

Fiscal Analysis Department

Minnesota House of Representatives



Issue Brief: Current Proposal for Minnesota's Income Tax Reciprocity Agreement with Wisconsin

Updated September 21, 2009

In June 2009, the Governor's unallotments and administrative actions included a proposal to reach an agreement to accelerate the timing of the payments received from Wisconsin for income tax reciprocity. In September 2009, in the absence of a re-negotiated agreement, the Governor terminated the income tax reciprocity agreement with Wisconsin, effective tax year 2010. This issue brief will describe income tax reciprocity and cover the revenue implications of each scenario considered by the Governor.

What is Income Tax Reciprocity?

Minnesota has income tax reciprocity agreements with three states: Wisconsin (1968), North Dakota (1969), and Michigan (1984). These agreements allow residents who live in one state and work in another, referred to in this document as *cross-border workers*, to file returns and pay taxes on personal service income in the state of residence. Personal service income includes salaries, wages, commissions and fees earned by an employee, but does not include other types of income such as gains on the sale of property, rental income, and lottery winnings.¹ In the absence of an income tax reciprocity agreement, wages and other personal service income are subject to tax in the state in which income is earned. Without a reciprocity agreement taxpayers would be required to file returns in both the state of residence and the state of employment, because both Minnesota and Wisconsin tax their residents on all of their income, regardless of where it was earned.

Minnesota Statutes 290.081 authorizes the Commissioner of Revenue to enter into income tax reciprocity agreements with other states but also gives the Commissioner the authority to terminate the agreements 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 statute specifies that the state with a net revenue loss "shall receive from the other state the amount of that loss," and defines arbitration procedures in case the two states cannot agree on the size of the payment. Other parts

¹ Minnesota Statutes 290.92, subdivision 1. Personal service income also excludes investment income, such as interest, dividends, and capital gains on intangible assets.

of the agreement, including payment dates, are negotiated by the Commissioners of Revenue of the two states and are not in statute.

When the agreement with Wisconsin was signed in 1967 (effective beginning with tax year 1968), the number of taxpayers who lived in one state and worked in the other was much smaller. Throughout the 1970's, the number of taxpayers living in Wisconsin and working in Minnesota increased. The growing imbalance, in terms of cross-border workers and the average income of cross-border workers, exacerbated the revenue loss to Minnesota due to reciprocity. The reciprocity agreements with North Dakota and Michigan, on the other hand, reflect a more typical reciprocity arrangement with more balance between the number of people affected in the two states and also in tax burden.

In 1973, Governor Anderson proposed the repeal of income tax reciprocity because it caused a revenue loss to Minnesota.² Reciprocity was retained after a reimbursement provision was enacted in both Minnesota and Wisconsin. Under this reimbursement provision, Wisconsin would make annual payments to reimburse Minnesota for its net revenue loss. The first payment from Wisconsin was received in 1975.³ The annual reimbursement from Wisconsin is paid with a lag because payment is based on final collection data.

Almost 30 years later in Governor Ventura's supplemental budget recommendations for the FY2002-03 biennium, termination of the reciprocity agreement with Wisconsin was proposed.⁴ Reciprocity was again retained after getting agreement on a statutory requirement that Wisconsin pay interest to Minnesota to compensate for the lag in payments. The next payment from Wisconsin -- for taxes on income earned in calendar year 2008 (plus interest) -- will be paid in December 2009 (which is in FY 2010).

Calculation of Reciprocity Payments

Income tax reciprocity payments are currently based on a 1995 benchmark study of tax year income tax returns. This study provided data about cross-border workers and income taxes foregone. The benchmark study results have been used since 1998 to calculate the annual income tax reciprocity payment that Wisconsin makes to Minnesota. The benchmark results are applied to a given year and adjusted for changes in: (1) total income tax collections; and (2) the most recent population estimates by county from the U.S. Census Bureau for both states. From Minnesota's perspective, the current income tax reciprocity payment structure with Wisconsin is problematic for three reasons⁵.

² Governor Anderson's 1973 proposal was to repeal income tax reciprocity. The proposal would have affected both Wisconsin and North Dakota.

³ Informational Paper 80, Education and Income Tax Reciprocity Agreements, Wisconsin Legislative Fiscal Bureau, January 2009, page i.

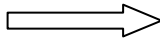
⁴ The Minnesota Senate also recommended termination at this point in the time but the Minnesota House of Representatives did not.

⁵ For additional background about the dispute regarding the calculation of reciprocity payments, see pages 5-8 and pages 25 to 26 in the *Report on the Advisability of Terminating Individual Income Tax Reciprocity with the State of Wisconsin* by the Minnesota Department of Revenue (March 2002). This report is available electronically from the Minnesota Legislative Reference Library. http://www.taxes.state.mn.us/legal_policy/other_supporting_content/reciprocity_report_2002.pdf

First, Minnesota contends that the methodology in the agreement for measuring net revenue loss is in conflict with the statute. This has been the source of a long dispute between Minnesota and Wisconsin, based on differing interpretations of statutory language. Preliminary estimates by Minnesota Department of Revenue (DOR) show that Wisconsin's failure to compensate Minnesota for the full revenue loss due to reciprocity costs Minnesota about \$3 million each year.

The table below provides an example of the differing interpretations for measuring net revenue. If cross-border workers were required to file returns in both states, many Minnesota workers would pay more in tax to Wisconsin than they now pay to Minnesota. But Minnesota limits the credit for taxes paid to other states to their Minnesota liability (on form [MI CR](#)). This results in a net loss to Minnesota under reciprocity. In the example in the table below, Minnesota's position on net revenue loss is \$2 million higher than under the current method, which deducts the full amount of the higher state income tax they would collect in the absence of reciprocity.

Table 1. Net Revenue Loss Interpretations⁶

	Minnesota Position:	Wisconsin Position: <i>Reflects Current Methodology</i>	Difference
	MN Tax on WI residents: \$64,758,000	MN Tax on WI residents: \$64,758,000	MN Tax on WI residents: \$0
<i>Item of Disagreement:</i> 	<i>MN Credit to MN Residents for Tax Paid to WI:</i> -\$14,839,000	<i>WI Tax on MN Residents:</i> -\$16,858,000	<i>Difference:</i> -\$2,019,000
	MN Net Revenue Loss: \$49,919,000	Current Payment: \$47,900,000	Revenue Loss to MN: -\$2,019,000

Second, the methodology does not adjust for changes in the percentage of each county's population that are cross-border workers. Minnesota contends that the number of Wisconsin cross-border workers is growing faster than the growth rate in state population calculated using the agreement methodology.

Third, there is a lag in reciprocity payments. This lag averages about 17 months and shifts revenue to later years. The current timing of the payments does not match the timing of Minnesota's actual income tax revenue loss. (Wisconsin reports that the interest payment to Minnesota is a cost to Wisconsin to the extent that the rate of interest required for payment exceeds actual interest earnings to the state).⁷

⁶ Report on the Advisability of Terminating Individual Income Tax Reciprocity with the State of Wisconsin by the Minnesota Department of Revenue (March 2002). Page 6.

⁷ Informational Paper 80, Education and Income Tax Reciprocity Agreements, Wisconsin Legislative Fiscal Bureau, January 2009, page 14.

Impact of Reciprocity on State Income Tax Revenues with Executive Actions

Governor Pawlenty proposed to permanently modify the reimbursement schedule so that the State of Minnesota would be reimbursed for losses closer in time to when the losses occur. If Wisconsin had agreed to accelerate the payment per the Governor’s request beginning with tax year 2010, Minnesota would have received half of the CY 2010 reimbursement in FY 2010 (by the end of June 2010) and half in FY 2011. Future reimbursements would have followed the same schedule.

That proposal would have provided a one-time shift forward of \$105.7 million in additional revenue into the FY 2010-11 biennium. To accelerate this payment per Minnesota’s request, Wisconsin would have needed to appropriate \$35 million in FY 2010 and \$70.7 million in FY 2011. There would be no additional revenue gain (or cost) to Minnesota in the FY 2012-13 biennium. Settle-up payments would have included interest.

With termination of the income tax reciprocity agreement (effective tax year 2010), there would be a permanent gain in state income tax revenue. Table 2 shows the estimated amount of new income tax revenue generated with termination. The FY 2010-11 biennium amounts would show a one-time increase of \$131 million or \$25.6 million more than the proposal to modify or accelerate the timing of the reimbursement payments. The FY 2012-13 biennium amounts of \$36.3 million show the amount of the on-going permanent revenue that would be gained by terminating reciprocity.

Table 2. Revenue Impact and Full Termination of Income Tax Reciprocity (Dollars in Thousands)	FY 2010-11 Biennium	FY 2012-13 Biennium
Estimated net increase in Income Tax Revenue (through Withholding from Cross-Border Residents). This would be new revenue not currently included in the forecast.	\$131,300	\$185,200
Cessation of Reimbursement from Wisconsin. This is income tax reciprocity agreement revenue that is currently included in the forecast for tax year 2011 and tax year 2012 that would no longer be owed to the state and would need to be subtracted from forecast tax revenue with termination.	\$ -	(\$148,900)
Total Estimated Increased Revenue*	\$131,300	\$36,300

* Administrative cost of processing more income tax returns in the absence of reciprocity would slightly offset the additional revenue gain. The administrative amount needed has not been determined and has not been included in this analysis.

According to DOR, terminating reciprocity generates more permanent revenue because:

- Income tax revenue would be paid to the state sooner, mainly through withholding (no time lag);⁸
- Net income tax revenue received would be higher than the payment received from Wisconsin including interest (there would no contention between Minnesota and Wisconsin about how to appropriately measure and allocate income tax revenue losses resulting from reciprocity);

⁸ In addition to withholding, revenue would also come from quarterly estimated payments (because reciprocity can also apply to the self-employed) and payments with the final return.

- In the first two years, there would be an overlap of income tax revenue from the new income tax withholding and the current law reimbursement payments received from Wisconsin for tax years 2008 and 2009. (Reimbursement payments for tax year 2008 and tax year 2009 would still be owed and because of the time lag are paid by Wisconsin to Minnesota in FY2010 and FY 2011). Since the reimbursement payments from Wisconsin are already included in the current law forecast, the revenue gain would come from the increased income tax withholding from cross border residents.

From Wisconsin's perspective, the termination of reciprocity creates a significant revenue loss in the first two years after reciprocity is ended. This loss to Wisconsin occurs because of the reimbursement lag under the current agreement. Wisconsin would still be liable for tax year 2008 and tax year 2009 payments to Minnesota.

The bottom-line based on analysis from DOR is that the current income tax reciprocity agreement with Wisconsin results in a revenue loss to Minnesota. The current reimbursement payment does not appropriately reimburse Minnesota for the full amount of revenue it would collect in the absence of reciprocity as outlined in the statute. The administrative action by the Governor to modify the timing of the current payment proposed in June 2009 would have: (1) eliminated the lag in reimbursement payments (but would not resolve any ongoing reimbursement issues related to the study methodology); and (2) provided the acceleration of reimbursement payment that has the effect of a one-time revenue gain in the FY 2010-11 biennium to the Minnesota budget.

Impact of Reciprocity on Taxpayers

According to DOR, 79,500 Minnesota and Wisconsin residents live in one state and work in the other and are affected by reciprocity. Of that number, there are about 57,000 Wisconsin residents who work in Minnesota and about 22,500 Minnesota residents who work in Wisconsin. So Wisconsin has more residents than Minnesota who cross the border into the other state for employment.

The proposal to accelerate the timing of the reimbursement would have no impact to Minnesota taxpayers, state agencies or employers. Changing the timing of the reimbursement would not change:

- taxpayer convenience (because taxpayers would still need to file/pay for the preparation of *one* tax return);
- taxpayer income tax liability (burden);
- administrative costs (increase or decrease) to state agencies for processing more income tax returns; and
- administrative impact to employers in terms of changing withholding for cross-border employees.

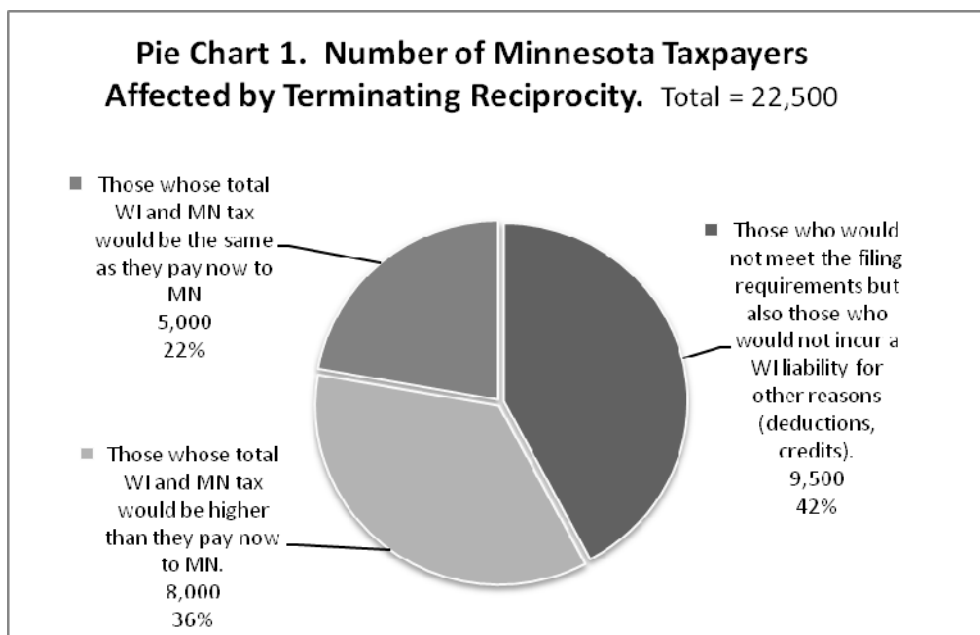
On the other hand, under termination, there is a quantitative impact in each of the areas listed above. The impact in each of these areas is described in the next section.

Taxpayer Convenience

Without 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.

As shown in pie chart 1, there would be about 13,000 Minnesota residents who would need to file two returns. This total is the sum of the following:

- 8,000 taxpayers whose total Wisconsin and Minnesota tax would be higher than they pay now to Minnesota.
- 5,000 taxpayers whose total WI and MN tax would be the same as they now pay to MN.



Source: Minnesota Department of Revenue, Tax Research Division, June 2009

Taxpayer Burden

In terms of income tax liability without income tax reciprocity, cross-border workers will pay the *greater* of the Minnesota or Wisconsin tax.⁹ If the Wisconsin tax is less than Minnesota tax, they would pay the same total tax, regardless of reciprocity. Ending reciprocity would make them file two tax returns and pay some tax in both states, but it would not change their total tax.

Over a wide range of incomes, Wisconsin tax liability exceeds Minnesota tax liability. Wisconsin has lower tax rates but its personal exemptions, standard deduction, and itemized

⁹ This results because the credit for taxes paid to other states (in both Minnesota and Wisconsin) is limited to the amount of tax that would be paid to the state of residency on that same income. If tax in the state in which the income was earned is higher, the credit does not offset the higher amount.

deductions are all considerably less generous than Minnesota's. For many taxpayers, Wisconsin broader tax base more than offsets Wisconsin's lower tax rates, resulting higher tax liability.¹⁰

Preliminary data from DOR show that the termination of reciprocity would raise taxes for an estimated 8,000 of the 22,500 Minnesota residents who work in Wisconsin. About \$3 million in additional revenue would be generated in a tax year, or about \$340 on average, per return. Put another way, the Wisconsin taxes on their personal income would be \$340 higher, on average, than the Minnesota taxes they pay on the same income. Appendix A provides more examples of a Minnesota taxpayer's burden with and without income tax reciprocity.

Administrative Impact to the State

Without reciprocity, DOR would incur more administrative costs. DOR estimates that about 33,500 of the 57,000 Wisconsin residents who work in Minnesota would have to file Minnesota returns. Additional administrative cost would be incurred for the printing and processing of more [MICR forms](#), [MINR](#) and [M1 forms](#).¹¹

Administrative Impact to Employers

Reciprocity results in additional administration for employers. First, Minnesota employers affected by reciprocity must keep track of MWR forms ([Reciprocity Exemption/Affidavit of Residency](#)) that are filed annually by employees. A copy of this form must be sent to the Department of Revenue in the state of employment each year. Second, Minnesota employers affected by reciprocity may be required to withhold tax for the state of residence based on nexus in the other state or for the convenience of the employee. Without reciprocity, employers would no longer need to file MWR forms. Also, state tax withholding would be the same for all employees and withholding would be remitted to only one state.

¹⁰ Effective tax year 2009, Wisconsin has enacted a new 7.75 percent top income tax rate bracket on annual income exceeding \$225,000 for individuals and annual income exceeding \$300,000 for married couples and has reduced its capital gains exclusion from 60 percent of long term capital gains to 30 percent.

¹¹ There will be a small fiscal impact with the elimination of reciprocity on property tax refunds (PTR). Under current law, Wisconsin residents cannot get a PTR as 183-day residents because the 183-day residency law does not apply to residents of income tax reciprocity states. Without reciprocity, some Wisconsin domiciliaries will be eligible for PTR as 183-day residents, creating a small general fund fiscal impact.

Final Observations

The table below highlights the major advantages and disadvantages of each tax policy scenario considered by the Governor.

Table 3: A Summary of Income Tax Reciprocity Scenarios Considered by The Governor

<i>Scenario A - - Accelerate Timing of Income Tax Reciprocity Payments</i>	
Advantages:	Disadvantages:
Provide a one-time increase in income tax revenue of \$105.7 million in the FY 2010-11 biennium.	The net revenue loss issue disputed by both Minnesota and Wisconsin would not be resolved and issues about the appropriate reimbursement for each state would linger.
	Payments from Wisconsin would be based on preliminary estimates (forecast revenues and population estimates). Settle-up payments based on actual collection data would still be needed.
<i>Scenario B - - Terminate Income Tax Reciprocity Agreement with Wisconsin</i>	
Advantages:	Disadvantages:
Provides a one-time increase in income tax revenue of \$131 million in the FY 2010-11 biennium. Income tax revenue would be paid to the state sooner through withholding with no time lag.	Increased taxpayer burden. Income tax liability for approximately 8,000 Minnesotans would increase in tax year 2010. On average, the estimated increase per return would be about \$340.
Provides a permanent revenue increase in income tax of about \$36 million in the FY 2012-13 biennium. Net income tax revenue collected from withholding would be higher than payments received from Wisconsin.	Increased taxpayer compliance costs. About 13,000 Minnesota taxpayers would be required to file two income tax returns and incur additional costs (time and financial) involved with preparing two returns.
Administrative time savings to Minnesota employers. Minnesota employers would need to process fewer MWR forms and would not have to withhold Wisconsin taxes. State withholding would be the same for all employees and withholding would be remitted to only one state (except for Michigan and North Dakota residents working in Minnesota).	Increased administrative costs to DOR. DOR would process more M1 CR forms and M1 NR forms from Minnesota residents. Also, about 33,500 additional filers from Wisconsin would need to file returns in Minnesota.

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Appendix A

DOR provided preliminary data on the taxpayer impact with the termination of income tax reciprocity for tax year 2008. The difference in tax with reciprocity and without reciprocity for a Minnesota taxpayer working in Wisconsin varies greatly depending on the taxpayer's income, filing status, total number of dependents and total itemized deductions. Two examples of taxpayer impact are provided:

Example A: Married Couple with 2 dependents Filing a Joint Return, with \$60,000 Income from Wages

Higher earning spouse, with 70 percent of total earnings (\$42,000) works in Wisconsin.

- With reciprocity, couple pays \$1,933 to Minnesota (and does not file in Wisconsin).
- Without reciprocity, they would pay \$1,995 to Wisconsin (on one spouse's earnings). Their Minnesota tax (on both spouse's earnings) of \$1,933 would be

	<i>With Reciprocity</i>	<i>Without Reciprocity</i>
Wisconsin tax	\$0	\$1,995
Minnesota Tax	\$1,933	\$ 580
Total	\$1,933	\$2,575
Difference		\$642
Percent change		33.0%

reduced to \$580 after receiving a \$1,353 tax credit from Minnesota for taxes paid to Wisconsin. The Minnesota Tax Credit of \$1,353 equals this amount because it is the Minnesota tax share times the Wisconsin share of income ($\$1,933 \times 70 \text{ percent} = \$1,353$). So their total tax without reciprocity would be \$1,995 to Wisconsin plus \$580 ($\$1,933 - \$1,353 = \580) to Minnesota, for a total of \$2,575. Without reciprocity, this couple pays 33 percent (\$642) more in total tax.

Example B: Single Individual with no dependents, \$50,000 Income from Wages

Minnesota resident working in Wisconsin (100 percent of total earnings earned in Wisconsin).

- With reciprocity, the individual pays \$2,468 to Minnesota
- Without reciprocity, the individual would pay \$2,693 to Wisconsin. The individual's Minnesota tax is reduced to \$0 by a \$2,468

	<i>With Reciprocity</i>	<i>Without Reciprocity</i>
Wisconsin tax	\$0	\$2,693
Minnesota Tax	\$2,468	\$ 0
Total	\$2,468	\$2,693
Difference		\$225
Percent change		9.0%

credit for taxes paid to Wisconsin. Without reciprocity, the individual pays 9 percent (\$225) more in total tax.