FISCAL ISSUE BRIEF

Summary of 2007 Chap. 149, Vetoed Omnibus Tax Bill

MINNESOTA SENATE
OFFICE OF COUNSEL, RESEARCH, AND FISCAL ANALYSIS

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QUESTIONS

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BACKGROUND

Few provisions with a fiscal impact on state tax revenues were enacted during the 2007 legislative session. The Legislature adopted Chapter 1 which conformed Minnesota's income tax to federal changes enacted since May 18, 2006 **for tax year 2006 only.** In addition, the Legislature passed two omnibus tax bills that were subsequently vetoed:

- Chapter 81 (HF 2294/SF 2003) proposed to modify property tax provisions, provide a homestead credit state refund, increase property tax refunds, provide a school bond agricultural credit, and add an income tax bracket with a new top rate.

- Chapter 149 (HF2268) proposed various changes to Minnesota's income, corporate franchise, sales, and property taxes, including increased payments for local property tax aids and credits.

This issue brief summarizes key provisions of Chapter 149, the vetoed Omnibus Tax Bill, and the fiscal impact those provisions would have had on General Fund revenues or appropriations.

INTRODUCTION

Chapter 149 provided for state General Fund tax increases totaling approximately $192.5 million in FY 2008-2009 and $230.5 million in FY 2010-2011. These revenues were generated from changes in treatment for foreign operating corporations (FOCs) and June accelerated sales tax payments, and removing the cap on securities registration fees. Chapter 149 also provided for General Fund tax reductions of about $13 million in FY 2008-2009 and $48 million in FY 2010-2011. These changes included conforming to federal tax changes for tax year 2007 only and creating several individual income credits and sales tax credits or refunds. In addition, the Omnibus Tax Bill increased appropriations for local government aid and property tax relief by $122 million in FY 2008-2009 and $250 million in FY 2010-2011. These changes are discussed in more detail below. Because Chapter 149 was internally balanced; it did not raise General Fund tax revenues beyond the General Fund tax expenditures and appropriations contained in the bill, its veto did not result in imbalances in the State's General Fund budget.

Federal Conformity

Because Minnesota uses federal taxable income as the starting point for determining state income tax liability, changes to federal taxable income are typically adopted by Minnesota. Minn. Laws (2007) Chapter 1, adopted for Minnesota income tax purposes for **tax year 2006 only** the following federal changes enacted by Congress since May 18 2006:

- Heroes Earned Retirement Opportunities Act allowed military personnel to count tax-exempt combat pay as earned income for purposes of making tax-deductible contributions to individual retirement accounts.

- The Pension Protection Act of 2006 made a number of changes to federal provisions relating to employer-provided benefit and contribution plans, IRAs, and Keogh plans, and imposed limits on certain deductible charitable contributions.

- The Tax Relief and Health Care Act of 2006 extended several expiring tax deductions. The most significant extensions were the higher education tuition expense deduction of up to $4,000 and the teacher classroom expense deduction of up to $250.

Chapter 149 adopted the same federal changes for another year, **tax year 2007 only.** The Pension Protection Act of 2006, among other provisions, authorized tax-free distributions from government pension plans for health and long-term care premiums and tax-free distributions from an IRA to a qualified charity for individuals age 70½ or older. In addition, to extending the existing deductions mentioned above, the Tax Relief and Health Care Act of 2006 also contained new provisions related health care savings accounts and new itemized deduction for mortgage insurance premiums.

Individual Income Taxes

Combat Zone Credit: Increased from $59 per month to $120 per month for service after 2006, estimated to cost $525,000 in FY 2008-2009.

Investment Tax Credit: Provided up to $2,000,000 in credits for investments in bioscience and medical device technology businesses, for an estimated $4.8 million in tax expenditures in FY 2008-2009.

Nonresident Income: Imposed the income tax on income earned while a Minnesota resident, but not payable until the individual has moved outside of Minnesota, estimated to increase General Fund revenues by $4.6 million in FY 2008-2009.

Fines, Fees, and Penalties: Included as taxable income these items paid to a government entity, estimated to increase revenues by $290,000 in FY 2008-2009.

Contractor Withholding: Required construction contractors to withhold two percent of payments to individual independent contractors, estimated to increase revenues by $3 million in FY 2008-2009.

CORPORATE FRANCHISE TAXES

Foreign Operating Corporations: Corporations will qualify for this treatment only if they derive at least 80 percent of their income from active foreign sources, and income from domestic sources will not receive FOC benefits or foreign royalty subtractions. However, the foreign royalty subtractions were increased from 80 to 90 percent. The FOC provisions were estimated to increase revenues $125 million in FY 2008-2009.

Accelerated Transition to Single Sales Factor: Accelerated by three years the current transition to a single sales factor method of apportionment from complete phase-in by 2014 to complete phase in by 2011. Increased the sales factor apportionment from 87 percent to 95 percent effective in tax year 2010. This provision was estimated to reduce revenues by $33 million in FY 2010-2011.

SALES AND USE TAXES

June Accelerated Sales and Use Tax: Increased the percentage of sales and use tax collections required to be paid by larger tax collectors in June from 78 percent of 85 percent, effective beginning with June 2009 sales tax collections. This provision increased revenues by $23 million in FY 2008-2009.

Sales Tax Exemptions: Provided a number of sales tax exemptions and refunds, including an exemption for capital equipment in the wood products industry (upfront not refunded); exemptions for materials used and consumed in agriculture productions; commuter rail, engines, and cars; public safety radio communication system in Itasca County; construction materials for low-income housing projects; and building materials used in and certain capital equipment incorporated into the Thomson-West legal reference and data center facility. The sales tax exemptions totaled over $7 million in increased tax expenditures in FY 2008-2009.

Local Option Sales Taxes: The cities of Clearwater, North Mankato, and Winona were granted authority to impose a one-half of one percent sales and use tax, subject to voter approval. The cities of Bemidji and Proctor and Cook County were authorized to extend current local option sales and use taxes. Cook County was granted authority to impose and additional one percent lodging tax and a three percent admissions and entertainment tax. The City of Duluth was authorized to increase its existing food and beverage tax from 1.5 percent to 2.25 percent. Revenues from the local option sales taxes were directed to pay for specific projects. Chapter 149 prohibited political subdivisions from advertising, promoting, expending funds, or holding a referendum in support of a local option sales tax through 2010. Further, Chapter 149 created a joint legislative subcommittee to study the sales and use tax and report back to the House and Senate Tax Committees no later than March 30, 2008.

PROPERTY TAXES

Class Rate Changes: Chapter 149 included the following class rate changes:

1) The class rate for agricultural homestead land was reduced from 0.55 percent to 0.5 percent. A new class 2b was established for unplatted rural land of at least ten acres which would not be used for agricultural purposes with a class rate of one percent of market value;
2) The first tier of class 1c homestead resorts was reduced from 0.55 percent to 0.5 percent. The market value eligible for the first tier was increased from $500,000 to $600,000 of market value;
3) The class rate on electric generation tools, implements and machinery was increased from 2.0 percent to 2.5 percent for taxes payable in 2009 and 3.0 percent for taxes payable in 2010 and thereafter. The class rate on utility transmission and distribution systems was increased from 2.0 percent to 2.15 percent for taxes payable in 2009 and 2.25 percent for taxes payable in 2010 and thereafter. Utilities were authorized to pursue recovery of the cost of property taxes that are higher than under current law due to the class rate changes through a rate adjustment;
4) Increased the market value eligible for the 1b disabled homestead classification from $32,000 to $50,000.

Property Tax Exemptions: Chapter 149 contained exemptions to the following types of property:

1) An electric generation peaking facility in Sherburne County;
2) Property exclusively used to operate a state-approved apprenticeship training program in which the participants receive no compensation and which is located within the metropolitan area or a city greater than 10,000 population in Greater Minnesota;
3) Monosloped roofs installed over feedlot or manure storage areas.

Property Classification Changes:

1) Community-service oriented properties that make qualified contributions at least equal to their property tax in the previous year would be treated as 4c commercial-seasonal property with a class rate of 1.5 percent and subject to the state general tax at the seasonal rather than the commercial rate;
2) Reduced the low-income housing threshold requirement from 75 percent of the units in the rental housing property must meet the qualifications to 20 percent of the units. Second, the units would qualify if they are subject to rent and income restrictions under the terms of financial assistance provided to the rental housing property by a local unit of government in addition to financial assistance provided by the state or federal government.
3) Disabled veterans, who have a certified military-service connected disability rated at 70 percent or higher, would receive a market value exclusion of $150,000 on their homestead. Those veterans with a military-service connected disability that is certified to be total and permanent would receive a homestead market value exclusion of $300,000.

Fiscal Disparities Study: Required the Commissioner of Revenue to conduct a study of the fiscal disparities program and to make a report to the House and Senate tax committees by February 1, 2009. $150,000 in FY 2008 was appropriated for this study.

OTHER

Local Deed and Mortgage Taxes: Authorized Hennepin and Ramsey counties to continue to impose a deed and mortgage tax and authorized Anoka, Dakota, and St. Louis counties to begin to impose a deed and mortgage tax. All proceeds designated to be used for environmental response activities. Taxing authority for all counties expires January 1, 2013.

Public Finance: Authorized the Metropolitan Council to issue debt for buses, authorized local units of government to establish trusts for payment of postemployment health benefits, increased net debt limits for local taxing authorities.

MINERALS

Taconite Production Tax: Modified distribution of proceeds of the taconite production tax and authorized the IRRRB to purchase forest land in the taconite assistance area.

School Aid Offset: Eliminated the offset against general education funding for taconite production tax distributions to school districts.

ECONOMIC DEVELOPMENT

JOBZ: Extended the duration of JOBZ benefits for up to 11 year. The extension does not apply if the business subsidy agreement was executed before this section becomes effective, to relocations in a JOBZ if the business received JOBZ benefits before the relocations, or to businesses located in the 11-county Twin Cities metropolitan area or in a city with a population of 50,000 or more or a city contiguous to such a city. This exclusion does not apply to cities that border another state.

Mall of America: Provided funding for Phase II of the Mall of America project by increasing the metropolitan area fiscal disparities levy, providing special rules for operation of the MOA tax increment financing district, and authorize the City of Bloomington to impose certain local taxes for support of the project.

Fergus Falls: Provided assistance to the city to enable it to develop the former regional treatment center site.

Tax Increment Financing: Provided special rules for operation of tax increment financing districts in Eagan, Minneapolis, Brooklyn Center, Burnsville, Fridley, New Brighton, and Eyota.

Dairy Investment Grant Program: Provided $500,000 for grants to be made by the Commissioner of Agriculture to dairy farmers who make qualifying expenditures.

Historic Rehabilitation Grant Program: Provided $300,000 to the Minnesota Historical Society for grants for historic rehabilitation programs.

Republican National Convention Guarantee: Appropriated $39,000,000 from the cash flow account to provide a guarantee for the host community's share of expenses for the 2008 Republican National Convention.

TAX AIDS AND CREDITS

The February 2007 state budget forecast projected General Fund expenditures for property tax aids and credits of $3.1 billion for FY 2008-09. If enacted, Chapter 149 would have appropriated an additional $122 million for property tax aids and credits in FY 2008-2009 and $250 million in FY 2010-2011. Details of these appropriations are discussed below.

Local Government Aid (LGA): The appropriation for LGA was increased by $70 million annually beginning with aids payable in 2008. The changes to the LGA formula were:

1) Eliminating the taconite aid offset;
2) Changing the maximum aid increase from 10 percent to 30 percent of levy for one year to prevent distortion by the aid caps in the first year of the distribution; and

3) Averaging the city aid distribution over two years to reduce volatility, beginning with aids payable in 2009.

Permanent aid base increases were granted to Taylors Falls ($30,000), Browns Valley ($100,000), and Mahnomen ($80,000). Temporary aid base adjustments were granted to Newport ($75,000 for 2008 to 2013), Crookston ($200,000 for 2008 to 2012) and Rockville ($30,000 in 2008 only).

Study of LGA: Established a study group to examine the current system of providing aids to local governments and make recommendations on improving the program, with the final report due by Dec. 15, 2008.

County Program Aid (CPA): Funding for CPA was increased by $6.5 million for aids payable in 2008, $7.5 million for aids payable in 2009 and indexed thereafter. County transition aid was made permanent at the 2007 level.

Township Aid: $5 million was allocated for aid to townships based on population, area and proportion of value classed as agricultural.

Property Tax Refund: The maximum homeowner property tax refund was increased by 25 percent for claimants with incomes under $10,000 and by approximately 20 percent for claimants with higher incomes. The threshold percentage for qualifying for the refund was reduced from four percent of income to three percent.

Other Aids: The 2007 appropriation of $600,000 to local governments in Mahnomen County affected by a loss of tax base due to the placement of property into trust status by the Bureau of Indian Affairs was made permanent. An appropriation of $500,000 was made to the Commissioner of Revenue in fiscal years 2008 and 2009 to provide aid to the city of Grand Marais and Cook County for costs related to the Ham Lake fire of 2007.

MISCELLANEOUS

Budget Reserve Account: Increased by $150 million to $803 million.

Priorities for Additional Revenues: $22.3 million for the 21st Century Minerals Fund, and created a tax volatility reduction account.

Budget Forecast: Required to include estimate of the effect of inflation on expenditures.

Securities Registration Fees: Removed the annual limit on amount that may be collected, resulting in an additional $25.8 million00,000 in revenues in FY 2008-2009.

River Centre Debt Service Appropriation: Appropriated $2 million to the City of St. Paul for debt service costs of the River Centre for fiscal year 2010.

Fiscal Issue Briefs offer background information and analyses on the budget process and specific budgeted issues related to matters that have been or are likely to be addressed by the Legislature. Senate Fiscal Issue Briefs can be viewed on the Office of Counsel, Research & Fiscal Analysis web site at www.senate.leg.state.mn.us/departments and follow the links to the Office of Counsel, Research, and Fiscal Analysis.