Fiscal Analysis Department
Minnesota House of Representatives

ISSUE BRIEF

Proposed Repeal of Income Tax Reciprocity Agreement with Wisconsin

(January 2002)

The Governor's Supplemental Budget Recommendations for FY 2002-2003 propose to repeal the income tax reciprocity agreement with Wisconsin, effective January 1, 2003. Repeal would increase tax revenue by $30 million in FY 2003, $62 million in FY 2004, and $8 million in FY 2005. The reciprocity agreement with Wisconsin dates back to 1968. (Minnesota's reciprocity agreements with Michigan and North Dakota would remain in effect.)

What is Income Tax Reciprocity?

Reciprocity simplifies tax filing requirements for many of the 25,000 Minnesota residents who work in Wisconsin and the 50,000 Wisconsin residents who work in Minnesota. The agreement allows cross-border workers to file and pay income taxes only in their home state. A Minnesotan with earned income in Wisconsin pays income tax on her Wisconsin earnings as if they were earned in Minnesota. Her Wisconsin employer withholds Minnesota income taxes from her paycheck,[1] and she files only a Minnesota income tax return.

Wisconsin residents working in Minnesota far outnumber Minnesotans working in Wisconsin. A higher proportion work full time, and they typically work at higher paying jobs. So reciprocity results in a net loss of revenue to Minnesota, while Wisconsin gains. Since 1975, Wisconsin has made annual payments to reimburse Minnesota for the net loss in revenue. The annual reimbursement payment is paid with a lag. For example, the payment for taxes on income earned in calendar year 2001 will be paid in December 2002 (which is in FY 2003) .

Income tax reciprocity agreements with other states are authorized by MS 290.081, but

[1] This is the ideal case. The Wisconsin employer will withhold Minnesota taxes (rather than Wisconsin taxes) only if the taxpayer files an annual affidavit with her employer. Even then, employers without nexus in Minnesota are not required to honor such a request. So some cross-border workers (particularly those working for smaller companies) must make quarterly estimated payments. If a taxpayer does not file the required affidavit, she would have to file a Wisconsin tax return to get a refund of her Wisconsin withholding.

the commissioner of revenue is given the power to withhold income tax reciprocity if that is deemed to be in the best interest of the state. Some provisions of the agreement with Wisconsin are set in Minnesota statute. The state with net revenue loss "shall receive from the other state the amount of that loss" and arbitration procedures are defined in case the states cannot agree on the size of that payment. Other parts of the agreement, including payment due dates, are left to be negotiated by the two commissioners of revenue and are not set in statute.[2] The Governor proposes to repeal all language that refers to the Wisconsin agreement, and proposes that the commissioner of revenue withhold reciprocity starting with the 2003 tax year.

Minnesota also has a higher education reciprocity agreement with Wisconsin. Students attending state colleges and universities in the other state pay home-state tuition (rather than non-resident tuition). Each year Minnesota transfers funds to Wisconsin as part of that agreement, but MS 136A.08 limits such payments to years in which an income tax reciprocity agreement is in effect (MS 136A.08). The Governor proposes to repeal the statutory language that ties higher education reciprocity payments to the existence of income tax reciprocity.

What Is the Fiscal Impact of Reciprocity?

The current reciprocity agreement has a fiscal impact on Minnesota for two reasons: First, the reimbursement is paid with a lag, which shifts revenue to later fiscal years. Second, the reimbursement payment is about $2 million smaller than Minnesota's net loss in revenue.

Table 1 shows the fiscal impact of income reciprocity for a single year (the 2003 tax year). First, because the reimbursement check is delayed, reciprocity shifts $60.1 million in revenue from FY 2003 ($30 million) and FY 2004 ($30.1 million) to FY 2005. Minnesota loses tax revenue it would receive in FY 2003-2004, but reimbursement is postponed until FY 2005. Second – in addition to shifting revenue across fiscal years – reciprocity also reduces total revenue by $2.2 million. The reimbursement check of $57.9 million is $2.2 million less than $60.1 million loss in tax revenue.

Table 1.
Fiscal Impact of Reciprocity Agreement
Tax Year 2003 Only

Fiscal Year	Fiscal Impact ($millions)	Cause of Revenue Change
2003	($30.0)	Reduction in net withholding (January 2003 to June 2003)
2004	($30.1)	Reduction in net withholding (July 2003 to December 2003) plus final payments (net of refunds) due April 15, 2004.
2005	$57.9	Reimbursement check from Wisconsin (December 2004)
Total	($ 2.2)	Net loss in Minnesota tax revenue

[2] In Wisconsin, however, the entire agreement is enacted in statute.

Why Are Payments Delayed?

The payment schedule and payment amounts are the product of negotiations between the Minnesota and Wisconsin commissioners of revenue. The annual payment is based on a study of 1995 tax returns, but each year's payment is calculated based on (1) each state's increase in income tax revenues and (2) the latest census estimates of population in the border counties. For tax year 2003, the tax collections totals will not be known until calendar year 2004. Although a more timely payment could be based on forecast tax revenues, with a later settle-up adjustment, the current agreement delays the payment until the collections totals are known.[3]

Why Doesn't Wisconsin Fully Reimburse Minnesota for Lost Tax Revenues?

Current payments are based on a detailed study that Wisconsin and Minnesota completed in 1995, using methodology from an earlier study. Minnesota has argued that the methodology is faulty. The dispute is discussed in more detail below. (See page 4.)

How Much Revenue Would Be Gained by Repealing Reciprocity?

Governor Ventura proposes to repeal reciprocity, effective for the 2003 tax year. The revenue impact of repeal – by fiscal year – is shown in Table 2.

Table 2.
Revenue Gain from Repealing Wisconsin Income Tax Reciprocity
($millions)

Source of Revenue Gain	FY 2003	FY 2004	FY 2005
Tax Year 2003 collections	$30.0	$30.1	
Tax Year 2004 collections		$32.0	$32.0
Tax Year 2005 collections			$34.1
Tax Year 2003 reimbursement from Wisconsin (under current agreement)	**	**	($57.9)
Total Change in Revenue	$30.0	$62.1	$ 8.2
"Under-reimbursement" for Tax Year 2003	**	**	$ 2.2
Revenue gain from speeding up payments	$30.0	$62.1	$ 6.0

**Payments received in these years are for earlier tax years and would not change if reciprocity were repealed effective January 2003.

The speedup of payments results in a large one-time gain spread over two fiscal years ($92.1 million in FY 2003-2004) as well as a permanent gain ($6 million in FY 2005 and later). Timing has an *ongoing* impact on revenue because income tax revenues are growing over time. If the reimbursement payment for tax year 2003 fully compensated

[3] The net loss shown on Table 1 does not include the interest foregone on the money during the one-or two-year delay. The $2.2 million loss would exist even if Wisconsin paid interest on the delayed payment.

Minnesota for its loss in revenues for that tax year ($59.9 million), the FY 2005 revenue gain of repeal would be $6 million.

In addition, there would also be a permanent gain of $2.2 million per year, starting in FY 2005, because of the $2.2 million difference between Wisconsin's reimbursement payment and Minnesota's revenue loss.

Table 3.
One-Time Money and Permanent Money
Resulting from Repeal of Reciprocity

Type of Revenue Increase	Revenue Increase ($millions)
One-time money	$30.0 (FY 2003) and $62.1 (FY 2004)
Permanent money	$8.2 (annually starting FY 2005)

Who Would Be Hurt by Repealing Reciprocity?

All cross-border workers would be inconvenienced by having to file both Minnesota and Wisconsin income tax returns. Minnesotans working in Wisconsin would file a Wisconsin tax return and pay Wisconsin tax on their Wisconsin earnings. They would also be required to file a tax return in Minnesota. On their Minnesota return they would claim a tax credit for taxes paid to Wisconsin. However, that "tax credit for taxes paid to another state" would be the *lesser* of (a) their Wisconsin tax or (b) the Minnesota tax on that same income. Without reciprocity, cross-border workers will pay the *greater* of the Minnesota or Wisconsin tax. If the Wisconsin tax is *less* than Minnesota tax, they would end up paying the same total tax, regardless of reciprocity. Repealing reciprocity would make them file two tax returns and pay some tax in both states, but it would not change their tax. On the other hand, if the Wisconsin tax is *higher* than the Minnesota tax, repealing reciprocity will raise their tax.

According to the Department of Revenue, repealing reciprocity would raise taxes for about 7,800 of the 25,000 Minnesota residents who work in Wisconsin. Taxes would rise by about $2 million in all – an average increase of $260 per taxpayer.[4]

For those 7,800 taxpayers, Wisconsin tax on their Wisconsin earnings would exceed what they now pay to Minnesota.[5] In general, Wisconsin taxes are higher for cross-border workers with incomes in the following ranges:

Married couple with two children:	$20,000 to $150,000
Single (no children):	$20,000 to $90,000
Single parent with one child:	Under $150,000.

[4] Although there are 25,000 Minnesotans who work in Wisconsin, only about 13,000 earn enough income to meet filing requirements. (Many of the others are students or part-time or seasonal workers.) About 7,800 of those 13,000 would pay higher taxes; the other 5,200 would see no change in their tax liability. Repealing reciprocity would help no Minnesotans (except, perhaps, tax preparers).

[5] For further explanation, see *Appendix B*.

Tables 4A and 4B in *Appendix A* show the change in taxes for representative households. Among the many examples included on those tables are the following three hypothetical Minnesota residents:[6]

- ?? A married couple with two children and an income of $80,000. The higher-earning spouse earns $56,000 in Wisconsin; the other spouse earns $24,000 in Minnesota. In 2001, with reciprocity, they paid $3,500 of income tax to Minnesota. Without reciprocity, they would have paid $621 more (an 18 percent increase in tax).

- ?? A single parent with one child earning $40,000 in Wisconsin would pay $1,563 in income tax to Minnesota in 2001, with reciprocity. Without reciprocity, she would pay $511 more (an increase of 33 percent).

- ?? A single taxpayer earning $40,000 in Wisconsin would pay $1,967 in income tax to Minnesota in 2001, with reciprocity. Without reciprocity, she would pay $153 more (an increase of 8 percent).

Who Would Gain from Repealing Reciprocity?

Repealing reciprocity would increase Minnesota tax revenues, as shown in Table 3 above. This increase in tax revenue – much coming at the expense of Wisconsin – would help solve the current budget problem, allowing either a smaller increase in taxes or a smaller cut in spending. Only about $2 million per year of the 3-year total of $100.3 million represents an increase in tax on Minnesotans. In this way, repeal would help Minnesotans who do not work in Wisconsin much more than it would hurt the cross-border workers.

Is Wisconsin Under-Reimbursing Minnesota?

The dispute between Minnesota and Wisconsin has centered on the $2.2 million gap between Minnesota's estimated annual revenue loss from reciprocity and Wisconsin's reimbursement payment for the same tax year. So far, the argument has been over this $2.2 million gap, not the timing of the reimbursement payments.

Reciprocity results in a tax cut for some Minnesotans who work in Wisconsin, and it results in a tax cut for some Wisconsin residents (high-income or very low income) who work in Minnesota. There are few if any cases where reciprocity raises anyone's tax liability. In each tax year, reciprocity reduces total combined Wisconsin and Minnesota tax collections. With a smaller total, there is no way for *both* states to receive "full compensation." The methodology underlying the current calculation of the reimbursement payment allocates the combined loss in tax revenue between the two states in a particular way.

[6] See notes below Table 4A, which describe additional assumptions made about these taxpayers.

There is no question that Minnesota's tax revenues are not "made whole" by the current payment from Wisconsin, *even if the delay in payment is ignored*. The Minnesota Department of Revenue has been pushing for an upward adjustment in the size of the annual payments for several years, arguing that the legal language in the agreement requires that Wisconsin fully compensate Minnesota for its loss in revenue. Wisconsin has not been willing to follow the arbitration procedures set in Minnesota statute to resolve the dispute (MS 290.081(c)).

Using the current methodology, Wisconsin's payment slightly *exceeds* the amount that Wisconsin gains in tax collections in the relevant year. *Ignoring the timing of payments*, reciprocity reduces Wisconsin's net revenues. Although Minnesota is "out" the $2.2 million, that $2.2 million does not represent a gain to Wisconsin.

The $2.2 million does not simply disappear, of course. It equals the tax cut that reciprocity provides for 7,800 Minnesota residents who work in Wisconsin. Similarly, under the current agreement, Wisconsin's net loss in tax revenue (after the reimbursement payment) equals the tax cut given to a few of its residents who work in Minnesota – those who pay less in Wisconsin taxes than they would pay to Minnesota.

Ignoring the delay in payment, the current reciprocity payments require Minnesota to pay for the tax break that reciprocity grants to some Minnesotans who work in Wisconsin; it requires Wisconsin to pay for the tax break that reciprocity grants to some Wisconsin residents who work in Minnesota.

However, the fiscal impact of the delay in payments should not be ignored. Wisconsin receives a one-time gain of almost $90 million plus an ongoing gain of about $6 million per year because the current agreement allows it to delay its reimbursement payments. If the fiscal impact of delayed payments is taken into account, Minnesota is paying a substantial price for reciprocity.

Conclusions

1. **Reciprocity under the current agreement is expensive for Minnesota -- $92 million in one-time money and $8.2 million annually in permanent money**. Much more important than the $2.2 million annual loss in tax revenue (equal to the gain to some Minnesota residents who work in Wisconsin) is the cost of delayed reimbursement – about $90 million in one-time money and $6 million in permanent money. More timely payment (like a change in the size of the payments) would require a negotiated change in the reciprocity agreement.

2. **Wisconsin gains from reciprocity**. The benefit of delaying payments far exceeds the small annual loss in net tax revenue (equal to the gain to some Wisconsin residents who work in Minnesota). The gain to Wisconsin from delaying payments is equal to Minnesota's loss from that delay.

3. **Reciprocity simplifies tax filing for some of the 25,000 Minnesota residents who work in Wisconsin and 50,000 Wisconsin residents who work in Minnesota.** Not all of the cross-border workers benefit from the simplification.[7] Reciprocity increases administrative costs to some extent for businesses and revenue departments.[8]

4. **Reciprocity cuts taxes for 7,800 Minnesotans who work in Wisconsin and an unknown (but probably smaller) number of Wisconsin residents who work in Minnesota**. With reciprocity, workers pay tax at their home state rates. Without reciprocity, workers pay the higher of the two states' rates.

   Reciprocity is an exception to the general rules about the sourcing of earned income for tax purposes. Workers generally pay income tax to the state where income is earned. Proponents of repealing reciprocity have referred to the tax benefits as a "subsidy" of cross-border workers (or employers). Those favoring reciprocity have argued that Minnesota residents working in Wisconsin should pay the same tax as their otherwise-identical neighbor who works in Minnesota.

Options for the Legislature

Under current law, the Governor does not need legislative action to end the income tax reciprocity agreement with Wisconsin. However, current law links the income tax reciprocity agreement to Minnesota's higher education reciprocity agreement with Wisconsin (MS136A.08 subd.3). Ending income tax reciprocity would end higher education reciprocity as well, unless the legislature changes that statutory language (as the Governor proposes).

The legislature has several options, including the following:

1. Enact the language proposed by the Governor, signaling legislative approval of terminating the current income tax reciprocity agreement (while retaining higher education reciprocity). The Governor could still decide not to terminate the agreement.

2. Do nothing. This would not prevent the Governor from terminating income tax reciprocity with Wisconsin, but such action – if taken – would likely terminate higher education reciprocity as well.[9]

---

[7] See footnote 1.
[8] The annual affidavits must be processed, and businesses must withhold for two states rather than one. The 1995 benchmark study cost each state $150,000. Reciprocity may also create tax compliance problems. On the other hand, repeal would increase the number of total tax returns filed (and more M1CR forms for "credits for taxes paid to other states")
[9] The higher education reciprocity payment with Wisconsin would be terminated. Wisconsin might choose to continue higher education reciprocity without that payment (about $2 million per year in recent years), but that seems unlikely.

3. Enact language directing the commissioner of revenue to withdraw from the current reciprocity agreement (or identifying circumstances under which the commissioner must withdraw from that agreement).

4. Enact language prohibiting the commissioner of revenue from withdrawing from the current income tax reciprocity agreement without legislative approval. This would, of course, be subject to gubernatorial veto (but not to line-item veto).

None of these options would change the income tax reciprocity agreements with North Dakota and Michigan.

Appendix A: Tax Increases for Representative Minnesota Families Who Work in Wisconsin

Table 4A.
Dollar Change in Total Tax Liability If There Were No Reciprocity
(Tax Year 2001)

Family Income	Married with 2 children, both spouses working (Spouse A earns 70% of income; Spouse B earns 30%)			Single parent with one child	Single person
	Spouse A works in WI	Spouse B works in WI	Both Work in WI	All income earned in WI	All income earned in WI
$ 10,000	$ 0	$ 0	$ 0	$ 0	$ 0
20,000	125	53	0	155	4
30,000	201	86	18	399	110
40,000	361	136	155	511	153
50,000	479	167	243	435	153
60,000	497	186	298	396	144
70,000	560	225	356	387	136
80,000	621	263	414	365	40
100,000	599	257	376	312	0
125,000	554	237	311	131	0
150,000	340	145	6	0	0
200,000	37	16	0	0	0
250,000	0	0	0	0	0

Calculated from tax year 2001 income tax returns under the following assumptions: (1) Expenditures eligible for federal itemized deductions equal 17% of total income; (2) only 55% of those expenditures are eligible for the Wisconsin "credit for itemized deduction" (because only medical, mortgage interest, and charitable deductions are eligible); (3) Minnesota residents are not eligible for the Wisconsin credit for school taxes (assumes they own no home and rent no apartment in Wisconsin); and (4) all income is earned income.

Wisconsin's income tax structure varies greatly from Minnesota's. In calculating Minnesota taxable income, taxpayers can deduct federal personal exemptions ($2,900 per person) and the federal standard deduction. Wisconsin allows only a $700 personal exemption, and the Wisconsin standard deduction phases out at higher incomes. Minnesota allows federal itemized deductions (except for addback of personal income tax). Wisconsin allows no itemized deduction for property taxes, and Wisconsin provides a 5% "itemized deduction credit" rather than a straight deduction. Minnesota's marriage penalty credit is available for earnings in Wisconsin, but Wisconsin's "married couple credit" is available only if *both* taxpayers have earnings in Wisconsin.

Refundable tax credits *received by Minnesota residents* are not affected by reciprocity. Minnesota's working family credit and dependent care credit do not depend on the location of earnings. Wisconsin's does not allow nonresidents to claim their earned income credit, even if they have earnings in Wisconsin.

Table 4B.
Percentage Change in Total Tax Liability*
If There Were No Reciprocity
(Tax Year 2001)

Family Income	**Married with 2 children, both spouses working** (Spouse A earns 70% of income; Spouse B earns 30%)			**Single parent with one child**	**Single person**
	Spouse A works in WI	Spouse B works in WI	Both work in WI	All income earned in WI	All income earned in WI
$ 10,000	---	---	---	---	0%
20,000	291%	123%	0%	38%	38%
30,000	35%	15%	3%	42%	42%
40,000	32%	12%	14%	33%	33%
50,000	28%	10%	14%	19%	19%
60,000	21%	8%	13%	14%	14%
70,000	19%	8%	12%	11%	11%
80,000	18%	8%	12%	9%	9%
100,000	13%	5%	8%	6%	6%
125,000	9%	4%	5%	2%	2%
150,000	4%	2%	0%	0%	0%
200,000	0%	0%	0%	0%	0%
250,000	0%	0%	0%	0%	0%

*Increase in tax *before refundable credits*.
Cells shown with "---" would pay no tax either way.

See other notes at bottom of Table 4A.

Appendix B. Why Are Wisconsin Taxes Higher?

The Minnesota Taxpayers Association's *Comparison of 1999 Individual Income Tax Burdens by State* (January 2001) calculated income taxes for representative households in each state. Their results are summarized in Table 5. Except at the highest and lowest income levels, Wisconsin's income tax burden exceeded that of Minnesota.

Table 5.
Which State Has Higher Income Taxes? Wisconsin or Minnesota?

Income ($1000s)	$7.5	$10	$15	$20	$25	$35	$50	$75	$100	$200
Type of Family										
Married, 2 children	Mn	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	Mn
Single parent, 2 children	Mn	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	Mn
Single	Mn	Mn	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	**Wi**	Mn	Mn

Some people are surprised to find that Minnesota income taxes are lower for so many households. After all, Minnesota's income tax rates (5.35%, 7.05%, and 7.85%) are higher than Wisconsin's tax rates (4.6%, 6.15%, 6.5%, and 6.75%). But tax liability depends both on tax rates and on a family's taxable income (after exemptions and deductions). Wisconsin's taxes are higher primarily because Wisconsin allows taxpayers to claim less in exemptions and deductions, resulting in higher taxable income.[10] Wisconsin's personal exemptions are much lower ($700 per person compared to $2,900 per person), and Wisconsin's standard deduction and itemized deduction credit are generally worth considerably less than the equivalent deductions allowed by Minnesota. Property taxes are not eligible for Wisconsin's five percent "itemized deduction credit." Moreover, the 5% credit rate is lower than all but the lowest tax rate, so the credit reduces tax liability by less than a deduction (as in Minnesota).

For Minnesotans working in Wisconsin *as cross-border workers*, the excess of Wisconsin tax over Minnesota tax may be even greater for two reasons: As nonresidents, they do not qualify for Wisconsin's income tax credit for school taxes; and they are ineligible for Wisconsin's married couple credit unless they *both* work in Wisconsin.

[10] For example, a married couple with two children and earnings of $80,000 would have taxable income that was effectively $8,000 to $10,000 higher in Wisconsin than in Minnesota (even after converting the itemized deduction credit and school property tax credit into a deduction of equal value).

For more information, contact Paul Wilson, 328 State Office Building, 651-297-8405 or Paul.Wilson@house.leg.state.mn.us