpayers will pay about $42 million more in taxes in 2011 and about $44 million more in 2012.
- *Phaseout of personal and dependent exemptions.* Higher income taxpayers will have up to 100 percent of their personal and dependent exemptions phased out. Over 60,000 Minnesota taxpayers will pay about $29 million more in taxes in 2011 and about $30 million more in 2012.

***How will taxpayers be affected by the sunset of marriage penalty relief in the working family tax credit?***

Under current law, the income level at which the Minnesota working family tax credit begins to phase out will be $5,080 higher for married couples filing joint returns in tax year 2011 than it will be for other filers. This additional amount matches provisions enacted in TRUIRJCA and provides some relief for marriage penalties on two-earner households. Although the TRUIRJCA extension of this provision applied to both 2011 and 2012, Minnesota has only enacted a parallel increase for tax year 2011. In 2012, the working family credit phaseout threshold for married filers will revert to the level in effect for other filers. An estimated 51,000 married couples will qualify for smaller working family credits; and the state will pay nearly $16 million less in credits.

***How will taxpayers be affected by the sunset of changes to the federal dependent care credit?***

Under current law, taxpayers with income in the phaseout range for the state credit qualify for the lesser of the state credit subject to state phaseout parameters, or the federal credit allowed for their income level. In 2013, federal qualifying expenses and credit rates will decrease to pre-EGTRRA levels. An estimated 22,000 Minnesota taxpayers will qualify for smaller state credits, and the state will pay about $2.0 million less in credits.

***Will sunsets of other federal provisions affect Minnesota tax revenue?***

TRUIRJCA also extended reduced federal tax rates on capital gains income. The reduced rates are scheduled to sunset after tax year 2012. In 2013 the maximum federal rate on capital gains income will increase from 15 percent to 20 percent for most filers, and from 0 percent to 10 percent for lower-income filers.

Past experience with capital gains rate changes indicates that taxpayers may accelerate sales of assets into the year with the lower rate and out of later years in which they expect a higher rate to be in effect. If taxpayers follow this pattern, it will lead to the shifting of taxable income into tax year 2012 from tax year 2013 and following years. However, some taxpayers may expect Congress to further extend the rates to 2013 and beyond.

Since Minnesota's income tax calculation starts with federal taxable income, any shift in the realization of gains will affect state as well as federal revenues. Because of recent experience with the extension of lower rates to tax years 2011 and 2012, the state economic forecast for November 2011 does not project any change in individual income tax revenues as a result of accelerated realization of gains; MMB will review this issue in preparing the February 2012 forecast.

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