

Tax savings from income tax deductions for homestead property taxes

Minnesota's tax code provides several benefits to homeownership including a property tax valuation exclusion, property tax refunds, and deductions for home property taxes on income tax returns. This paper analyzes the benefits of the income tax deduction for homestead property taxes on both state and federal income tax returns.

Highlights

Homeowners can deduct their homestead property taxes on their income tax return if they itemize deductions. This reduces the amount of income subject to both state and federal income taxes. Lower taxable income reduces the income taxes owed. For the 2010 tax year, these deductions saved Minnesota taxpayers an estimated \$120 million in Minnesota income tax and \$403 million in federal income tax.

Approximately 868,000 Minnesotan homesteads received a benefit on their income tax returns from deducting homestead property taxes. For Minnesota homesteaders who received a benefit, the average state deduction was \$153. The average combined state and federal benefit was \$644. Homesteads with over \$180,000 in income received a net reduction in income taxes of \$347 for the state deduction and \$1,474 for the state and federal deductions combined. (See Table 1.)

Table 1. Average benefit of deduction by income range

Income Range	Count of Homesteads	Percent of Homesteads with a State Benefit	Average State Benefit	Percent of Homesteads with a Federal Benefit	Average Federal Benefit
< \$20,000	128,999	3%	\$ 63	11%	\$ 183
\$ 20,000 to \$ 40,000	244,388	23%	70	31%	194
\$ 40,000 to \$ 80,000	523,328	51%	101	56%	318
\$ 80,000 to \$120,000	307,623	74%	140	79%	495
\$120,000 to \$180,000	152,412	86%	175	91%	794
> \$180,000	110,281	88%	347	50%	1,127
STATEWIDE	1,467,031	53%	153	56%	491

How it works

Homeowners who itemize deductions are allowed to deduct their homestead property taxes on their income tax return. This reduces the amount of income subject to both state and federal income taxes. The tax savings depends on the marginal tax rate.

For example: A Minnesota couple with \$80,000 of taxable income pays Minnesota tax at a marginal rate of 7.05 percent. If their home property tax is \$2,000, that \$2,000 tax deduction would reduce Minnesota income tax by \$141 ($\$2,000 \times 7.05\%$).

The overall state tax benefit to the taxpayer, however, is something less than that amount. Because taxpayers can deduct what they pay in Minnesota income tax on their federal income tax return, any policy that reduces Minnesota income tax liability will increase federal income tax liability. That is, a lower Minnesota income tax means a smaller deduction on the federal return and thus a higher federal tax amount.

In the example, the state income tax reduction of \$141 will reduce the amount claimed as an itemized deduction for state income taxes by \$141. If the couple is in the 25 percent federal tax bracket, this will offset 25 percent of the \$141 in state income tax savings. The \$35 increase in federal tax (25% of \$141) would cut the net benefit of the state deduction to \$106 (\$141 reduction in state tax - the \$35 more in federal tax).

The benefit from the home property tax deduction is generally greater at the federal level because federal tax rates are higher. The federal itemized deduction for \$2,000 of home property taxes would reduce federal income tax by \$500 (25% of \$2,000). Combined with the \$106 net savings in state tax, the tax benefit totals \$606, offsetting 30.3 percent of the home property tax burden.

Property tax deduction benefits are limited to itemizers. Homeowners who do not itemize deductions get no benefit. The average income tax benefit rises for those with higher income for three reasons:

1. Those with higher incomes are more likely to itemize deductions.
2. Average homestead property taxes rise with income.
3. Income tax rates (both state and federal) are higher at higher income levels.

The tax benefits for higher-income taxpayers are reduced, though, because those with high incomes are more likely to be subject to the Alternative Minimum Tax (AMT), and home property taxes are not deductible under either the state or federal AMT.¹

Analysis

For the 2010 tax year, homestead property tax records were matched with income tax records using the homesteaders' Social Security numbers. We did not have homesteader data for 3 smaller counties with about 11,000 homesteads (Chippewa, Murray, and Swift). The measure of income used in this analysis includes both taxable and non-taxable income, including nontaxable:

- Social Security and pension income
- interest income
- workers' compensation
- public assistance
- other nontaxable sources of cash income.

¹ In 2010, there was no limitation on itemized deductions at high income levels. The limitation existed in earlier years and has since been reinstated at both the state and federal levels. When the limitation is in effect, it reduces or eliminates the tax benefit of itemized homestead property tax deductions for those with incomes above the threshold.

The final dataset included approximately 1.467 million Minnesota homesteads.

For each homestead, we estimated three amounts:

- A. The amount state income tax would increase if state law changed to no longer allow deduction of property taxes on Minnesota income tax returns.
- B. The amount federal income tax would decrease due to reduced federal itemized deductions for state income tax due to the change in A.
- C. The amount federal income tax would increase if federal law changed to no longer allow deduction of property taxes on federal income tax returns.

The net benefit from the state deduction is the sum of A and B. The total federal and state tax benefit from the itemized deduction for home property tax is the sum of A, B, and C.

For these estimates we used only property taxes attributable to the homestead property. This may be less than the total amount a taxpayer claims as an itemized deduction because property tax paid on second homes (including cabins) is also deductible. On the other hand, the tax attributable to the homestead property can exceed the amount claimed as an itemized deduction, because the itemized deduction is the homestead property tax net of any Property Tax Refund.

Detailed Results

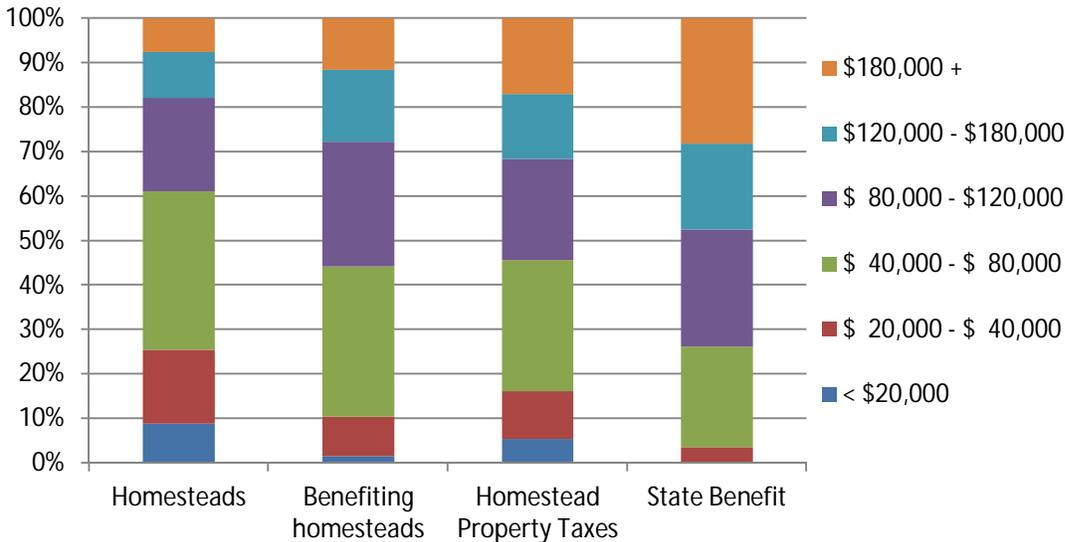
For the 2010 tax year, 868,000 Minnesotan homesteads that itemize deductions would have paid an additional \$144.3 million in Minnesota income tax if they did not deduct homestead property taxes. This increase would have been partially offset by a reduction in federal tax liability of \$24.4 million. If the federal deduction was eliminated, federal tax liability would have risen by \$402.5million. (See Table 2.)

Table 2. Benefit of Deduction by Income Range (\$ millions)

Income Range	A. State Tax Benefit of State Deduction	B. Federal Tax Offset of State Benefit	C. Benefit of Federal Deduction	Total Benefit (A + B + C)
< \$20,000	\$ 0.3	\$ 0.0	\$ 2.6	\$ 2.9
\$ 20,000 to \$ 40,000	4.6	-0.5	14.7	18.8
\$ 40,000 to \$ 80,000	32.4	-5.4	93.5	120.5
\$ 80,000 to \$120,000	39.3	-7.6	120.2	151.9
\$120,000 to \$180,000	30.2	-7.2	109.7	132.7
> \$180,000	37.5	-3.7	61.8	95.6
STATEWIDE	144.3	-24.4	402.5	522.4

Benefits are generally larger for higher-income homeowners. Homesteads with over \$120,000 in income represented 18 percent of all Minnesota homesteads, 28 percent of benefiting homesteads, paid 32 percent of homestead property taxes and received 47 percent of the state benefit. (See Chart 1.)

Chart 1. Distribution of Homesteads, Benefiting Homesteads, Taxes and State Benefit by Income Range



Of the 896,715 homesteaders with incomes under \$80,000, 43 percent benefited from deducting property taxes. Of those with incomes over \$180,000, almost 90 percent received a state benefit, but only 50 percent received a federal benefit because many of them were subject to the federal Alternative Minimum Tax. (See Table 1.)

The benefit of the state deduction is 7 percent of the average homesteader’s property tax liability. The combined benefit of state and federal deduction is 21 percent of the average homesteader’s property tax liability. Average total benefit peak at 29 percent of property taxes for homesteaders with incomes above \$120,000. (See Table 3.)

Table 3. Benefit as a Share of Property Taxes for Homesteaders who Benefit

Income Range	A. Average State Benefit	B. Average Federal Benefit	C. Average Homestead Tax	State Benefit Share of Tax (A / C)	Federal Benefit Share of Tax (B / C)
< \$20,000	\$ 63	\$ 183	\$ 1,440	4%	13%
\$ 20,000 to \$ 40,000	70	194	1,498	5%	13%
\$ 40,000 to \$ 80,000	101	318	1,918	5%	17%
\$ 80,000 to \$120,000	140	495	2,527	6%	20%
\$120,000 to \$180,000	175	794	3,281	5%	24%
> \$180,000	347	1,127	5,237	7%	22%
STATEWIDE	153	491	2,325	7%	21%