

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.

Why do provisions of the 2001 federal tax law expire after 2010?

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 expire after tax year 2010. Since 2001, however, Congress has made some of these provisions permanent, including the:

- ▶ deduction for restitution received by victims of the Nazi regime;
- ▶ modification of pension and IRA provisions; and
- ▶ exclusion of investment earnings of qualified tuition programs.

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 will result 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. Minnesota chose to provide the same relief in the state working family credit and included a sunset that matches the federal sunset.
- ▶ 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?

Expiring provisions that will affect the most taxpayers and have the largest revenue impact at the state level include:

- ▶ *Marriage penalty relief in federal standard deduction.* Under EGTRRA, the standard deduction for married joint filers equals twice the amount allowed for single filers. If this sunsets, the estimated amount allowed for married joint filers will fall from \$11,400 in tax year 2010 to \$9,700 in tax year 2011, and an estimated 431,000 Minnesota filers will pay an estimated \$45 million in additional state income tax in tax year 2011.
- ▶ *Limit on itemized deductions.* Under current federal law, no limit on itemized deductions applies to high-income taxpayers in 2010. But in

2011, high-income filers will be subject to the pre-EGTRRA limit, and those with incomes over about \$170,000 will have up to 80 percent of their itemized deductions disallowed. This will affect an estimated 113,000 returns and result in increased Minnesota income tax revenues estimated at \$52 million in tax year 2011.

- ▶ *Phaseout of personal and dependent exemptions.* Under current federal law, high-income filers will be able to claim the full amount of personal and dependent exemptions in tax year 2010. But in 2011, taxpayers with incomes over about \$250,000 will be subject to the phaseout of personal and dependent exemptions in effect before EGTRRA was enacted. This will affect an estimated 64,000 returns and result in increased Minnesota income tax revenue estimated at \$32 million in tax year 2011.

If the federal government extends any of these provisions and if Minnesota conforms, the state will have to forego the additional tax revenue in tax year 2011 and following years.

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 \$3,130 higher for married couples filing joint returns in tax year 2010 than it will be for other filers. This additional amount matches provisions enacted in EGTRRA and provides some relief for marriage penalties on two-earner households. In 2011, the phaseout threshold for married filers will revert to the level in effect for other filers, and an estimated 34,000 married couples will qualify for smaller working family credits; and the state will pay about \$9 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 2011, federal qualifying expenses and credit rates will decrease to pre-EGTRRA levels. An estimated 25,000 Minnesota taxpayers will qualify for smaller state credits, and the state will pay about \$2.2 million less in credits.

Will sunsets of other federal provisions affect Minnesota tax revenue?

The 2003 federal tax act (the Jobs Growth and Tax Relief Reconciliation Act of 2003, or JGTRRA) reduced federal tax rates on capital gains income. The reduced rates are scheduled to sunset after tax year 2010. In 2011 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 will 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. This will lead to the shifting of taxable income into tax year 2010 from tax year 2011 and following years.

Since Minnesota's income tax calculation starts with federal taxable income, the shift will affect state as well as federal revenues. The state economic forecast for November 2009 projects increased individual income tax revenues of \$263 million in tax year 2010, with a corresponding decrease in revenues in 2011 and 2012.

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