

Tax Expenditure Budget

FY 2022-2025

Tax Research Division
Minnesota Department of Revenue

Presentation to the Senate Tax Committee Feb. 15, 2022

The report will be posted to the Department of Revenue website at:
<https://www.revenue.state.mn.us/tax-expenditure-reports>

Legislative Mandate

18th Minnesota Tax Expenditure Budget

(Minn. Stat. 270c.11)






- Due February 1 of even-numbered years
- Major project—Includes estimates for 310 separate items across 15 taxes
 - 17 analysts working since last summer
 - Led by Randy Sanford, Curtis Walker, Alex Hevern and Nick Greene

Outline

- “Tax Expenditure” as a Concept
- Using the Tax Expenditure Budget
- The scope of Tax Expenditures
- Looking Ahead

Tax Expenditures are statutory provisions which reduce the amount of revenue that otherwise would be generated by granting special and selective tax relief to a subset of taxpayers

“Tax Expenditure” as a Concept

- If the only goal were to raise revenue, then it would be best to have a broad income tax base & low rates.
- But state policy makers want to...
 - encourage home ownership  Mortgage Interest Deduction
 - help pay for child care  Child Care Credit
 - recognize/reward combat veterans  Combat Credit
 - increase business start-ups  Angel Investment Credit
 - help beginning farmers buy land &/or farm assets  Beginning Farmer Credit
- Could design a direct expenditure program to meet each of these goals.

Defining a Tax Expenditure

It's a tax expenditure [in the TEB] only if:

1. Tax applies statewide
2. Provides preferential treatment
3. Has a revenue impact
4. Is not subject to an alternative tax
5. Is not counted as a direct expenditure
6. Legislature has authority to impose tax
7. It is included in the definition of the tax base

Defining the Reference Tax Base

Reference Tax Base defined in chapter introductions

- Income Taxes: *Income from all sources less expenses that are reasonable & necessary to generate that income*
 - deduction allowed only for “true” depreciation
 - personal & dependent exemptions & standard deduction assumed part of basic tax structure
 - graduated rates & different tax brackets by filing status assumed part of basic tax structure
 - for corporate tax, equal-weight apportionment & throwback rule
- Sales Tax: Base includes all final purchases of tangible goods or services
 - business purchases of capital equipment are in the base

Tax Expenditures ≠ Direct Expenditures

- No line in the biennial budget
- No regular review process (this is changing!)
- Most have no limit on growth over time (“auto-pilot”)
- Authorized by tax committees
- Often limited public access to program information
- Difference of perception: “Cut taxes” rather than “Increase government spending”

Number of Tax Expenditures by Tax:

• Individual Income Tax	104
• Corporate Franchise Tax	32
• Estate Tax	6
• General Sales & Use Tax	92
• Motor Vehicle Sales Tax	18
• Excise Taxes (motor fuels, alcohol, tobacco)	16
• Mortgage & Deed Taxes	8
• Gambling Taxes	6
• Insurance Taxes	10
• Property Taxes	12
• Motor Vehicle Registration Tax	10
• Air-Flight Property & Registration	<u>2</u>
Taxes	TOTAL
	316

1.66 Home Mortgage Interest

Legal
Citation

Minnesota Statutes, Sections 290.0122, ~~Subd. 2, 5~~ and 290.0132, Subd.19(b)

Description
of Current
Law

A taxpayer may take an itemized deduction for interest paid on debt secured by a principal or second residence. Mortgage interest is deductible on up to \$750,000 of debt used to buy, build, or improve a principal or second residence. If the debt is used for any other purpose, the limitation is \$100,000 of debt. If more than one home is involved, the limitations apply to the total amount. This deduction is one of several deductions subject to the limitation of itemized deductions for higher-income taxpayers.

History

Home mortgage interest was deductible without limitation until restrictions were enacted in 1987. In 2018, the federal limitation was temporarily decreased from \$1 million to \$750,000 in debt. In 2019, Minnesota established its own itemized deduction for home mortgage interest, with a limit of \$750,000.

Number
Affected

An estimated 138,100 returns will claim this deduction in tax year 2021.

Dollar
Impact

Fiscal Year	2022	2023	2024	2025
State General Fund	\$78,400,000	\$83,200,000	\$91,800,000	\$107,000,000

Using the Tax Expenditure Budget

TEB can give guidance on how to broaden a tax base to reduce rates

Three Cautions:

1. Repeal of some tax expenditures would increase complexity (e.g. Federal Conformity items)
2. Repeal of some tax expenditures would cause compliance challenges
3. Tax expenditures interact so can't add estimates together

Interactions among Tax Expenditure Items

Example: Repealing multiple itemized deductions raises less than the sum of the estimates shown separately

Simple sum (items 1.63-1.68)	\$258 mill.
Adjust for interactions:	<u>-87 mill.</u>
Tax expenditure for all combined:	\$171 mill.

Using the Tax Expenditure Budget

Unlike revenue estimates, tax expenditure estimates:

- Ignore interactions among provisions
- Ignore any impact on other taxes
 - Example: vehicle registration tax changes can have an impact on income tax collections
- Do not adjust for “effective dates”
 - Example: timing provisions like tax deferrals
- Do not generally take collectability into account
 - Example: isolated or occasional sales (4.79)
- Are updated only every two year

The Scope of Tax Expenditures

Income Tax Expenditures

	\$ millions
Gross Revenue	21,101.8
Tax Expenditures with significant administrative barriers to repeal	5,583.1
Other Tax Expenditures	1,415.0
Net Revenue	12,512.0

Repealing the Tax Expenditures that cause few or no administrative problems would allow the rates to be changed:

	Current	Alternative
1 st Bracket	5.35%	4.65%
2 nd Bracket	6.8%	6.10%
3 rd Bracket	7.85%	7.15%
4 th Bracket	9.85%	9.15%

Effect of 2019 Tax Bill on Itemized Deductions

Provision	2018 Tax Expenditure Budget		2022 Tax Expenditure Budget		Change
	Counts (TY2017)	Amount (FY2018)	Counts (TY2021)	Amount (FY2022)	
1.63 Medical Expenses	109,200	\$57,000,000	36,700	\$44,900,000	-21%
1.64 Real Estate Taxes	601,800	\$160,600,000	151,000	\$49,500,000	-69%
1.65 Other Taxes	465,400	\$14,200,000	2,500	\$300,000	-98%
1.66 Home Mortgage Interest	540,700	\$227,600,000	138,100	\$78,400,000	-66%
1.68 Casualty and Theft Losses	700	\$800,000	300**	\$800,000	0%
1.67 Charitable Contributions	562,800	\$238,400,000	134,900	\$83,900,000	-65%
1.70 Charitable Contributions for Non-Itemizers	212,900	\$9,600,000	617,800	\$62,800,000	554%

Corporate Franchise Tax Expenditures

	\$ millions
Gross Revenue	3,472.8
Tax Expenditures with significant administrative barriers to repeal	148.7
Other Tax Expenditures	936.7
Net Revenue	2387.4

Repealing the Tax Expenditures that cause few or no administrative problems would allow the rates to be changed:

	Current	Alternative
Rate	9.8%	7.05%

Sales Tax Expenditures

	\$ millions
Gross Revenue	14,610.1
Tax Expenditures by Government, Nonprofits, & Businesses	4,634.1
Tax Expenditures by Consumers (primarily)	3,450.9
Net Revenue	6,525.2

Repealing the Tax Expenditures that are consumer (primarily) goods & services:

	Current	Alternative
Rate	6.875%	4.495%

Sales Tax Selective Services

Pages
117-118
of the TEB

Fiscal Year	2022
Business Purchases	
<i>Services:</i>	
Legal	\$321,300,000
Accounting and Bookkeeping	279,300,000
Architectural and Engineering	328,800,000
Research and Development	119,000,000
Specialized Design	30,100,000
Computer	677,700,000
Management Consulting	305,600,000
Other Consulting and Development	91,900,000
Advertising and Related	241,100,000
Office Administrative	79,900,000
Facilities Support	38,000,000
Employment	460,200,000
Business Support	77,100,000
Other Support	48,400,000
Other Miscellaneous	90,500,000
Professional and Technical	
Other	800,000
<i>Repair and Maintenance:</i>	
Automotive	\$30,400,000
Electronic Equipment	39,200,000
Commercial Machinery	86,600,000
Personal Property	20,200,000
Business–Total	\$3,366,000,000

Consumer Purchases	
<i>Services:</i>	
Legal	\$94,700,000
Accounting and Bookkeeping	17,500,000
Brokerage Charges and Investment Counseling	30,500,000
Bank Service Charges, Trust Services, and Safe Deposit Box Rental	15,500,000
Advertising and Related	1,300,000
Employment	700,000
Personal Care	59,600,000
Funeral	39,700,000
Other Personal	9,600,000
<i>Repair and Maintenance:</i>	
Automotive	\$142,600,000
Personal Property	27,600,000
Consumer–Total	\$439,300,000
Grand–Total	\$3,805,000,000

Property Tax Expenditures

- Tax expenditures result in tax shifts, not changes in tax levels
- Largest tax expenditures are classification & exemptions
 - Classification system determines how tax levies are shared among types of property
- Report does not include property exempted under federal law or the MN Constitution (schools & churches)

PROPERTY TAX

CLASSIFICATION SYSTEM & ALTERNATIVE TAX BASES

Total State and Local Levies
Tax shift under uniform tax base

Farm Homestead HGA	-1%
Farm Homestead Land	+114%
Farm Non-Homestead	+26%
Timber	+97%
Seasonal Rec. Res.	+8%
Residential Homesteads	+20%
Residential Non-Homesteads	+17%
Apartments	+12%
Commercial -Ind 1st Tier	-24%
Commercial -Ind 2nd Tier	-46%
Comm. Seasonal Rec.	+8%
Public Utility Real	-41%
Railroad	-50%
Mineral	-46%
Personal	-50%
 Total Real & Personal Property	 -0%

See pages
190-191 of
the TEB

New: Tax Expenditure Review Commission

Created in 2021

Membership: 8 legislators and Commissioner of Revenue

- Responsibilities:
 - Define tax expenditures' objectives
 - Evaluate tax expenditures on rotating basis
 - Effectiveness in achieving purpose
 - Compare to similar spending programs
 - Suggest modifications or repeal
 - Information provided by Department of Revenue
 - Revenue impact and potential rate change from repeal
 - Distribution of benefits (incidence analysis) for 'significant' tax expenditures

Looking Ahead

- Schedule of report will change to November before budget years, to allow consideration of tax expenditures as part of biennial budget process
- Next report due November 2024
- New content in next report:
 - Purpose statements as defined by TERC
 - Estimated rate change reduction if provision is repealed
 - Incidence analyses of significant income and sales tax expenditures

QUESTIONS?

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