

Overview of Income, Corporate Franchise, Sales and Other State Taxes

**A Presentation to the
House Committee on Taxes**

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by

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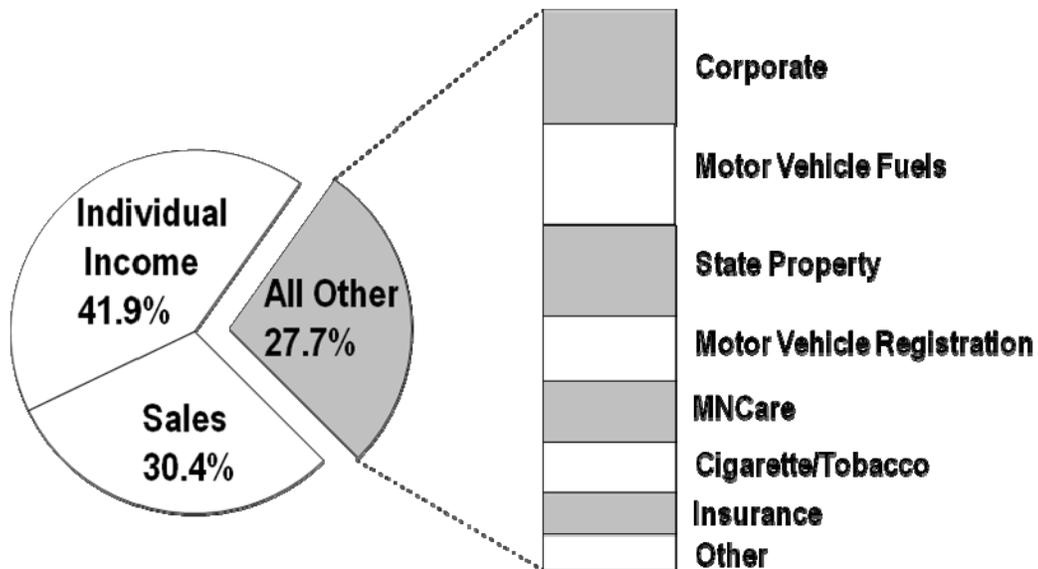
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State Taxes

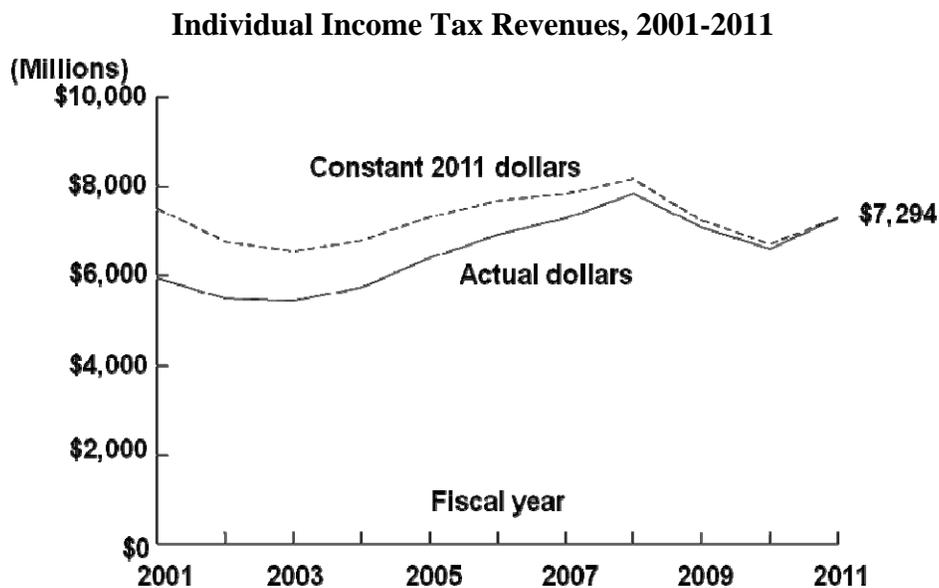
Minnesota State Tax Collections (\$17,399 million in FY 2011)			
Individual Income	\$7,294	Tobacco	\$424
Sales	5,284	Insurance Premiums	348
Corporate Franchise	968	Estate	154
Motor Vehicle Fuels	847	Mortgage and Deed	122
State Property	762	Alcoholic Beverages	77
Motor Vehicle License	545	Gambling	38
MNCare Taxes	503	Other	33

Most state taxes are credited to the General Fund. Some, however, are dedicated in whole or in part to other funds. For example, the Motor Vehicle Fuels tax is constitutionally dedicated to the Highway User Trust Fund. The data shown here lists the full amount of projected collections for all state taxes in fiscal year 2011, including those that do not go to the General Fund.



The Individual Income Tax

1. Individual Income Tax Revenues and Distribution of Tax Burden
 - a. **Revenues.** The individual income tax is projected to raise \$7.3 billion in revenue in fiscal year 2011. This includes \$59 million in projected reciprocity payments from the state of Wisconsin on behalf of Wisconsin residents who work in Minnesota. These payments will terminate with the ending (for tax year 2010) of reciprocity; the fiscal year 2011 payment is the final payment.



2. **Distribution of the individual income tax burden.** The Department of Revenue's 2009 *Minnesota Tax Incidence Study* estimated how the income tax burden was distributed across Minnesota households in 2006. Updated estimates (based on a newer tax sample and the November 2010 economic forecast) will be released in early March 2011. (See http://taxes.state.mn.us/legal_policy/Documents/other_supporting_content_2009_tax_incidence_study_links.pdf.) Because the income tax burden as a percent of income rises steadily from *negative* 0.9% of total income for the poorest fifth of Minnesota households to 5.1% of income for the richest fifth of Minnesota households (and 6.0% for the richest 1%), economists describe the income tax as a *progressive* tax.

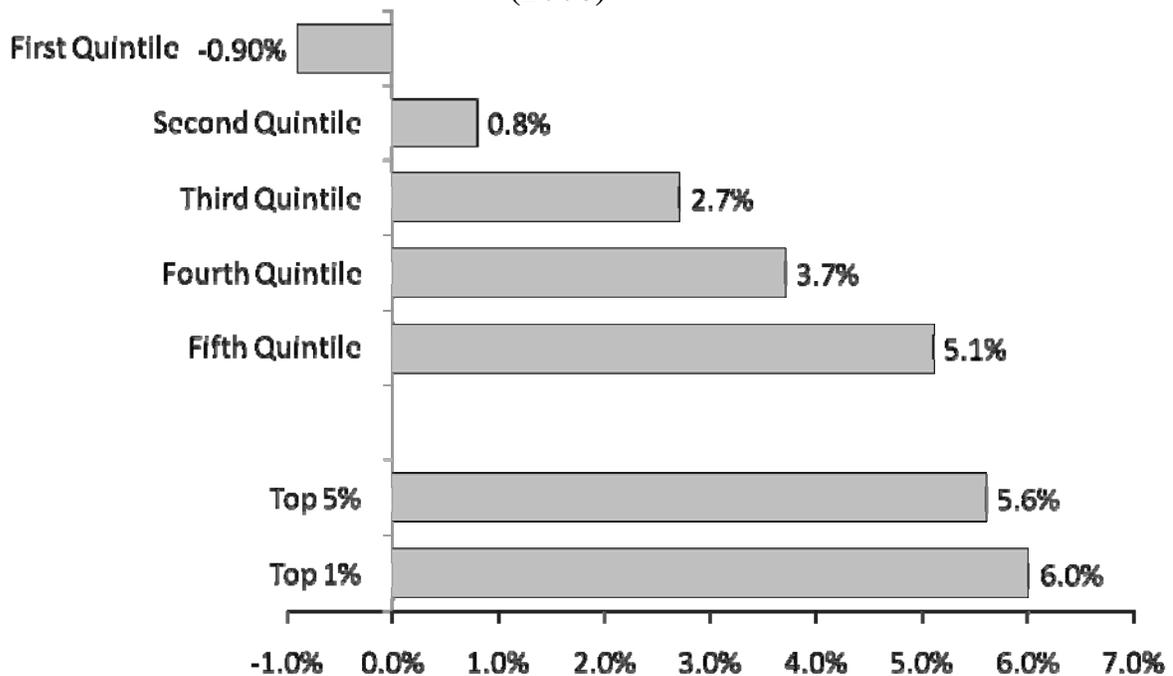
The richest fifth of Minnesota households (with 58.3% of total income) were estimated to pay 72.8% of the total individual income tax in 2006.

**Distribution of Individual Income Tax
 by Population Quintiles
 (2006)**

Quintile	Income Range	Percent of Total Income	Tax Paid (000s)	Percent of Total Tax	Effective Tax Rate
First	\$16,056 or less	2.8%	-\$39,649	-0.6%	-0.9%
Second	\$16,057 – 30,951	6.9%	95,944	1.4%	0.8%
Third	\$30,952 – 51,501	12.0%	540,186	8.0%	2.7%
Fourth	\$51,502 – 86,673	20.0%	1,234,261	18.3%	3.7%
Fifth	Over \$86,674	58.3%	4,910,979	72.8%	5.1%
Total	All incomes	100%	\$6,741,721	100%	4.1%
Top 5%	Over \$175,704	32.2%	2,985,160	44.3%	5.6%
Top 1%	Over \$447,889	17.2%	1,705,201	25.3%	6.0%

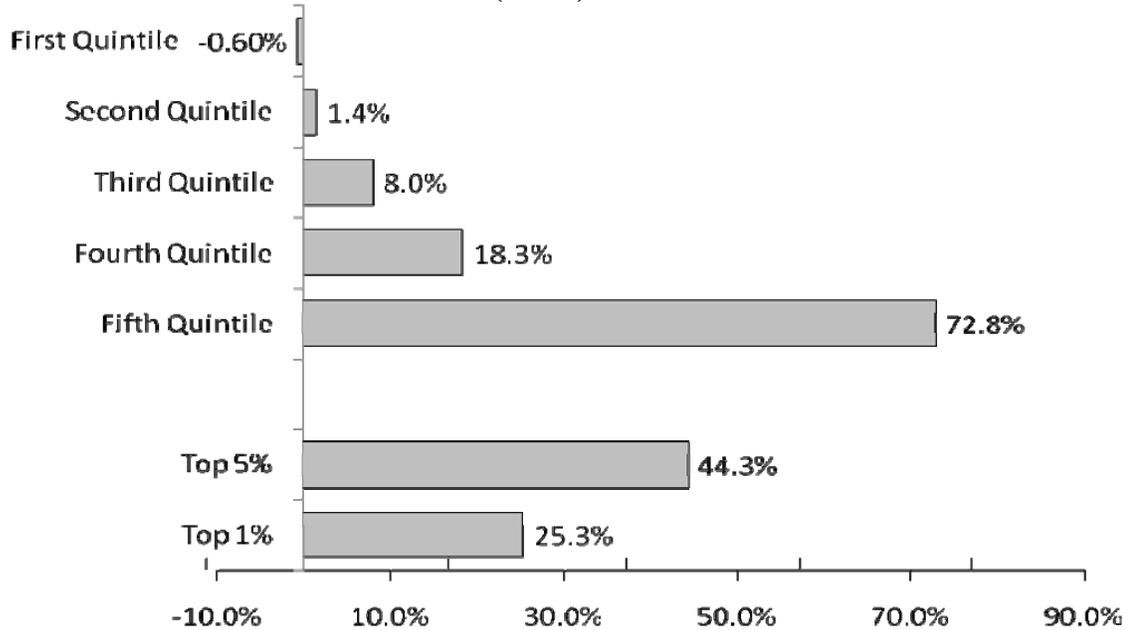
Source: MN Dept. of Revenue, 2009 Tax Incidence Study, page 29

**Income Tax Burden
 Effective Tax Rates by Population Quintiles
 (2006)**



Source: Department of Revenue, 2009 Tax Incidence Study

Income Tax Burden Distribution by Population Quintiles (2006)



Source: Department of Revenue, 2009 *Tax Incidence Study*

3. **Reliance on the federal tax.** The Minnesota individual income tax closely follows the federal individual income tax. It applies a progressive tax rate structure to taxable income, a measure of net income that is adjusted for family size (by allowing deduction of personal and dependent exemption amounts) and is reduced by a variety of deductions.
 - a. Taxpayers do much of the calculation of the tax base in filling out the federal form.
 - b. The law incorporates federal law by reference.
 - c. Federal compliance and enforcement efforts generally flow through to the state and vice versa.
 - d. **Policy implications.** The heavy reliance on the federal tax has some important policy implications.
 - i. Reliance on the federal tax makes it relatively easy for taxpayers to comply with and for the state to administer the tax.
 - ii. The state must regularly (usually annually) adopt changes made by congress to keep in close step with the federal tax.
 - iii. Minnesota's policy options are limited on basic issues of the tax base; the state is in a sense captive to congressional decisions.

- iv. Federal tax legislation enacted while the 2010 Legislature was meeting or after it adjourned has resulted in a separate schedule (M-1NC) for Minnesota taxpayers to make adjustments to federal taxable income for (among other items):
 - (1) fair market value of health coverage of adult children under age 27 excluded from income under an employer plan
 - (2) exclusion from adjusted gross income of IRA distributions to charities
 - (3) depreciation of restaurant property and certain leasehold improvements
 - (4) increased AGI limits on charitable deduction of contributions of capital gain real property for conservation purposes, with more generous rules for farmers and ranchers
- v. Federal tax legislation enacted after the 2010 Legislature adjourned resulted in extension to tax year 2010 of several items to which Minnesota has not conformed in the past. The Department of Revenue has included lines on form M-1M for these items, including:
 - (1) increased section 179 expensing – for tax years 2006 through 2009 Minnesota has required addition of 80% of the difference between the pre-2003 allowance and the increased federal allowance in the current tax year, with one-fifth of the amount added back then subtracted in each of the five following tax years
 - (2) bonus depreciation – Minnesota has required addition of 80% of bonus depreciation in the current tax year, with one-fifth of the amount added back then subtracted in each of the five following tax years
 - (3) additional standard deduction for real estate taxes and/or motor vehicle sales tax
 - (4) above-the-line deduction for classroom educator expenses
 - (5) above-the-line deduction for college tuition and fees

4. **Minnesota tax rates and alternative minimum tax**

- a. **Rates.** Minnesota's income tax rates for tax year 2011 are 5.35, 7.05, and 7.85%

Minnesota Tax Rates and Brackets, 1998-2009

Brackets for married joint filers*	1998	1999	2000 and after
\$0 to \$33,770	6%	5.5%	5.35%
\$33,771 to \$134,170	8%	7.25%	7.05%
Over \$134,170	8.5%	8%	7.85%

* Brackets shown are at 2011 levels; and are adjusted for other filing statuses

- b. **AMT.** Minnesota also has an individual alternative minimum tax (AMT) that uses a broader tax base and has a lower rate (6.4%). If an individual's tax is higher under the AMT than under the regular tax, the individual must pay the AMT. The AMT typically affects taxpayers with large amounts of certain deductions or preference items. The itemized deductions for property taxes and home mortgage interest and accelerated depreciation are the tax preferences that most often subject taxpayers to the Minnesota AMT. The 2006 tax law substantially increased the AMT exemption amounts, and reduced the number of taxpayers subject to the AMT to about 15,400 per year for tax year 2011.

5. Minnesota deductions and credits

a. Difference between deductions and credits

- i. **Deductions.** A deduction (also called a "subtraction") is a subtraction from taxable income. The value of a deduction equals a taxpayer's marginal tax rate multiplied by the amount of the deduction. As an example, a taxpayer in the 7.85% bracket who qualifies for a \$1,000 deduction receives a tax benefit of \$78.50 from the deduction. Low-income taxpayers may not benefit from a deduction. A taxpayer whose taxable income is reduced to zero by federal deductions and exemptions would not benefit from the same \$1,000 deduction.
- ii. **Credits.** A credit is a subtraction from tax liability. A nonrefundable credit can be used to reduce liability to zero. A refundable credit, in contrast, is paid to the filer as a "refund" if the credit amount exceeds liability. As an example, a taxpayer who has \$500 of liability and qualifies for a \$1,000 nonrefundable credit has his or her liability reduced to zero. In effect, this taxpayer only benefits from the first \$500 of the credit. If the credit were refundable, the filer would receive a \$500 refund in addition to having liability reduced to zero.

b. Minnesota additions

- i. Minnesota requires various types of income to be added to federal taxable income. These include:

- (1) Interest from municipal bonds of another state or political subdivision of another state (also federally tax-exempt dividends from mutual funds that invest in other states' municipal bonds)
 - (2) Expenses deducted federally that are attributed to income not taxed by Minnesota
 - (3) Additions resulting from explicitly not conforming to federal law:
 - a. Domestic production activities deduction
 - b. Section 179 expensing deduction
 - c. Bonus depreciation deduction
 - d. Federal subsidies received by employers for providing prescription drug coverage to retirees
 - (4) Additions resulting from federal law changes enacted during or since the end of the 2010 session
 - a. The fair market value of health coverage of adult children younger than age 27 excluded from income under an employer plan
 - b. Distributions made directly from IRAs to charities, and basis adjustments to other charitable contributions
 - c. Accelerated depreciation for various kinds of property
 - d. S corporation donations of appreciated property Educator expense deduction
 - e. Higher education tuition expense deduction (extended to tax year 2010)
 - f. Classroom educator expense deduction (extended to tax year 2010)
- c. **Minnesota Subtractions (deductions)**
- i. Minnesota conforms to federal itemized deductions, including deductions for mortgage interest, property taxes, charitable contributions, investment interest, casualty and theft losses, various business expenses, and medical expenses that exceed 7.5% of the taxpayer's adjusted gross income. Minnesota requires taxpayers to add back the federal itemized deduction for state income of sales taxes paid. This addition is limited to the amount that exceeds the federal standard deduction, so as to preserve the standard

deduction amount for all filers. Minnesota also disallows the additional standard deduction for real estate taxes.

- ii. Minnesota allows various state deductions. These include:
 - (1) Subtractions required by federal law:
 - a. Interest on U.S. government obligations
 - b. Railroad retirement benefits
 - c. On-reservation earnings of members of an Indian tribe
 - (2) Subtractions required by not conforming to federal law:
 - a. Portion of bonus depreciation added to MN taxable income in previous years
 - b. Portion of section 179 expensing added to MN taxable income in previous years
 - (3) K-12 education expenses (discussed more under the K-12 credit)
 - (4) Charitable contributions: taxpayers who do not itemize at the federal level may deduct 50% of charitable contributions that exceed \$500.
 - (5) Military pay
 - a. for active service and training performed outside Minnesota
 - b. for National Guard and reserve active service performed in Minnesota
 - c. for active service performed in Minnesota by nonresident members of the military
 - d. for National Guard and reserve training performed in Minnesota (starting in tax year 2009)
 - e. for active service performed in Minnesota by resident members of the military (starting in tax year 2009)
 - (6) Elderly subtraction
 - (7) Up to \$10,000 of unreimbursed expenses related to organ donation
 - (8) JOBZ business and investment income

- (9) Gain on sale of farm property if taxpayer insolvent
- (10) Foreign tax payments that exceed the federal foreign tax credit
- (11) Post-service education awards for service in AmeriCorps
- (12) Reciprocity subtraction (residents of Wisconsin, Michigan, and North Dakota)

d. **Nonrefundable Minnesota Credits**

- i. **Marriage penalty credit.** Designed to offset the penalty implicit in Minnesota's rate and bracket structure. As an example, in tax year 2011 single filers pay 5.35% on the first \$23,100 of taxable income, while married joint filers pay 5.35% on the first \$33,770 of taxable income. Without the marriage penalty credit, two people each with taxable income of \$23,100 would pay lower tax as single filers than if they married. As in this example, the rate and bracket structure imposes the largest penalty on married couples with relatively equal incomes; these couples qualify for the largest credit. Taxpayers determine their credit using a look-up table in the tax instructions. The credit amount depends on the couple's taxable income, and the earned income of the lesser-earning spouse. Earned income is defined to include taxable pension and social security income, since those types of income are tied to an individual's earnings history.

The maximum credit depends on the income tax rates in effect in a given year; for tax year 2011 the maximum credit is \$347. Total marriage penalty credits for fiscal year 2011 are projected at \$60.5 million with approximately 400,000 filers qualifying for credits annually.¹

- ii. **Credit for taxes paid to other state.** Resident taxpayers pay tax on all of their income, even if it is taxable in another state. If they pay tax on some of their income in another states (e.g., they earned income in another state or had investment income sourced to another state), they are allowed a credit against their Minnesota tax for taxes paid to the other state. The credit is intended to prevent this income from being subject to double taxation.
- iii. **Long-term care credit.** Taxpayers may claim 25% of long-term care insurance premiums paid as a credit, up to a maximum of \$100 per beneficiary (\$200 for married couples filing joint returns). The credit is only allowed for premiums that are not claimed as an itemized deduction for medical expenses at the federal level. Before tax year 2000, policies

¹ Projections of the cost of this and other credits are taken from the Minnesota Department of Revenue's *2010-2013 Tax Expenditure Budget*, available on-line at http://www.taxes.state.mn.us/taxes/legal_policy/Documents/other_supporting_content_2010_tax_expenditure_links.pdf.

had to include inflation protection in order to qualify for the credit. For tax year 2000 and following years, a taxpayer only has to have been offered inflation protection when purchasing the policy in order for the policy to qualify.

\$7.7 million in long-term care credit is projected for fiscal year 2011.

- iv. **Transit pass credit.** Taxpayers may claim a credit equal to 30 percent for the cost of transit passes provided to their employees. The credit applies to the employer's subsidy in providing the passes (e.g., the difference between the cost the employer incurs versus what it charges the employee). This credit is estimated to reduce revenues by \$100,000 for FY 2011.
 - v. **Credit for past military service.** Retired members of the military with at least 20 years of service or who separated due to a disability are allowed a \$750 credit. The credit is phased out for taxpayers with adjusted gross income (including military retirement income) in excess of \$30,000. In its first year of applicability (tax year 2009), 1,507 claimants claimed the credit, reducing tax revenues by \$1 million.
 - vi. **Section 125 health insurance credit.** New enrollees in a section 125 health insurance plan qualify for a credit equal to 20 percent of the first 12 months of premiums that they pay. To qualify, the taxpayer may previously not have had health insurance and must have household income within specified ranges of the federal poverty thresholds. (This is one of the few tax benefits that disqualifies individuals whose incomes are too low, not just because they do not have enough tax liability to take up the credit.) Tax revenues for FY 2011 are estimated to be reduced by about \$700,000 as a result of the credit; actual tax year 2009 claims equaled about \$44,000 from 122 individuals.
- e. **Refundable Minnesota Credits.**
- i. **Working Family Credit.** The working family credit, like the federal earned income credit, provides a wage supplement equal to a percentage of the earnings of low-income individuals. Up until tax year 1998, the working family credit equaled a percentage of the federal earned income tax credit. In 1998, Minnesota *decoupled* the working family credit from the federal credit, in order to structure the state credit to decrease the work disincentive faced by low-income filers leaving the state's cash public assistance program. Income eligibility for the federal and Minnesota credits are the same; everyone eligible for the federal credit is also eligible for the Minnesota credit.

The maximum credit in tax year 2011 is \$1,788 for claimants with two or more children; \$927 for claimants with one child; and \$116 for claimants with no children. The credit is subject to an income-based phaseout.

Filers become ineligible for the credit when their incomes exceed: \$40,889 for claimants with two or more children; \$35,999 for claimants with one child; and \$13,670 for claimants with no children. Both the maximum credit amount and the credit phaseout are indexed annually for inflation. Prior to tax year 2011, the phase-out was higher for married filers than for other filers (\$3,130 higher in tax year 2010).

In tax year 2008, 297,107 recipients claimed credits with an average credit amount of \$581. A total of \$183.4 million in working family credits are projected to be paid in fiscal year 2011.

- ii. **K-12 Education Credit.** A credit is allowed for qualifying K-12 education expenses. The credit equals 75 percent of qualifying education expenses. A maximum credit of \$1,000 per child for each child in grades K-12. The credit is subject to an income-based phaseout that starts at \$33,500 of income. For families claiming the credit for one or two children, no credit is allowed for incomes over \$37,500. The income limit increases by \$2,000 for each additional child claimed. The maximum credit amounts and income phaseout are not indexed for inflation.

Qualifying K-12 education expenses include academic tutoring, academic books and materials, fees paid for transportation, music lessons and rental or purchase of instruments, after-school enrichment programs and academic summer camps, and up to \$200 of computer hardware and educational software.

K-12 education expense deduction

In addition to the credit, a deduction for K-12 education expenses is allowed. The maximum deduction is \$1,625 for each child in grades K-6, and \$2,500 for each child in grades 7-12. The benefit depends upon the tax rate; a taxpayer in the top bracket (7.85%) would derive a \$196 benefit from a \$2,500 deduction. Taxpayers may not claim both the deduction and the credit for the same expenses. The same expenses qualify for the deduction as for the credit, with the exception that nonpublic school tuition qualifies for the deduction.

In tax year 2008, 54,031 recipients claimed the credit with an average credit amount of \$264. A total of \$13.2 million in K-12 education credit is projected to be paid in fiscal year 2011.

- iii. **Dependent care credit.** Minnesota's dependent care credit is tied to the federal credit, which equals a percentage of qualifying dependent care expenses paid to others so that the parent can work or look for work. The maximum Minnesota credit is \$720 for one child, and \$1,440 for two or more children. The credit is subject to an income-based phaseout that for tax year 2011 begins when income reaches \$23,720; taxpayers with incomes over \$37,370 are not eligible for the credit. The income phaseout is indexed annually for inflation, but the maximum credit is not. The dependent care credit uses the definition of qualifying expenses under the

federal dependent care credit. The Minnesota credit differs significantly from the federal credit, however. The federal credit is not refundable and is claimed mainly by middle and upper income taxpayers. The Minnesota credit, by contrast, is refundable and limited to lower income families.

In tax year 2008, 36,106 recipients claimed the credit with an average credit amount of \$392. A total of \$14.2 million in dependent care credits are projected to be paid in fiscal year 2011.

- i. **JOBZ jobs credit.** A refundable credit applies to proprietorships, S corporations, and partnerships (including LLCs) operating in Job Opportunity Building Zone (JOBZ) areas who hire additional higher paid employees. The credit effectively applies, at a 7% rate, to wages paid over \$30,000 and below \$100,000 (amounts are indexed for inflation since 2003).
- iv. **Military service credit.** Allows a refundable credit of \$120 for each month served in a combat zone or qualified hazardous duty zone during the tax year. An estimated 2,500 taxpayers will qualify for \$1.8 million in credits, for an average credit of \$720.
- v. **Bovine tuberculosis testing credit.** Allows a refundable credit equal to half the cost of testing cattle for bovine tuberculosis (25 percent for farms organized as corporations). The estimated cost for FY 2011 is \$100,000. The estimated cost per calf for testing is \$10. The cost fluctuates with the extent of tuberculosis in the state.
- vi. **Research credit.** The 2010 Legislature extended the longstanding research credit (often referred to as the research and development credit) under the corporate franchise tax to shareholders of S corporations and partnerships (including LLCs taxed as partnerships) subject to the individual income tax. The legislation also made the credit refundable. The credit's calculations are based on the similar federal credit, which applies to increases in expenditures for qualifying research over a base amount. The credit rate is 10 percent of the first \$2 million of qualifying expenditures and 2.5 percent of the amount over that. Qualifying expenses are largely for cost of paying employees (and for their supplies) who are engaged in qualifying research. (Purchases of long lived equipment does not qualify.) The estimated cost of credit for S corporations and partnerships in FY 2011 is \$1.1 million.
- vii. **Small business investment credit.** The 2010 Legislature enacted an angel investment credit, allowing qualifying investors in qualifying small Minnesota businesses to receive a credit equal to 25 percent of their equity type investments up to a maximum of \$125,000 (\$250,000 for a married joint filer). No business may receive investments qualifying for more than \$1 million in credits. To qualify businesses must be certified by the Department of Employment and Economic Development (DEED) and

must be involved in specified technology fields. They also may not be involved in certain prohibited lines of business. The credit sunsets in 2015 and is limited to \$12 million per year (\$11 million for tax year 2010), administered through the DEED certification process.

- viii. **Historic structure rehabilitation credit.** The 2010 Legislature also enacted a historic rehabilitation credit equal to the similar federal credit. Investors have the option of claiming this credit as a grant instead. The credit is equal to 20 percent of the qualifying costs of rehabilitating historic structures, with the grant equal to 90% of the credit that would otherwise be allowed. The estimated cost of the credit for FY 2011 is \$609,000. An additional \$548,000 is estimated to be paid as grants.
6. **Modeling capabilities.** Both House Research and the Fiscal Analysis Department use the House Research Income Tax Simulation (HITS) model to prepare estimates of the effect of changes to the income tax system. The model uses a sample of income tax returns and the growth assumptions made in the most recent economic forecast prepared by Minnesota Management and Budget. The Minnesota Management and Budget, the Department of Revenue and the Minnesota Senate use the same model to estimate the impact of income tax changes and in preparation of state revenue forecasts. Types of changes that can be modeled include changes to the rates, exemption amounts, deductions, and changes to the various credits.
7. **Historical Highlights**
- a. **1933: Enactment.** Tax was first enacted in 1933 with rates ranging from 1% to 5%. Minnesota was one of the first states to enact an individual income tax. (Wisconsin was the first state to do so.) Some features:
 - i. One rate schedule was used, i.e., no separate filing statuses for married couples, singles, and so forth. Each individual paid tax on his or her own income.
 - ii. Federal income taxes were deductible.
 - iii. A large number of itemized deductions were deductible.
 - iv. Personal credits were provided, rather than the exemption amounts.
 - b. **1961: Withholding tax.** Withholding tax was imposed in 1961. Before enactment of the withholding tax, all filers were required to directly pay the tax.
 - c. **1961: Tying tax to the federal tax.** In 1961, the tax was first directly linked to the federal income tax by adopting federal adjusted gross income as the starting point in computing the tax base.
 - d. **1970s: Rate Changes.** Various surtaxes and rate increases were imposed over the years. The “Minnesota Miracle” in 1971 was financed with a significant

increase in the rates. At one point during the 1970s the top rate was increased to 18%, although this rate was repealed before it went into effect. A top rate of 17% applied for a period of time in the 1970s; federal taxes were deductible, though.

- e. **1979: Indexing.** The 1979 Legislature indexed the tax bracket, standard deduction, and personal credit amounts for inflation.
- f. **Early 1980s: Temporary rate increases.** Temporary surtaxes were imposed and repealed during the recessions in the early 1980s, to help make up for downturns in state revenues.
- g. **1985: Closer conformity to federal tax.** The 1985 Legislature made major changes, including:
 - i. Substantial rate reduction
 - ii. Federal filing status rules (Before 1985, the Minnesota tax applied on an individual bases; with the adoption of federal filing status rules, the possibilities of marriage penalties and bonuses were created)
 - iii. Optional rate schedule with lower rates and no federal tax deduction
- h. **1987: Tax reform.** In the wake of the 1986 federal tax reform, the 1987 Legislature dramatically restructured the tax. The changes included:
 - i. Adopted FTI as the starting point for the Minnesota calculations. This had some important effects:
 - (1) Eliminated personal and dependent credits in favor of personal and dependent exemptions
 - (2) Eliminated the federal income tax deduction (at this point, the deduction was an option that subjected the taxpayer to a higher rate schedule)
 - (3) Adopted all the federal rules for itemized deductions
 - (4) Eliminated a number of state deductions, such as the pension exclusion, the deduction for military pay, and unemployment compensation exclusion
 - (5) Adopted federal tax reform changes, including the new passive loss rules, and the repeal of the 60% exclusion for capital gains and the sales tax deduction
 - (6) Major simplification – the tax was now reported on one page form with considerable “white space”

- ii. Reduced tax rates – top rate was now 8% (with “bubble” applying marginal rate of 8.5% to some taxpayers)
- i. **1991: Working family credit and rate increase.** In 1991, the legislature increased the top rate to 8.5% (“bursting the bubble”) and adopted the working family credit (Minnesota’s earned income credit). This credit began at 10% of the federal earned income credit. It has been increased in later legislative sessions so that the average working family credit claimed in Minnesota is about 33% of the average federal earned income credit claimed in Minnesota.
- j. **1997-1998: Property tax rebates.** In 1997 and 1998, the individual income tax system was used to provide large (about \$500 million each) property tax rebates.
- k. **1997: K-12 credit.** In 1997, the refundable credit for K-12 education expenses was provided, effective in 1998. In 2001 (effective for tax year 2002), the credit was limited to 75 percent of qualifying expenses.
- l. **1999-2000: Rate reduction.** In 1999 and 2000, the legislature enacted substantial across-the-board cuts in the tax rates. The bottom rate was reduced from 6% to 5.35% and the top rate from 8.5% to 7.85%.
- m. **1999: Marriage penalty credit.** The 1999 Legislature enacted the marriage credit to address the “marriage penalty” that results from the difference in widths between the married and single rate brackets (as described above under 5.d.i)
- n. **2000: Transit pass credit.** The 2000 Legislature enacted this credit to encourage employers to subsidize transit passes for their employees.
- o. **2006: Bovine Tuberculosis Testing Credit and Military Service Credit.** The 2006 Legislature enacted the Bovine Tuberculosis Credit in response to the appearance of Bovine TB in the state; feeder cattle must be tested before being shipped out of state until the federal government declares the state free of the disease. The military credit equals \$59 for each month of service in a combat zone of qualified hazardous duty area, retroactive to September 11, 2001.
- p. **2008: Credit for past military service, motor fuels credit, and expansion of military pay subtractions (all effective in tax year 2009).** The 2008 Legislature enacted a new credit for military retirees, phased out for those with income over \$30,000. It included in the Transportation Finance Law a credit intended to at least partially offset the motor fuels tax increase on taxpayers in the first income tax bracket. It also provided new subtractions for military pay for training in Minnesota, and for active service performed by Minnesota residents in Minnesota.
- q. **2009: Section 125 health insurance credit.** The 2009 Legislature enacted the section 125 health insurance credit for moderate income individuals who enrolled in these plans and did not previously have health insurance.

- r. **2010: Angel investment credit, research credit, historic rehabilitation credit.**
The 2010 Legislature enacted two refundable new credits, the angel investment credit and the historic rehabilitation credit, and extended the existing corporate franchise tax credit for research and development to S corporations and partnerships under the individual income tax credit. In addition, the research credit was made refundable. To finance the cost of these new credits, the motor fuels credit was repealed.

8. **Recent Trends in Policy Changes to Tax**

Surveying the last 15 years or so of changes to the Minnesota individual income tax system, three trends stand out.

- a. **Major reform and simplification early in the period.** During the 1985-87 sessions, the governor and legislature undertook major efforts to simplify and “reform” the tax. The pre-1985 tax was quite complex. It was out of step with federal tax in some respects (e.g., in using individual, rather than married couple, filing and using personal credits rather than exemptions). Furthermore, it reflected an accumulation of many policy decisions to use the tax system to further non-tax goals (e.g., encouraging solar energy, pollution clean-up, and conservation tillage, to name a few) and to make micro adjustments to achieve equity goals (e.g., personal credits, rather than exemptions). The 1985 and 1987 changes are quite remarkable in clearing the underbrush and ending up with a very simple tax that closely followed the federal tax with only a few unimportant differences.
- b. **Growing use of the tax to administer transfers and payments to businesses.**
A second trend, particularly during the 1990s, was the cooption of the tax as a mechanism for delivering income transfers and program payments. Policymakers have discovered that the tax provides a relatively efficient way make modest payments to large numbers of recipients using refundable credits. These credits are paid to recipients as refunds, when they exceed the recipient’s tax liabilities. Minnesota has long provided a refundable dependent care credit (since 1977), but this was a modest enterprise (few affected taxpayers and small cost). The 1990s saw the addition of two much larger transfer programs with the working family credit and the education credit. In 2006 Minnesota added two new refundable credits, for bovine tuberculosis testing costs and a credit analogous to a bonus for military service in combat zones since September 11, 2001. In 2008 Minnesota added two more credits (past military service and motor fuels for lower-income taxpayers, both effective in tax year 2009 with the first cost appearing in FY 2010). In 2009 another credit (the section 125 health insurance credit) was added, although this credit was nonrefundable. 2010 saw a net increase of two refundable credits with the enactment of three new credits (angel investment, historic rehabilitation, and research) and repeal of one refundable credit (motor fuels).

Below are the numbers claiming these credits in tax year 2008 and their projected costs in FY 2011. The costs include both the offset against tax and refund amounts.

Refundable Credit	Number Claiming*	FY 2011 Cost**
Dependent Care	36,106	\$14,200,000
K-12 Education	54,031	13,200,000
Working family	297,107	183,400,000
Bovine testing		100,000
Military service (combat zone)	2,500	1,800,000
Angel investment***	NA	17,000,000
Historic rehabilitation (including grants)	NA	1,200,000
Research	NA	1,100,000
* Dept. of Revenue, 2008 income tax processing data. ** Dept. of Revenue, <i>Tax Expenditure Budget FY 2010-13</i> ; and estimates prepared during 2010 session. *** FY 2011 cost includes tax year 2010 cost plus one-half of tax year 2011 cost		

- c. **Creeping complexity.** The 1987 Act was the high-water mark for simplification. Since then, the legislature has slowly been adding features to the tax for many of the same policy reasons that underlay the provisions that were repealed in 1985 and 1987. Some of these include:
- i. Elderly exclusion
 - ii. K-12 education credit
 - iii. Charitable contribution subtraction for nonitemizers
 - iv. Credit for long-term care insurance
 - v. Transit pass credit
 - vi. Marriage penalty credit
 - vii. Subtraction for disposition of farm property
 - viii. Subtraction for foreign taxes in excess of the federal foreign tax credit
 - ix. Subtraction for organ donation expenses
 - x. Bovine tuberculosis testing credit

- xi. Subtractions for various categories of military pay
- xii. Failure to conform to special federal depreciation and expensing rules under various federal laws
- xiii. Failure to conform to the educator expense deduction, and the tuition expense subtraction
- xiv. Failure to conform to federal changes enacted during the 2010 Legislature under the federal health care reform legislation.

Sales Taxes

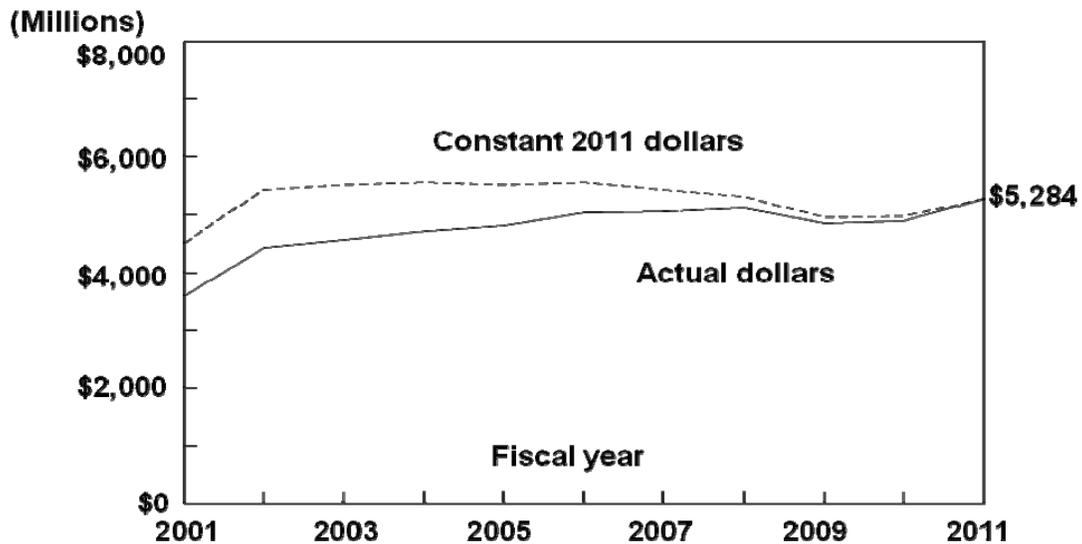
Minnesota is one of 46 states (plus DC) that levies a sales and use tax.

Amount of State Revenue Generated

The general sales tax, motor vehicle sales tax, and payments in-lieu of sales tax on lottery tickets will raise a combined \$5.3 billion in fiscal year 2011. \$4.5 billion is from the general sales tax, \$250 million from the rate under the Legacy Amendment (0.375% rate), \$479 million from motor vehicles sales tax and \$24 million from lottery tickets. Sales taxes account for slightly less than 1/3 of total state tax revenue.

Sales Tax Revenues

Sales Tax Revenues, 2001-2011



Distribution of the Sales Tax Burden

The *Minnesota Tax Incidence Study* estimates how the sales tax burden is distributed across Minnesota households. (See http://taxes.state.mn.us/legal_policy/Documents/other_supporting_content_2009_tax_incidence_study_links.pdf.)

Because the sales tax burden as a percent of income falls steadily from 6.0% of total income for the poorest fifth of Minnesota households to 1.8% of income for the richest fifth of Minnesota households, economists describe the sales tax as a *regressive* tax.

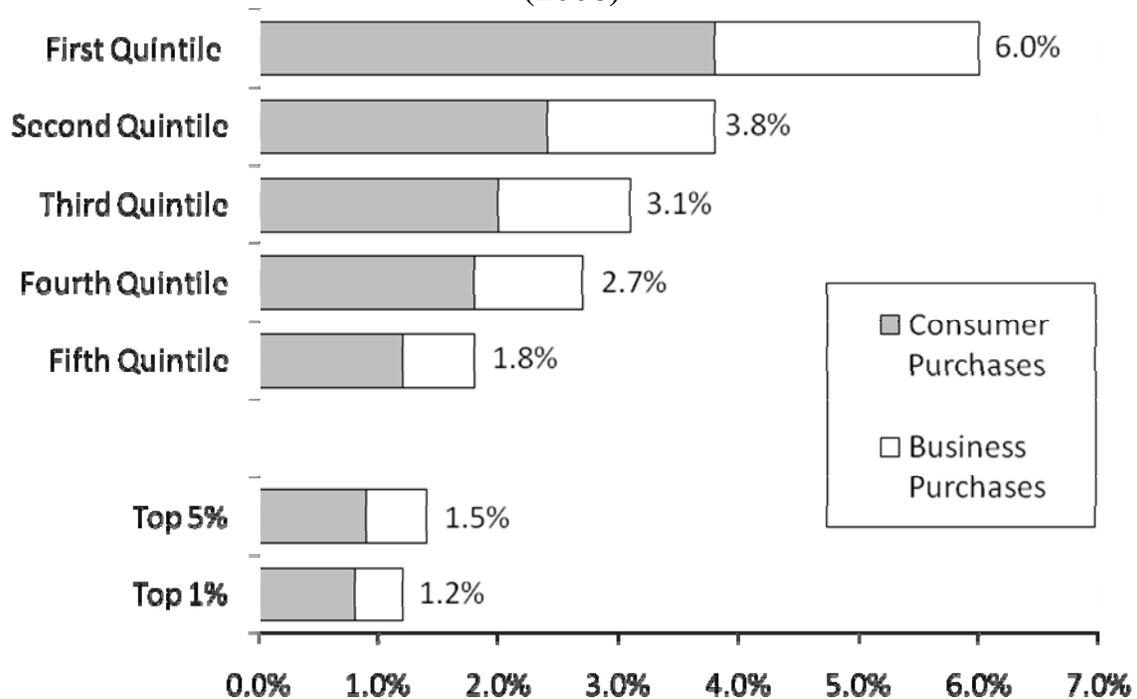
The richest fifth of Minnesota households (with 58.3% of total income) are estimated to pay 44.7% of the total sales tax.

**Distribution of Sales Tax Burden
 by Population Quintiles
 (2006)**

Quintile	Income Range	Percent of Total Income	Tax Paid (000s)	Percent of Total Tax	Effective Tax Rate
First	\$16,056 or less	2.8%	\$275,900	7.0%	6.0%
Second	\$16,057 – 30,951	6.9%	429,167	10.8%	3.8%
Third	\$30,952 – 51,501	12.0%	609,804	15.4%	3.1%
Fourth	\$51,502 – 86,673	20.0%	877,410	22.1%	2.7%
Fifth	Over \$86,674	58.3%	1,770,057	44.7%	1.8%
Total	All incomes	100%	\$3,961,618	100.0%	2.4%
Top 5%	Over \$175,704	32.2%	792,715	20.0%	1.5%
Top 1%	Over \$447,889	17.2%	338,874	8.5%	1.2%

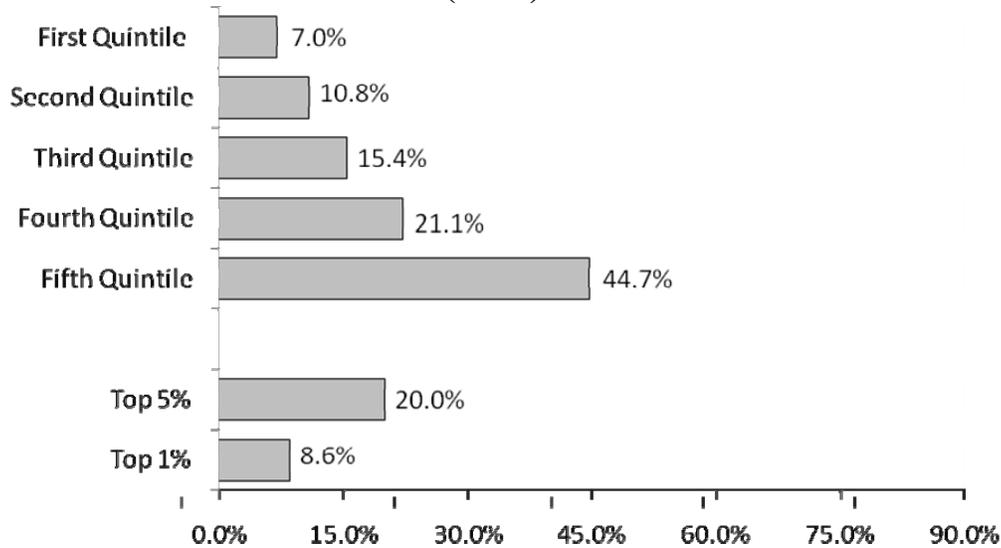
Source: MN Dept. of Revenue, 2009 Tax Incidence Study, page 29

**Sales Tax Burden
 Effective Tax Rates by Population Quintiles
 (2006)**



Source: Department of Revenue, 2009 Tax Incidence Study

Sales Tax Burden² Distribution by Population Quintiles (2006)



Source: Department of Revenue, 2009 Tax Incidence Study

Dedication of Revenue

Motor Vehicle Sales Tax (MVST). A constitutional amendment providing for the phase-in of a complete dedication of MVST revenues to transportation and transit funding passed at the 2006 general election. In FY 2007, 53.75 percent of MVST revenue went towards transportation purposes, and 46.25 percent remained in the general fund. In FY 2008 the percent dedicated to transportation purposes increased to 63.75 percent. The percent of MVST revenues dedicated to transportation is increasing by 10 percent a year and will reach 100 percent in fiscal year 2012.

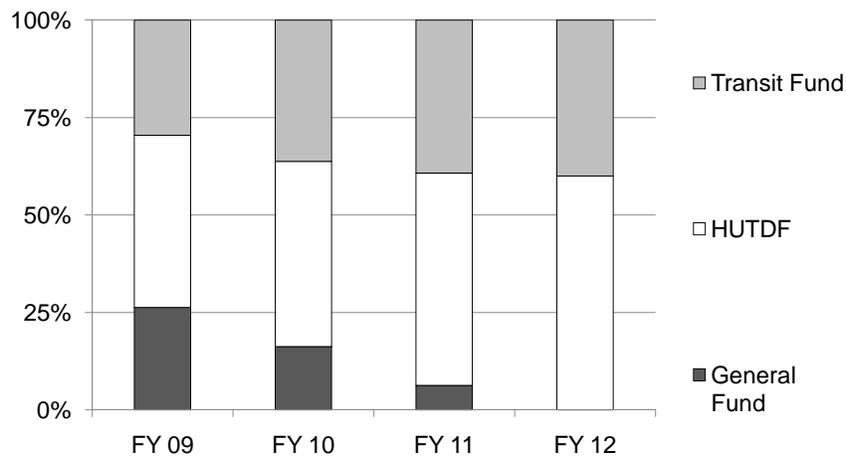
The constitutional amendment required that “no more than 60 percent” of the dedicated revenue go to the highway user trust distribution fund (HUTDF), and “not less than 40 percent” go towards public transit assistance (Minn. Const. art. XIV, § 13). The final distribution codified in statute is 60 percent to HUTDF and 40 percent to transit. Of the 40 percent dedicated to transit – 36 percent goes to transit in the metropolitan area and 4 percent goes to the Greater Minnesota transit fund. The estimated loss in revenues to the general fund is about \$326.4 million annually by FY 2012.

The original split of the transportation revenues during the phase-in period was proportional to the final split at full phase-in (i.e., 60 percent to HUTDF, 36 metropolitan transit, 4 percent Greater Minnesota transit). In 2009 the split during the phase-in was changed for FY 2010 and FY 2011. In both years the percentage going to HUTDF is reduced and in FY 2010 Metro Transit receives an additional amount equal to the lesser of 1.5% or \$6 million and the Greater

² Includes indirect effect of tax paid by businesses.

Minnesota Transit fund receives an additional amount equal to the lesser of \$1.25% or \$5 million. The additional payments in FY 2011 are the lesser of 1.5% or \$6.75 million; and the lesser of 0.25% or \$1.25 million respectively. The distribution of MVST revenues during the transition will be as follows.

Motor Vehicle Sales Tax by Fund (Percent)



Revenue from motor vehicle leases. Unlike motor vehicle sales, motor vehicle leases are subject to the general sales tax of 6.875% and are not subject to the constitutional dedication. During the 2008 session, revenues from the sales tax on motor vehicle leases were statutorily dedicated to transportation. The dedication, when fully phased in, was to equal the revenue from the tax on motor vehicle leases, minus the amount of revenue needed to fund a new low income motor fuel tax credit. 50 percent of the net revenues after the subtraction go to the Greater Minnesota transit account and the remaining 50 percent go to the county state-aid highway fund. The portion going to the state-aid highway fund is distributed to the counties in the seven county metropolitan area except for Hennepin and Ramsey Counties, based on county population.

The dedication began with FY 2010 revenues, which were paid in to the funds in FY2011. The dedication of net revenue is phased in on the same schedule as the MVST dedication. This means the percentage of revenue to be dedicated is:

- 83.75% of FY 2010 net revenue
- 93.75% of FY 2011 net revenue
- 100% of net revenues for all subsequent years

The low income motor fuels credit was repealed during the 2010 legislative session and the amount subtracted from the sales tax revenues from motor vehicle leases and kept in the general fund was changed to the following flat dollar amounts:

- \$30.1 million in FY 2011 and \$31.1 million in FY 2012
- \$32 million in FY 2013 and subsequent fiscal years.

For the FY 2011-12 biennium, the gross sales tax revenues from motor vehicle leases is less than the required subtractions so no money is being transferred to the Greater Minnesota Transit account or the county state-aid highway fund. It is anticipated that there will be no transfers out of the general fund until FY 2013 when an estimated \$1.8 million will be divided between the two dedicated funds. The dedication amount is estimated to be \$6.54 million in FY 2014.

In-lieu tax on lottery tickets. 72.43 percent of the revenue collected from the in-lieu tax on lottery tickets is deposited in various natural resources funds to fund natural resource conservation and enhancement, trails, and zoos. The remainder goes to the general fund.

The legacy amendment sales tax increase. In 2008, voters approved a constitutional amendment to increase the general state sales tax by 3/8th of one percent (0.375%). The additional rate will be imposed for twenty years, beginning July 1, 2009. The revenue raised by the additional tax is estimated to be \$249.8 million in FY 2011. The revenue is dedicated as follows:

Forecasted Legacy Amendment Fund Receipts (in millions)						
Fund	FY 2010	FY 2011	FY 2010-11	FY 2012	FY 2013	FY 2012-2013
Outdoor Heritage (33%)	75.9	82.4	158.3	84.7	87.4	172.1
Clean Water (33%)	75.9	82.4	158.3	84.7	87.4	172.1
Parks & Trails (14.25%)	32.8	35.6	68.4	36.6	37.7	74.3
Arts & Cultural Heritage (19.75%)	45.4	49.3	94.7	50.7	52.3	103.0
Total All Funds (100%)	230.0	249.8	479.8	256.7	264.9	521.6

Source: Minnesota Management and Budget Department, November 2010 forecast.

The rate increase affects all sales subject to the general sales tax under Minnesota Statutes, Chapter 297A. However, the rate increase does not apply to the motor vehicle sales tax (MVST), which is imposed under Chapter 297B. The MVST rate remains at 6.5 percent, although the tax on motor vehicle leases will increase to 6.875% since leases are taxed under Chapter 297A.

Rates

- General sales tax– 6.875%
- Short term motor vehicles rentals – 13.075%
- Manufactured housing and park trailers – 6.875% on 65% of the cost
- Motor vehicle sales taxes 6.5%

Like most states with a sales tax, Minnesota has a complementary “use tax.” If the seller does not collect the tax on a taxable item used in the state, the purchaser is responsible for submitting the tax owed. Most businesses pay use tax but few individuals do. In 1996, the state enacted a *de minimis* exemption for individuals. An individual does not owe a use tax unless his/her purchases subject to the use tax exceed \$770 per year (\$53 of tax liability).

The general rate changed in 2009. The sales tax rate was 3.0 percent in 1967 when it was enacted. The 1991 change was the enactment of the “optional” local sales tax of ½ percent. This “optional” tax was officially rolled into the state tax rate in 1994. On July 1, 2009, the rate increased to 6.875% due to the legacy amendment approved during the 2008 election. The increase in the constitutional amendment is only effective for 20 years; under current law the tax will revert back to 6.5% at the start of FY 2030.

<i>Period</i>	<i>Rate</i>
August 1, 1967 - October 31, 1971	3.0%
November 1, 1971 - June 30, 1981	4.0%
July 1, 1981 - December 31, 1982	5.0%
January 1, 1983 - June 30, 1991	6.0%
July 1, 1991 – June 30, 2009	6.5%
July 1, 2009 – June 30, 2029	6.875% ³
July 1, 2029 – future years	6.5%

Minnesota’s state sales tax rate is relatively high. Only the following six states have state rates as high as Minnesota (6.875%), as of January 1, 2010:⁴

California (8.25%) Indiana (7%) Mississippi (7.0%)
New Jersey (7.0%) Rhode Island (7.0%) Tennessee (7.0%)

However, many states have a number of *local* sales taxes and their combined state and local tax rate are in the 6% to 11% range. The maximum state and local combined sales tax rate in

³ The rate increase does not apply to the sales of motor vehicles. See the previous discussion on this rate increase.

⁴ Source: Federation of Tax Administrators. Nevada has a rate of 6.85%, almost as high as Minnesota.

Minnesota is 7.875% (in Duluth and Cook County). At least 15 other states have a maximum combined state and local tax rate of 8.0% or higher.

Tax rates increased for selected goods and services during the 1990s. The state used taxes on selected goods and services to raise small amounts of revenue (motor vehicle rental) or to pay for specific programs (waste disposal fees). If the state wants to continue to comply with the SSUTA, the ability to impose a different tax rate on specific goods will be limited.

<i>Service/good taxed</i>	<i>Additional Rate</i>
900 telephone service July 1, 1991 – June 30, 1995	\$0.50/call
Short-term motor vehicle rental enacted July 1, 1991, as a flat fee of \$7.50/rental and converted into a percent rate July 1, 1994	+6.2%
Residential waste fees enacted July 1, 1993, and moved to a separate tax (CH. 297H) in 1997	+\$2.00/year
Nonresidential waste fees enacted July 1, 1993, at the rate of \$0.12/cubic yard, increased January 1, 1995, and moved to a separate tax (Ch. 297H) in 1997	\$0.60 per cubic yard

Tax Base

In theory the sales tax is a broad-based tax levied on final consumption and not on intermediate goods, but in reality this is not true. In Minnesota the sales tax is a transaction tax rather than a consumption tax. Many final consumer purchases of goods and services are exempt, while a number of business purchases are taxed.

Final sales of most goods (personal property) and a limited number of services make up the tax base. Generally, goods are taxable unless specifically exempted and services are not taxable unless specifically included in the law. Improvements to real property are not taxable but purchases of construction materials are taxable. Sales of motor vehicles are exempt from the general sales tax in chapter 297A but subject to a comparable motor vehicle sales tax under chapter 297B.

A major share of the sales tax is paid by businesses rather than consumers. In theory, the sales tax is a tax on final consumption but the reality is that the tax is applied to a number of business purchases. According to the Department of Revenue's 2009 *Tax Incidence Study*, about 45 percent of the general and motor vehicle sales taxes are paid on purchases by business.

Exemptions

There has been a cumulative erosion of the tax base over time. When the tax was enacted in 1967 there were 14 exemptions in the exemption section of the statute (§ 297A.25). By 1990 there were 46 exemptions in § 297A.25 and other exemptions in separate sections or buried in definitions. The 2000 sales tax recodification effort identified 104 exemptions. There are currently 110 exemptions to the tax base listed in statute, although a sizable number of these are exemptions of business purchases. Major sales tax exemptions include:

General exemptions:

- Food for home consumption
- Clothing
- Home heating fuels
- Motor fuels subject to the per gallon motor fuels tax
- All drugs for human consumption
- Newspapers and subscription magazines
- Cigarettes⁵

Business exemptions:

- Capital equipment
- Farm machinery
- Certain direct inputs to agricultural and industrial production
- Certain direct inputs for some taxable services
- Telecommunications equipment
- Construction exemptions for certain businesses and nonprofits

Exemptions for certain entities:

- Purchases by school districts, the federal government and public libraries
- Purchase by local governments of marked public safety vehicles
- firefighting equipment
- Selected other sales to local governments
- Purchases by nonprofit charitable organizations including hospitals
- Certain sales made by nonprofit organizations
- Purchases made by qualifying businesses located in a Job Opportunity Building Zone (JOBZ)

Most base expansions have been as a result of a state fiscal crisis. The most recent expansion, the taxation of most installation and delivery charges enacted in 2001, was done partly to bring the state in compliance with the SSUTA. However, the 1992 expansion to include local government purchases was a result of three years of budget shortfalls and was an alternative to cutting local government aids. The other expansions listed were also in response to state budget shortfalls. They include:

⁵ When cigarettes were exempted from sales tax during the 2005 session, the tax was replaced with a per pack tax at the wholesale level. The per pack rate is 6.5% of the average retail price based on a survey. The survey is conducted every year. The tax can be found in Minn. stats. § 297F.25. In comparison other tobacco transactions are subject to the general sales tax rate of 6.875%.

<i>Item Added to the sales tax base</i>	<i>Effective Date</i>
Prepared food (e.g., restaurant meals, deli takeout)	7/1/81
Cigarettes (no longer subject to general tax)	1/31/82
Candy and soda	5/1/82
Admissions to recreation areas, tanning parlors, health clubs, etc.	6/1/87
Nonprescription drugs	6/1/87
State agency purchases and state and local government purchases of motor vehicles	7/1/87
Car washing, towing, and rustproofing; parking	7/1/87
The "1987 services": dry cleaning; laundry; alteration and repair of clothing, carpeting and drapes; building cleaning and maintenance; detective and security services; lawn services and tree trimming	10/1/87
Most purchases by local governments except school districts	6/1/92
Most installation and delivery charges	1/1/02

The legislature has followed a policy of reducing sales taxes on business inputs. This decision is consistent with the theory that the sales tax should be a tax on final consumption. Taxing business inputs is a hidden tax on final consumption since the tax paid on inputs is built into the price of the final good or service. If the final product is also subject to the sales tax, a tax on inputs results in tax "pyramiding." Major changes since 1987 that have reduced the sales tax on business inputs include:

<i>Change in taxation of the selected business inputs</i>	<i>Session enacted</i>
Reduce the rate on new and expansion capitol equipment from 4% to zero*	1987
Exempt mining equipment	1990
Began a phased reduction of the tax on replacement capital equipment from 6.5% to 2.0%	1994
Exempt special tooling	1994
Phase out the tax on replacement capital equipment from 2% to zero*	1996
Exempt inputs to the "1987" taxable services (similar to the existing exemption for inputs to agricultural and industrial production)	1997
Phase out the tax on farm machinery from 2.0% to zero by June 30, 2000	1998
Telecommunications equipment	2001
Purchases by qualifying businesses in JOBZ	2003
Miscellaneous construction exemptions for various agricultural and other processing facilities**	Various

<i>Change in taxation of the selected business inputs</i>	<i>Session enacted</i>
* Both these exemptions are administered as refunds. ** A number of the miscellaneous construction exemptions are also administered as refunds.	

Minnesota could broaden its sales tax base. Minnesota has a narrow base and there are a number of goods and services that could be added to the tax base. With a broader tax base, the same revenue could be raised with a lower tax rate. The following list of exempt goods and services (and the estimated revenue impact in FY 2011) is taken from a more complete list in the latest *Minnesota Tax Expenditure Budget*.

<i>Selected Examples of Potential Base Expansion</i>	<i>Revenue impact at 6.875% rate FY 2011 (\$ millions)</i>
Goods	
Food products	\$697
Clothing	297
Motor fuels	553
Residential heating fuels	130
Residential water and sewer	57
Newspapers and subscription magazines	66
Services	
Business services	\$2,147
Legal (consumer)	91
Motor vehicle repair (consumer)	122
Accounting (consumer)	13
Funeral services	19
Repair and maintenance of personal property	13
Personal care services	86
Other personal services	17
Purchases by exempt entities	
Schools	\$104
Hospitals and surgical centers	71
Nonprofit organizations (excluding hospitals)	88

<i>Selected Examples of Potential Base Expansion</i>	<i>Revenue impact at 6.875% rate FY 2011 (\$ millions)</i>
Local governments (excl schools & hospitals)	30

Source: Minnesota Department of Revenue, Tax Research Division, 2010-2013 *Tax Expenditure Budget*

Current Taxability of Selected Base Expansions in Neighboring States

T = Taxes E = Exempt

<i>Potential Base Expansion</i>	<i>State</i>				
	<i>Minnesota</i>	<i>Iowa</i>	<i>North Dakota</i>	<i>South Dakota</i>	<i>Wisconsin</i>
General Groceries	E	E	E	T	E
Clothing	E	T	T	T	T
Services:					
Motor vehicle repair	E	T	E	T	T
General repair	E	T	E	T	T
Legal	E	E	E	T	E
Accounting	E	E	E	T	E
Business	E	Mixed ⁶	E	T ⁷	E
Personal Services	Mixed	Mixed ⁸	E	T	Mixed ⁹

Source: FTA Report – State Sales Taxation of Services, April 1997 with 2002 updates.

External factors affecting the sales tax base

⁶ Iowa taxes a limited number of business-related services such as nonhuman laboratory testing, executive search firms, and temporary help agencies..

⁷ South Dakota taxes all services except those specifically exempted.

⁸ In addition to the services that are taxable in Minnesota, Iowa taxes a number of other services such as dance schools, dating services, mini-storage, investment counseling, household moving, interior decorating, bug and pest extermination, and barbers and beauticians.

⁹ Wisconsin taxes a limited number of personal services such as laundry, garment alterations, gift wrapping, fishing and hunting guide services and spas and tanning parlors.

The economy has changed from a goods based to a service based economy. Services accounted for 42.1 percent of personal consumption expenditures in 1965. By 2009, that share had increased to 66.7 percent. The sales tax base is growing at a slower rate than the total economy.

The Internet impacts the sales tax in multiple ways. The state cannot require remote sellers to collect the state tax (see Sales tax and remote sales below). Internet sales have increased the amount of total remote sales and therefore the lost tax revenue. The Department of Revenue's most recent estimate for the loss in 2011 is \$204 million with \$149 million due to e-commerce and \$55 million to catalog sales.¹⁰ The Internet also allows for the sale of digital goods (i.e., electronic greeting cards, downloaded music), which are not currently taxable. The substitution of digital goods for taxable tangible goods also erodes the sales tax base.

Sales tax and remote sales

There are limitations to the state's ability to collect the tax. The state cannot require a business to collect our sales tax unless it has a physical presence in this state (the legal term is nexus). The duty to collect is considered an undue burden on interstate commerce. The two main Supreme Court cases dealing with this issue are *Bellas Hess* in 1967 and *Quill* in 1992. In the past, mail order companies were the major remote sellers, but the Internet has provided a new opportunity for remote sales.

The court ruled in *Quill* that remote sellers do not have to collect the sales tax because it imposes an undue burden on interstate commerce. The ruling stated that the complexity of the different tax systems was too much of an administrative cost to business. The court stated that Congress could take action to overturn the ruling legislatively. Congress has proposed but not passed legislation that would make the duty to collect contingent on sales tax simplification by the states.

Streamlined Sales and Use Tax Agreement (SSUTA – formerly SSTP)

In January 2000, states realized that they would have to develop their own agreement to simplify and coordinate state sales tax systems. This was necessary if there was to be any chance of congressional or court action to require remote sellers to collect the sales tax; therefore the **Streamlined Sales Tax Project (SSTP)** was initiated. The SSTP was a voluntary effort supported by the National Governor's Council (NGA), National Council of State Legislatures (NCSL), the FTA, and the National League of Cities (NLC) to develop an agreement to simplify tax administration and collection among states, and develop standard *definitions* to be used by all states in defining their sales tax base.

¹⁰ This is the estimate loss of retail sales. A large share of the unpaid use taxes on business purchases are probably related to remote sales as well but are not included in this estimate.

The final Streamlined Sales and Use Tax Agreement (SSUTA) was adopted by the project on November 12, 2002. It has been amended several times since then, most recently in December 2010. Currently 24 states, including Minnesota, have adopted the required legislation and are members of the SSUTA. Four of the states are associate members, meaning they have adopted the conforming legislation and it will go into effect in the next year. Only member states are part of the governing board and may vote on changes to the agreement. The other states with a state sales tax are acting in an advisory capacity to the SSUTA governing Board.

Gross receipt taxes related to SSUTA. Minnesota was one of the first states to modify its sales tax law to conform to the agreement (mainly in the 2001 and 2002 sessions). One aspect of the agreement requires one tax rate on all taxable items except for sales of electricity, natural gas, or other heating fuels, and motor vehicles, aircraft, modular homes, manufactured homes, and mobile homes. The state could keep the separate rate on manufactured homes and rental cars but had to eliminate its sales tax rate of 9.0% on alcoholic beverages; therefore in 2005 the sales tax rate on alcoholic beverages was lowered to the general rate and a 2.5% gross receipts tax was enacted to replace the lost revenue.

Revenues associated with being a SSUTA member state. One benefit of participating in the SSUTA is that a number of businesses has come forward and voluntarily registered to collect the Minnesota sales tax, either directly with the state under its SSUTA amnesty provision, or through the SSUTA central registration system. For the period between 10/1/2005, when the agreement went into effect, until the end of FY 2010 the state has collected \$87.4 million in sales tax revenues from these businesses.

Current compliance with SSUTA. Every year each SSUTA member state undergoes an annual review to ensure they are still in compliance with all provisions of the agreement. In the fall of 2010 Minnesota was found to be out of compliance. The state includes “ring tones” in its definition of taxable telecommunications. The SSUTA includes ring tones in the definition of audio digital goods. To get back into compliance with the agreement the state must either exempt ring tones from the sales tax or begin taxing all audio digital goods (mainly downloadable music such as iTunes). The sanction for the state’s violation of the agreement has not yet been determined but could range from something as minor as loss of the state’s voting privileges to elimination of our participation in the SSUTA voluntary registration and collection program.

Local Sales Taxes

Authority to Impose

- Cities have a general authority to impose up to a 3% lodging tax for tourism purposes.
- In 1971 the legislature prohibited local governments from imposing or increasing a local sales or income tax. This means that all new local sales taxes or changes in existing local sales taxes require enacting a special law.
- In 1997 the legislature adopted local sales tax rules (Minn. Stat. § 297A.99) to be followed when authorizing any new local sales tax. The rules require that local sales taxes use the same base as the state tax, that it be a sales and use tax, and that the tax be

administered by the Department of Revenue. All older local sales taxes had to conform to these rules as well.¹¹

- The 2005 and 2006 sessions saw a resurgence of interest and authorization of local sales taxes. A number of new taxes were authorized and the authorities for existing taxes were extended.
- Several additional sales taxes were authorized or extended during the 2008 legislative session, General authority in the metropolitan area and in Greater Minnesota for counties to impose taxes for transit and transportation projects was also granted. The 2008 tax bill also enacted a provision prohibiting local governments from spending money advocating or promoting additional local sales tax bills. That provision expired June 1, 2010.
- No new general local sales taxes were authorized in 2009 or 2010 although several new food and beverage and lodging taxes were allowed.

General local sales taxes that are currently imposed:

- Duluth (1973) 1.0%
- Rochester (1983) 0.5%
- Minneapolis (1986) 0.5%
- Mankato (1991) 0.5%
- St. Paul (1993) 0.5%
- Hermantown (1996) 0.5%
- Two Harbors (1998) 0.5%
- Proctor (1999) 0.5%
- New Ulm (1999) 0.5%
- Central Minn. Cities (2002) 0.5 %
(includes St. Cloud, Sauk Rapids, Sartell, St. Augusta, St. Joseph, and Waite Park)
- Albert Lea (2005) 0.5%
- Bemidji (2005) 0.5%
- Willmar (2005) 0.5%
- Austin (2006) 0.5 %
- Baxter (2006) 0.5 %
- Owatonna (2006) 0.5 %
- Hennepin Co. (2006) 0.15%
- Clearwater (2008) 0.5%
- North Mankato(2008) 0.5%
- Cook County (2008) 1.0 %
- Metro Transit tax (2008) 0.25 %
(imposed by Anoka, Dakota, Hennepin, Ramsey, and Washington Counties)

Common characteristics of general local sales taxes

- Usually authorized to fund a specific “bricks and mortar” project
- Usually imposed at a 0.5% rate

¹¹ Duluth’s local sales and use tax is an anomaly. It was enacted in 1973 and for 10 years was the only local sales tax in the state. It tends not to follow general practices. There is no requirement that proceeds be spent for a specific purpose, and there is no expiration provision.

- The tax does not usually extend to motor vehicles although many have an alternative flat \$20 tax on motor vehicles sold by local dealers
- Normally has an expiration provision – the tax either expires when a certain amount has been raised or on a certain date
- In recent years all have required a local referendum at the next general election

Local governments with authority to impose a tax

- The two remaining metro area counties (Carver and Scott) may, by resolution, impose the 0.25% transit tax already imposed by the other metro area counties in the future
- Any county not imposing the 0.25% transit tax may impose a 0.5% tax for transportation purposes with voter approval.

The Corporate Franchise Tax

2. The Basics

- a. **Tax base** is net income of “C” corporations. The tax applies only to C corporations. S corporations, partnerships, and other “pass-through entities” (such as RICs, REMICs, and REITs) are generally not subject to the corporate tax. Most base concepts roughly follow the federal income tax – federal depreciation rules are used and so forth. However, the state deviates on a number of items of modest importance, including (ranked based on revenue importance):
 - i. Dividend received deduction (This deduction is intended to avoid taxing income to corporate entities more than once; federal law has a similar, but not identical, deduction.)
 - ii. Foreign source income and foreign operating corporation provisions
 - iii. Exemption for insurance companies (They pay a gross premiums tax instead.)
 - iv. The special temporary federal depreciation rules (“bonus depreciation”) enacted in 2002, 2003, and 2008 through 2010 do not apply.
 - v. The section 179 expensing rules do not apply.
 - vi. Income attributable to operating in a Job Opportunity Building Zone (JOBZ) is exempt from taxation.
- b. **Apportionment formula.** For multi-state corporations, a state can constitutionally tax only income fairly attributable to the state. Thus, a method must be used to determine the income attributable to in-state activity. All states do this with an apportionment formula; most use a 3-factor formula.
 - i. **3-factor formula.** Minnesota uses a 3-factor formula based on the Minnesota shares of property, payroll, and sales. The formula is used to derive a fraction that is multiplied by total income to determine the Minnesota proportion of each factor. The 2005 Legislature provided for phasing-in apportionment based only on the sales factor, over a period of eight years (2007 – 2014). The phase-in schedule is listed below in section 6a. The weighting of the factors for tax year 2011 is:
 - (1) Property (Minnesota property/total property) – 5%
 - (2) Payroll (Minnesota payroll/total payroll) – 5%
 - (3) Sales (Minnesota sales/total sales) – 90%

- ii. **Combined reporting.** For complex corporations (i.e., those with multiple corporations, such parent-subsidiary or brother-sister corporations), Minnesota uses a system of combined reporting for unitary businesses. This method requires each corporation in a unitary group to calculate its tax based on the total income of the unitary group, using its own factors as the numerator and the total group's apportionment factors as the denominator. This method prevents most transactions among related corporations in the unitary group from affecting the total tax liability of the group. State corporate taxes that do not use this method allow corporations to artificially shift income (e.g., through "transfer pricing" among the related corporations) to states in which income is lightly taxed or is not taxed at all. Minnesota has used combined reporting since 1982.
- c. A **tax rate** of 9.8% applies to Minnesota taxable income.
- d. **Tax credits.** Corporations are allowed various credits. These include:
 - i. **Research credit.** This credit applies to increases in research and development expenditures over a base amount. This credit roughly follows the federal credit, except it is limited to research conducted in Minnesota and is refundable (starting tax year 2010).
 - ii. **Credit for taxes paid to another state.** This credit is intended to prevent the same corporate income from being taxed by Minnesota and another state. It applies in very few circumstances, since apportionment prevents most double taxation. The credit applies when another state assigns (rather than apportions) income and Minnesota taxes the same income (either by assignment or apportionment).
 - iii. **Enterprise zone credits.** These credits apply to certain activities in border city enterprise zones, if the credits are granted by the cities with the enterprise zones.
 - iv. **JOBZ job credit.** A refundable credit applies to corporations operating in Job Opportunity Building Zone (JOBZ) areas who hire additional higher paid employees. The credit effectively applies, at a 7% rate, to wages paid over \$30,000 and below \$100,000 (amounts are indexed for inflation since 2003).
 - v. **Historic rehabilitation credit.** A refundable credit applies equal to the comparable (nonrefundable) federal credit, effective beginning for tax year 2010.
- e. **Alternative minimum tax.** An AMT applies under which corporations are required to compute their tax using a broader tax base (less generous depreciation allowances and so forth) and lower rate (5.8%). If the AMT is higher than the regular tax, the corporation must pay the AMT amount.

- f. **Minimum fee.** This tax is not limited to C corporations, but also applies to S corporations and partnerships (in all of their various incarnations: regular partnerships, limited liability companies, limited liability partnerships, and so forth). The tax ranges from \$100 to \$5,000, depending upon the size of the business measured by Minnesota property, payroll, and sales. The fee schedule is shown in the box below. The fee is an add-on minimum tax. A corporation pays the minimum fee, regardless of the amount of regular tax (or AMT) that is paid.

**Corporate Franchise Tax
Minimum Fee Schedule**

Property, Payroll and Sales	Fee
less than \$500,000	0
\$500,000 to 1,000,000	\$100
\$1,000,000 to 4,999,999	\$300
\$5,000,000 to 9,999,999	\$1,000
\$10,000,000 to 19,999,999	\$2,000
\$20,000,000 or more	\$5,000

3. **Revenues**

- a. **Overview.** The corporate franchise tax is a relatively minor source of state revenue. It is estimated to provide about 3% of nondedicated general fund revenues for FY2011.
- b. **Amount.** For fiscal year 2011, Minnesota Management and Budget estimates that the corporate franchise tax will raise \$0.8 billion (November 2010 forecast). As noted above, revenues from the tax are among the most volatile of the major state tax sources. For example, they have ranges from \$529 million in FY2002 (during a recession) to \$1,171 million in FY2007 (during end of the last expansion). This was a 121 percent increase in revenues over a 5-year period. For FY 2010 they dropped back to \$663 million, a 43 percent decline in a 3-year period.
- c. **Characteristics of revenues.**
- i. **Elasticity.** Revenues from the tax are elastic; they grow as the economy and corporate profits grow. However, increased use of pass-through entities and other factors have dampened this effect somewhat. For example, S corporations have grown from 22% of all corporations filing federal returns in tax year 1985 to over 55% in 1999. (Minnesota and federal status are the same.) “Check-the-box” rules have made it easier to

operate in partnership form. Until recently, corporate profits have not always grown as fast the overall economy. Use of various tax shelters mechanisms (including the foreign income provisions under Minnesota law) likely also reduced corporate tax revenues somewhat. The net result is that corporate tax receipts have lagged somewhat.

- ii. **Volatility.** Revenues from the corporate franchise tax are the most volatile of the major state tax sources. The table below provides examples of the effect of the 1981-82, 1990-92, 2001-02, and the 2007 to 2009 recessions on corporate tax revenues. As can be seen, for the 1981-82, 2001-02, and the projections for the current recession, revenues declined by one-third or more. These numbers do not take into account inflation (high during the early 1980s) and that several legislative changes were made to increase revenues in 1981-82 and 2006-2008 periods. In 2008, DOR estimated that legislated changes would raise corporate franchise revenue by about \$90 million per year, making the FY2006 to FY2010 changes even larger, if the comparison were made on a constant base. By contrast, 2002 revenues are slightly lower as a result of legislative changes (increasing the sales factor used in apportioning income).

**Corporate Franchise Tax Revenues
 Peak to Trough Change During Recessions**

Fiscal Year	Revenues (millions)	Percent change
1980	\$381.2	-33.3%
1983	254.3	
1990	478.9	-12.2%
1992	420.3	
2000	800.1	-33.8%
2002	529.5	
2007	1,171.1	-43.3%
2010	663.5	
Source: MN Management & Budget		

Revenues also increased by over 47% between FY2004 and FY2005, providing further evidence of the volatility. This large increase appears mainly to be attributable to the recovery of corporate profits after the recession.

4. Historical Highlights

- a. The tax was enacted in 1933 (at same time as the individual income tax) with graduated rates from 1% to 5%. These were the same as the individual income

tax rates. As with the individual tax, federal tax was deductible. In 1937, the rates were converted to a flat rate of 7%.

- b. In 1939, the legislature allowed manufacturing corporations to use sales weighted (70%) apportionment.
- c. In 1953, the weighted apportionment option was extended to all corporations (not just manufacturers).
- d. Over the years the legislature has changed the rate of the tax several times, imposed surtaxes, and adopted various minimum tax mechanisms.
- e. In 1971, the federal income tax deduction was repealed and rates were raised to 12%. This was done to raise money to finance the “Minnesota Miracle.”
- f. In 1982, the research credit was enacted and combined reporting apportionment was adopted.
- g. In 1987, the tax was significantly restructured in response to federal tax reform. This involved adopting the tax base expansions that were part of federal tax reform, requiring all taxpayers to use weighted apportionment, reducing the tax rate (9.5%), and adopting the “factors” minimum tax.
- h. In 1988, the legislature enacted provisions granting preferential treatment to various types of foreign source income.
- i. In 1990, the rate was increased from 9.5% to 9.8%.
- j. In 1999, the legislature increased the sales weighting of the apportionment formula to 75%-12.5%-12.5% (effective tax year 2001).
- k. In 2005, the legislature adopted an 8-year phase-in of 100% sales apportionment.
- l. In 2008, the legislature rewrote the preferences for income received from foreign sources or by certain corporations with foreign operations, so these preferences were limited to income derived from foreign sources as provided under federal law.

5. Recent Trends in Policy Changes to the Tax.

- a. **Minnesota.** There have been few policy changes to the corporate franchise tax in the last decade. Major changes were made in response to federal tax reform (in 1986) and its aftermath. In the late 1980s and early 1990s, the minimum tax was restructured to eliminate the “factors tax.” Proposals have been made to move toward 100% sales apportionment, but other than the baby step taken in 1999, nothing has been done on this.
- b. **Foreign source income provisions.** In 1988, Minnesota adopted a series of interrelated provisions governing the taxing of foreign source income. These

provisions were enacted in response to the adoption of combined (or unitary) reporting in 1982. These provisions essentially allow certain qualifying domestic corporations (“Foreign Operating Corporations” or FOCs) to exclude 80 percent of their income from taxation. This is done on the theory that these corporations – which were intended to be primarily (defined at 80%) conducting foreign operations – would be afforded similar treatment to true foreign corporations. The law also allows exclusion of 80 percent of the foreign royalty and similar income paid by foreign corporations or FOCs. These provisions have been in place for 21 years. In 2005, the legislature modified the law to require FOCs to have substantial property (at least \$2 million) and payroll (\$1 million) in foreign countries to qualify. This was done to reduce the ease of shifting domestic source income into “shell” type corporations and qualifying for the reduced tax rates that apply to this income. A 2005 Minnesota Supreme Court decision made it clear that corporations that follow the required form under the law will qualify for the preferential tax treatment. In 2008, the legislature limited the preferential treatment for FOCs and for foreign royalty and similar to income meeting the rules defining foreign income for federal income tax purposes. For more detail on FOCs and these provisions, see the House Research Department website.

- c. **Other states.** The general trend in other states is to increase the sales weighting of the apportionment formulas. A fair number of states have gone from equal weighting to double sales weighting and a few states have gone to 100% sales apportionment for some or all types of businesses. Many separate reporting states have adopted provisions designed to minimize the effect of tax avoidance structures used by multi-state corporations (in particular holding companies for intangibles that are based in Delaware or Nevada). These provisions typically disallow the deduction of expenses (e.g., payments to holding companies for intangibles that are intended to shift income to states where such income is not taxed – typically Delaware or Nevada). Several states have adopted combined reporting rules – e.g., Massachusetts, West Virginia, and Wisconsin – and combined reporting is under consideration in more states (e.g., it is being proposed by various policy makers in Pennsylvania and Maryland).
- d. **Fundamental restructuring.** The tax theory underpinning the tax is shaky, at best. Public finance experts have always been very dubious about the theory of a corporate income tax. They typically favor the use of value added taxes or VATs. Three states, Michigan, Ohio and Texas, have recently restructured their corporate taxes by shifting to gross receipts taxes or a combination of gross receipts and profits taxes (Michigan). Proposals have been made in other states to restructure or repeal corporate taxes.
 - i. **Proposals in other states.** Some of the states in which they have been proposed by governors or tax study commissions include
 - (1) Utah
 - (2) Montana

- (3) West Virginia (tax study commission)
- (4) Louisiana
- (5) Nevada

These proposals have generally not resulted in enacted tax changes. The state of New Jersey made major changes in its corporate tax in 2002, based on the recommendation of its governor to raise revenues. These changes, however, were largely intended to address problems (income shifting by corporations) that arise under a state tax using separate reporting. Minnesota already uses combined reporting and thus its tax is not as susceptible to this type of manipulation.

- ii. **Laws in other states.** New Hampshire (as a minimum tax that is added to its corporate income tax) has a VAT tax as a business tax. (Michigan previously had a VAT, but repealed it in favor of a gross receipts and profits tax combination.) Michigan, Ohio, Texas, Washington, and West Virginia have gross receipts based business entity taxes. These taxes are not as volatile as profits based taxes, but are not favored by experts because they can result in pyramiding or multiple tax burdens. Like a sales tax on business inputs, they favor vertically integrated businesses.
- iii. **Minnesota.** In Minnesota, the Senate passed a VAT twice (in 1997 and 1998), not as a replacement for the franchise tax, but as a source of revenue to pay for property tax reform. A University of Minnesota economics professor completed a study of replacing the Minnesota corporate franchise tax with a VAT style tax for the Legislative Coordinating Commission in 2005.

6. Policy Issues and Perspectives on the Tax

- a. **Tax falls unevenly on businesses.** The tax applies only to C corporations. Businesses doing business in other forms (partnerships, S corporations, and so forth) are not taxable. C corporations tend to be larger businesses. Most publicly held corporations are C corporations. As a result, the tax becomes, in effect, a toll charge on being a public company with access to public securities markets.
- b. **Tax incidence is unclear.** Experts differ on the incidence of the corporate tax. The popular perception is that the tax is progressive; these (non-expert) observers apparently think the tax falls on owners of corporate stock who have high incomes. This may be true for the federal tax. For a state tax, the ability of capital to flow across state borders to seek its highest return limits the ability of a state to tax capital. Thus, for a high tax state like Minnesota, a portion of the tax probably shifts forward to consumers or backward to labor. The 2009 Tax Incidence Study (p. 104), prepared by the Department of Revenue, estimates that Minnesota consumers bear 48% of the tax, Minnesota labor 8%, and Minnesota

capital 5%. The rest of the tax (39%) is borne by nonresidents, much of which is likely borne by capital.

- c. **The tax is a hidden tax.** Despite repeated surpluses and calls for tax cuts of many types during the 1990s, the corporate tax rarely showed up on the lists of popular candidates for cutting. This reflects an obvious fact: few people are even vaguely familiar with or care about the tax. The tax is imbedded in prices. Real people only pay it in the prices they pay for goods or services or in reduced wages (or returns on capital). In short, most don't know they're paying it. The hidden nature of the tax raises accountability concerns, but makes the corporate tax politically popular.
- d. **The tax may cause competitive problems.** There is some empirical evidence that a high corporate tax can cause states problems in competing for new investment. This conclusion is controversial and other studies find it to not be the case. However, economic theory would suggest it is so.

7. Sales Weighting and Apportionment

- a. In the 2005, the legislature enacted a governor's recommendation to adopt an 8-year phase-in of 100% sales apportionment. Periodically proposals are made to accelerate this phase-in, but none of them have been enacted into law. Business groups may advocate for accelerated implementation of 100% sales apportionment. Thus, it is useful to review the effects. The table shows the phase-in schedule.

Tax Year	Sales	Property	Payroll
2007	78%	11.0%	11.0%
2008	81%	9.5%	9.5%
2009	84%	8.0%	8.0%
2010	87%	6.5%	6.5%
2011	90%	5.0%	5.0%
2012	93%	3.5%	3.5%
2013	96%	2.0%	2.0%
2014	100%	0.0%	0.0%

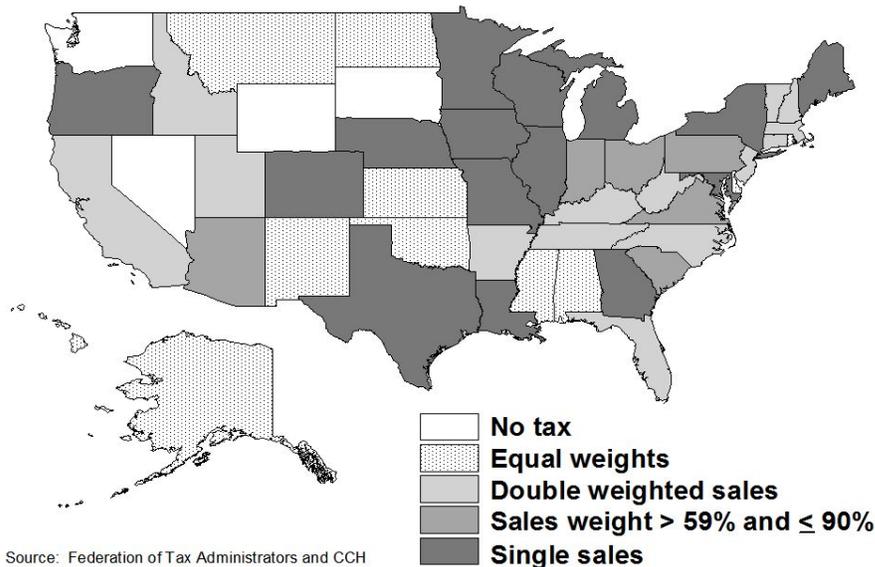
- b. **Effects on different types of businesses**
 - i. 100% Minnesota businesses (those with 100% of their property, payroll, and sales located in Minnesota) would be unaffected. They derive neither a benefit, nor experience higher taxes. However, the cost of the tax cut could be used to fund a general rate reduction, which would benefit all payers of the tax.

- ii. Minnesota businesses whose Minnesota sales factor is lower than the average of the property and payroll factor would receive a tax cut. The larger the disparity, the bigger the benefit. A classic example would be a business with most of its operations (headquarters, plants, and so forth) in Minnesota, but which makes its sales nationwide (e.g., 3M or General Mills).
- iii. Businesses who have higher Minnesota sales factors and lower average Minnesota property and payroll would have tax increases. The classic example is a national manufacturer of consumer products with few facilities in Minnesota (e.g., Proctor & Gamble or Microsoft).

c. **Trend in other states**

As noted above, the trend in other states has been to increase the weight of the sales factor. (Minnesota was ahead of the curve in this regard, adopting 70% sales weighting in 1939 as an option.) Indiana is scheduled to use single sales in 2011 and South Carolina in 2013. The map below shows the apportionment formulas for manufacturers as of tax year 2010. As can be seen (Minnesota is at 90%), a fair number of states now weight sales more heavily than Minnesota does, including all of the surrounding states except North Dakota.

Apportionment of Corporate Income
Applicable to Manufacturers

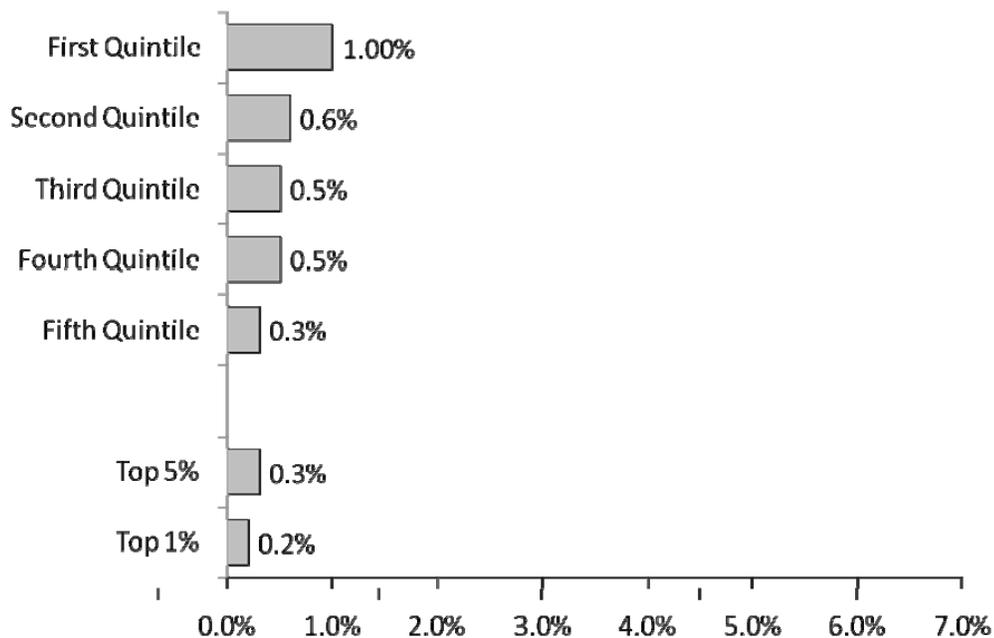


- d. **Competitiveness effects.** The principal argument for sales weighting is that it increases the state's competitiveness, i.e., it will attract investment or economic activity to the state, because it reduces the effective tax rate on new investment in

plant and equipment. Some empirical studies support this conclusion. It should be noted, however, that sales apportionment increases the “nexus penalty” associated with the corporate tax. It may discourage an out-of-state profitable business that sells in Minnesota, but otherwise has no facilities in Minnesota, from locating facilities in Minnesota. Doing so would subject it to Minnesota tax (nexus) and substantially increase its tax. Thus, sales apportionment may discourage national companies (without nexus) from locating branch plants or distribution facilities in Minnesota. For companies with nexus, it has a positive effect on the incentive to locate more facilities in Minnesota, regardless of their factors.

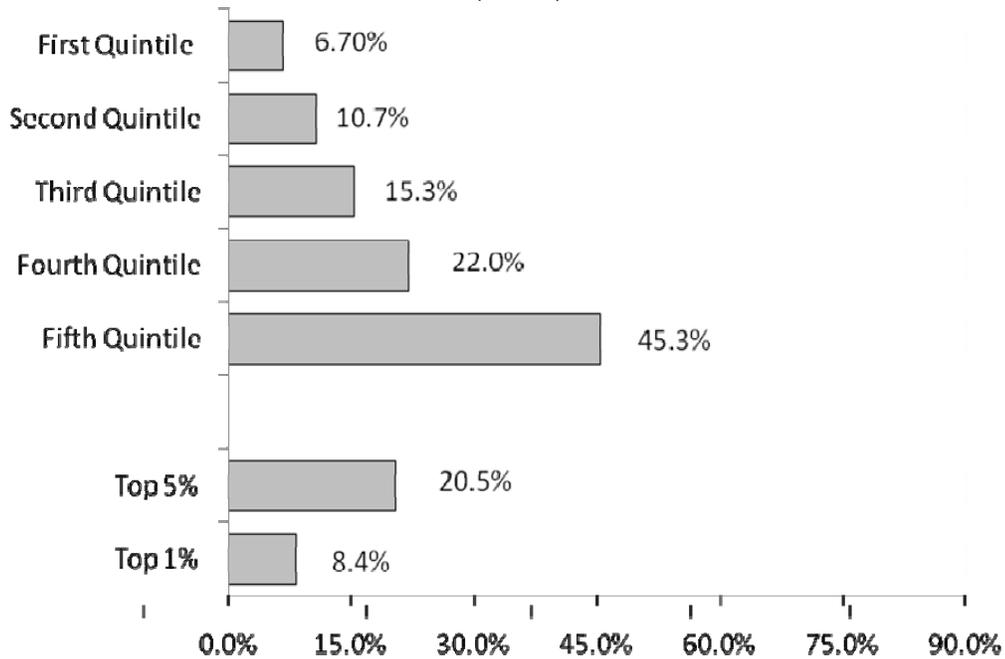
- e. **Incidence effects.** Apportionment formula issues affect the incidence of the tax, i.e., the real people who actually pay the tax (consumers v. shareholders v. workers). Increasing the sales weighting generally will shift the incidence of the tax toward consumers. Using 100% sales weighting reduces competitiveness concerns, precisely because it makes the tax more like a sales tax/consumption tax. This is so because corporations will pay the tax based on their Minnesota sales, regardless of where their capital is located. This makes it much more likely that the tax will be passed along to consumers.

Corporate Tax Burden Effective Tax Rates by Population Quintiles (2006)



Source: Department of Revenue, 2009 *Tax Incidence Study*

Corporate Tax Burden Distribution by Population Quintiles (2006)



Source: Department of Revenue, 2009 *Tax Incidence Study*

Motor Vehicle Fuels Tax

Tax Base

The tax is imposed on gasoline, diesel fuel, and other motor fuels used by vehicles on the public highways. Aviation fuel purchased, stored, or withdrawn from storage in Minnesota is taxable.

Exemptions

Motor fuels used by public transit systems receiving state financial assistance are exempt. Compressed natural gas and propane used as a motor fuel are exempt from the tax. Vehicles using natural gas or propane fuel are instead subject to an annual fee, based on the number of miles driven during the prior year.

Tax Rates

Highway motor fuels are taxed at a basic rate of \$.25 per gallon. This rate was increased by the 2008 legislature from a rate of \$.20 per gallon.

An additional **debt service surcharge** applies at variable rates, as shown in the table.

Fiscal year	Surcharge rate (per gallon)
2009	0.5
2010	2.1
2011	2.5
2012	3.0
2013	3.5*
*This is a maximum rate. Actual rate is to be set annually by the commissioner so that revenues equal the total amount of debt service.	

Thus, the combination of the regular tax rate and the surcharge will yield a maximum rate of 28.5 cents per gallon (in FY2013 and later). The current rate (FY2009) is 28.5 cents per gallon.

Aviation fuels are subject to a graduated, declining tax rate according to the following schedule. The graduated rates are provided through a refund system.

Number of Gallons Used During Calendar Year	Tax Rate
0 - 50,000	\$.05/gal
50,001 - 150,000	\$.02/gal
150,001 - 200,000	\$.01/gal
200,001+	\$.005/gal

Revenue

	FY2011 Revenues (millions)	% of Total State Tax Revenue
Highway Fuels	\$846.8	4.9%
Aviation Fuels	3.8	< 0.1%

As required by the Minnesota Constitution, revenues from highway fuels are deposited in the Highway User Tax Distribution Fund. Moneys in this fund are used to pay for state trunk highways (60%), county state aid streets (31%), and municipal state aid streets (9%). Revenues from the aviation fuels tax are deposited in the State Airports Fund.

Cigarette and Tobacco Tax and Fees

Tax Base

The tax is imposed on sales of cigarettes and tobacco products (cigars, pipe tobacco, chewing tobacco, snuff, etc.). The tax on cigarettes is imposed on a per unit base (i.e., per cigarette). The tobacco products tax is a percentage of the wholesale price.

Tax Rates

Cigarettes	\$.48/pack of 20
Tobacco Products	35% of wholesale price

Health impact fee. The 2005 Legislature enacted a 75 cents/pack health impact fee on cigarettes and 35 percent of the wholesale price of tobacco products. This fee is imposed and collected in the same manner as the cigarette excise tax. Combining the Minnesota's excise tax and fee, the burden equals \$1.23 per pack and 70 percent of the wholesale price of tobacco products.

Nonsettlement cigarette fee. A special cigarette fee of 35 cents/pack applies to "nonsettlement cigarettes." These are cigarettes produced by manufacturers other than the major companies that settled the liability lawsuits filed by the state or companies that voluntarily elect to participate and make annual payments (as approved by the Attorney General). This fee was enacted by the 2003 Legislature. By its terms, it was intended to compensate the state for cost attributable to the use of these cigarettes (similar to what settling companies are paying) and to deter youth smoking. The Minnesota Supreme Court upheld the constitutionality of the fee in a 2006 decision; the U.S. Supreme Court declined to review the case. *Council of Independent Tobacco Mfr. v. State*, 713 N.W.2d 300 (Minn. 2006) *cert. denied* 549 U.S. 1052 (2006). Collections under this fee are not included in the collection numbers listed below. This fee yielded about \$2.7 million in FY 2011.

Enforcement and Collection

The cigarette tax is collected and enforced through a stamp mechanism. Each pack of cigarettes is required to be stamped with a tax stamp. Cigarette distributors apply these stamps with heat applied stamp machines, approved by the commissioner of revenue.

Revenue

Fiscal Year 2011 (in millions)	\$424
Percent of Total State Tax Revenue	2.4%

Revenues from the tobacco products tax are deposited in the general fund. Cigarette tax revenues of \$22.25 million/year go to fund the Academic Health Center, \$8.55 million/year to the medical education and research account, and the rest to the state general fund. The health impact fee revenues (estimated to be \$202.8 million for FY2011) are deposited in a health impact

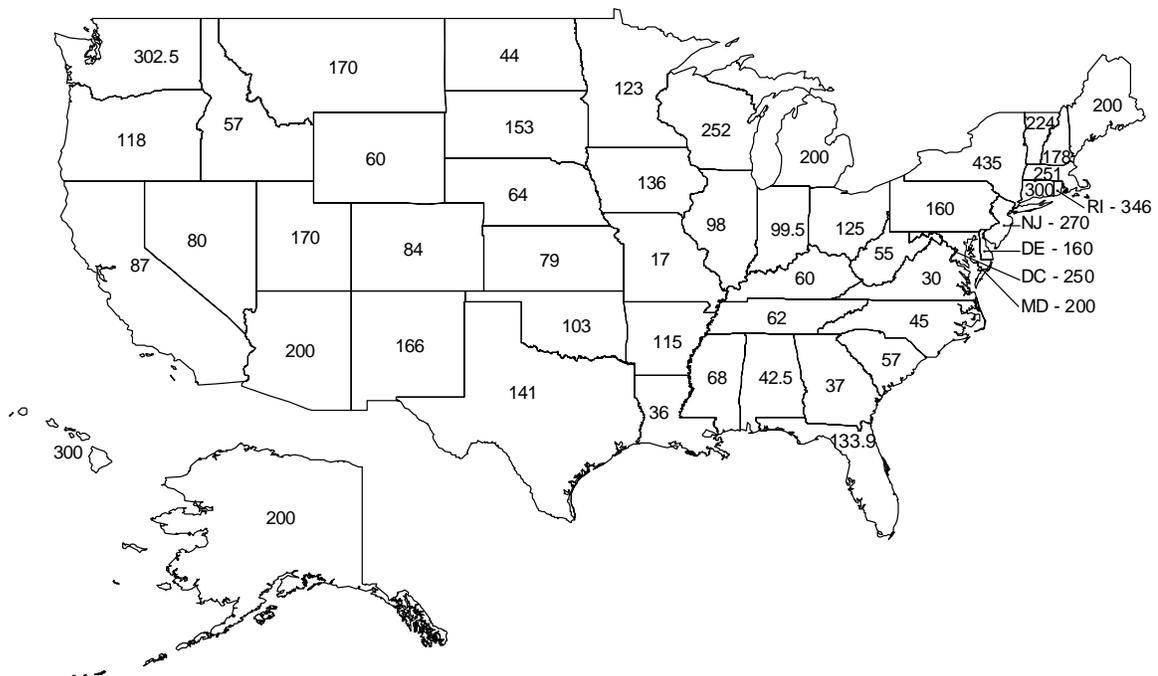
fund and are transferred to the general fund after the commissioner of human services certifies that state health programs have incurred tobacco-related costs equal to the fee revenues.

Comparison with Other States

The map below shows the tax rates in other states as of July 1, 2010. The map does not reflect the effect of general sales taxes (including Minnesota's per pack tax in lieu of the sales tax). Some states have no sales tax or exempt cigarettes from sales taxation, lowering the overall tax burden.

State Cigarette Tax Rates*

as of 7/1/2010
cents per pack



* These exclude some significant local taxes.
Source: Federation of Tax Administrators and other sources

Alcoholic Beverage Excise Taxes

Tax Base

Tax is imposed on alcoholic beverages (liquor, wine, sparkling wine, and beer) on a per unit of volume basis (i.e., gallon, liter, or barrel).

Tax Rates

The rates vary by the type of beverage and, in the case of wine and beer, by the alcohol category in which the product falls. The rates are as follows:

Liquor (distilled spirits)	\$5.03/gallon	\$1.33/liter
Wine < 14% alcohol	\$.30/gallon	\$.08/liter
Wine > 14% but < 21%	\$.95/gallon	\$.25/liter
Wine > 21% but < 24%	\$1.82/gallon	\$.48/liter
Wine > 24%	\$3.52/gallon	\$.93/liter
Sparkling wine	\$1.82/gallon	\$.48/liter
Cider	\$.15/gallon	\$.04/liter
Beer > 3.2% alcohol	\$4.60/barrel*	
Beer < 3.2% alcohol	\$2.40/barrel*	

* A barrel contains 31 gallons. Thus, the tax rates for beer on the basis of gallonage are \$.15 for "strong beer" (3 cents for a 12 ounce beer) and \$.08 for 3.2 beer (2 cents for a 12 ounce beer).

Exemptions

Only limited exemptions apply under the tax:

- Sacramental wine
- Product sold to food processors and pharmaceutical companies
- The first 25,000 barrels of beer produced by a brewery with annual production of less than 100,000 barrels (A barrel is 31 gallons.)

Collection

Tax is imposed on the manufacturer or licensed distributor of the beverage.

Comparison with Other States

Minnesota's wine and beer excise taxes are average or below average compared with most other states. The table to the right compares Minnesota's tax with taxes in surrounding states. Minnesota's tax on distilled spirits (liquor) is among the higher taxes for states with excise taxes. A number of states (including Iowa) have liquor monopolies and a portion of the price markup is a *de facto* tax; it is difficult to compare the tax burden with these states.

Excise Tax Rates (per gallon) Bordering States			
	Strong Beer	Table Wine	Liquor
IA	\$.19	\$1.75	N.A.
MN	.15	.30	\$5.03
ND	.16	.50	2.50
SD	.27	.93	3.93
WI	.06	.25	3.25

Source: Federation of Tax Administrators

Minnesota also imposes a 2.5% gross receipts tax on sales of alcoholic beverages, in addition to the regular 6.5% state sales tax. This additional tax replaced a higher sales tax rate and is discussed briefly in the sales tax section. Only North Dakota (of the surrounding states) imposes a similar gross receipts tax (2%) in addition to an excise tax. Thus, the total Minnesota alcohol tax burden is higher than suggested by simply comparing excise tax burdens.

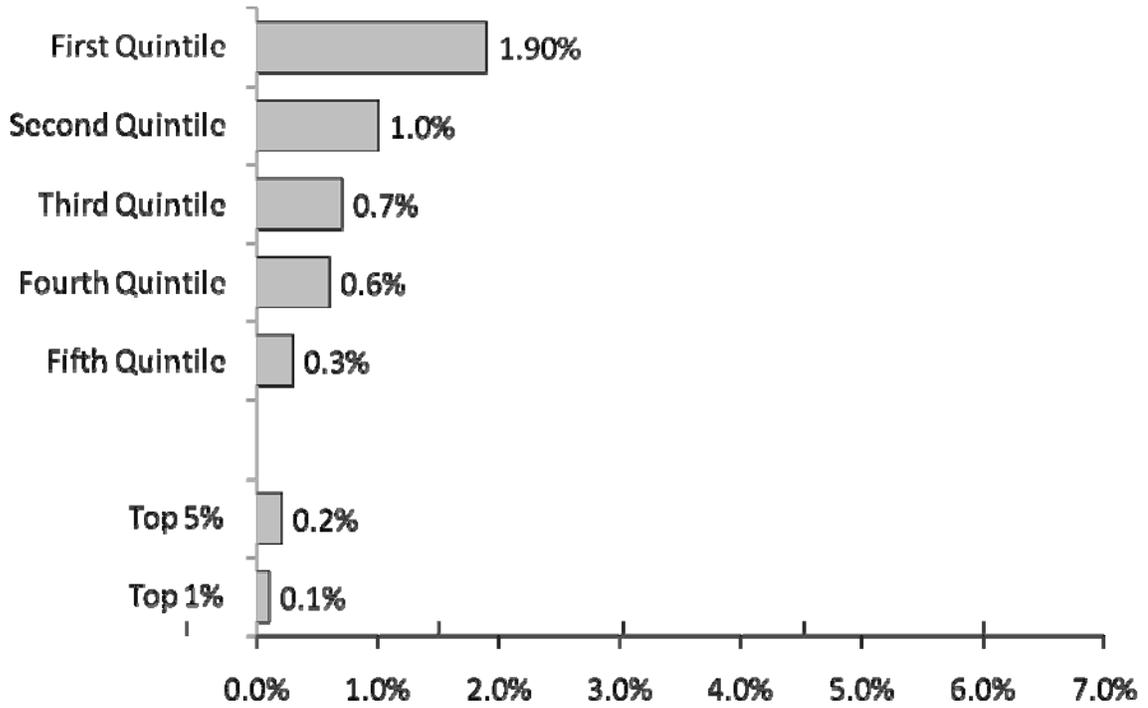
Revenue

Fiscal Year 2011 (in millions)	\$77.4
Percent of Total State Tax Revenue	0.5%

The actual FY2010 revenues by beverage type and for the gross receipts tax are shown in the table below.

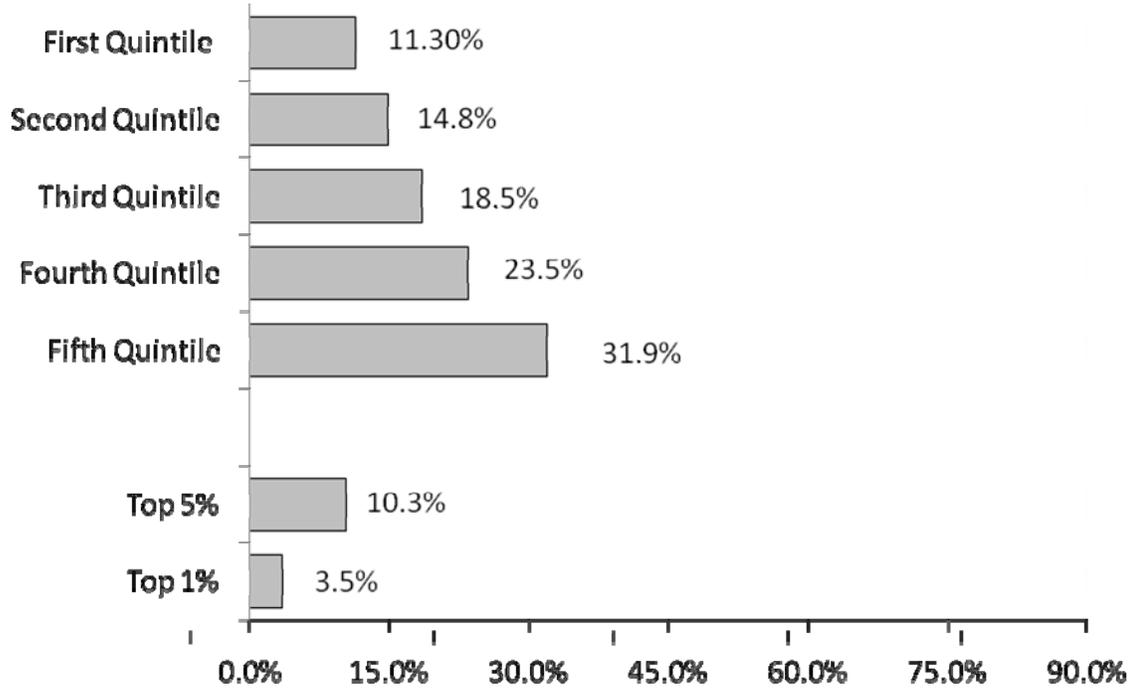
Special Alcoholic Beverage Taxes Revenues FY2010 (\$ amounts in thousand)		
Beverage Type	Revenues	% of Total
Beer < 3.2%	\$305	0.2%
Beer > 3.2%	15,481	10.8%
Cider	42	0.0%
Wine < 14%	3,520	2.5%
Wine > 14%	437	0.3%
Sparkling Wine	791	0.6%
Distilled Spirits	54,993	38.4%
Excise tax total	75,570	52.8%
2.5% gross receipts tax	67,609	47.2%
Total	\$143,179	
Source: MN Department of Revenue		

Excise Tax Burden (Fuels, Cigarette, and Alcohol) Effective Tax Rates by Population Quintiles (2006)



Source: Department of Revenue, 2009 *Tax Incidence Study*

**Excise Tax Burden (Fuels, Cigarette, and Alcohol)
Distribution by Population Quintiles
(2006)**



Source: Department of Revenue, 2009 *Tax Incidence Study*

Motor Vehicle License Tax

1. **Tax Base.** Tax base consists of the base value of the passenger vehicles (plus a minimum amount) and minimums or weight based fees for commercial vehicles.
 - a. Tax applies only to vehicles using the public highways.
 - b. Base value is determined from the manufacturer's suggested retail price, using a statutory depreciation schedule. Accessories and optional equipment are generally not included in the base value.
2. **Exemptions.** Exemptions include vehicles owned by governmental units, school buses, ambulances, fire vehicles, and so forth. Exempt vehicles are required to have exempt registration plates.
3. **Tax Rate.** For passenger automobiles, the tax consists of \$10 plus 1.25 percent of the automobile's base value. However, the tax cannot be less than \$35. For commercial and other types of vehicles, the tax is based on weight and age.
4. **Revenue**

Fiscal Year 2011 (in millions)	\$545
Percent of Total State Tax Revenue	3.1%

As required by the Minnesota Constitution, revenues are deposited in the Highway User Tax Distribution Fund. Moneys in this fund are used to pay for state trunk highways (60%), county state aid streets (31%), and municipal state aid streets (9%).

MinnesotaCare Taxes

Tax Base

The MinnesotaCare taxes are a series of gross revenues taxes on most health care products and services. All health care providers, including hospitals, physicians, chiropractors, psychologists, and dentists, are subject to tax. The tax on legend drugs, however, is imposed at the wholesale level, rather than on retailers. Deductions are allowed for certain types of medical research performed by nonprofit health care providers.

Exemptions

Exemptions include revenues from Medicare and the federal employees health benefits program. Nursing home and home health care services are generally exempt from taxation.

Tax Rates

The tax rate is 2 percent.

Special Features

The law authorizes providers to “pass-through” the tax to third party payors, such as insurance companies and health maintenance organizations. This permits providers to shift the burden of the tax (as would be expected generally by economic principles), even if otherwise binding contracts with their purchasers prohibited it. The tax also provides a limited research credit for certain institutions.

Revenues

Fiscal Year 2011 (in millions)	\$503
Percent of Total State Tax Revenue	2.9%

Dedication of Revenues

Revenues are deposited in the health care access fund, which finances the MinnesotaCare program.

Insurance Premiums Tax

Tax Base

The tax is imposed on gross insurance premiums (less return premiums).

Exemptions

All reinsurance and insurance provided by fraternal benefit societies is exempt.

Tax Rate

The basic tax rate is 2 percent. Mutual insurance companies with assets of \$1.6 billion or less (on 12-31-89) pay 1.26 percent on their property and casualty premiums. Town and farmers' mutual companies and mutual companies with \$5 million or less in assets pay 1 percent. The tax rate for life insurance is 1.5 percent. Higher rates may be imposed on out-of-state insurers under the retaliatory tax (see below).

Nonprofit health service corporations (such as Blue Cross) and health maintenance organizations (HMOs) pay at a 1 percent rate. The proceeds of the tax on these companies are deposited in the health care access fund to finance the MinnesotaCare program.

A fire safety surcharge applies to homeowners, commercial fire, and commercial non-liability multi-peril policies. The surcharge replaced the old fire marshal tax. The rate is generally 0.65 percent (0.5 percent for some mutual insurance companies). The replacement of the tax with a surcharge was intended to prevent other states from using the tax in computing their retaliatory taxes. A firefighters' relief surcharge of 2 percent is placed on fire insurance written on property located in first class cities.

A \$1 per vehicle per year surcharge applies to comprehensive auto insurance (the surcharge is levied at a rate of 50 cents per 6-month period). The proceeds of this surcharge are deposited in the auto theft prevent account.

Retaliatory Tax

A "retaliatory tax" provides that out-of-state insurance companies are taxed at the higher of (1) the regular premiums tax or (2) the tax that the company's state of domicile (where its home office is located) imposes on Minnesota companies. This tax does not apply if the state of domicile does not have a retaliatory tax (three states) or has a reciprocal nonretaliation law (two states).

Revenue

Fiscal Year 2011 (in millions)	\$348
Percent of Total State Tax Revenue	2.0%

Mortgage Registry Tax

Tax Base

Tax is imposed on the principal debt, which is secured by a mortgage of real property in the state.

Exemptions. The various exemptions apply. These include:

- Marriage dissolution decrees
- Mortgages to acquire or improve agricultural use real property
- Contracts for deed
- Mortgages under low and moderate income housing programs operated by federal, state, and local governments
- Mortgages to correct a legal description for the property

Rate

The rate is 0.23 percent of the principal debt.

Collection

The lender who records or registers the mortgage of real property pays the county treasurer in which the land is located, pays the tax at the time of recording the mortgage. The law imposes the legal incidence of the tax, however, on the borrower or the mortgagor.

Revenue

Fiscal Year 2011	Total Amount (in millions)
Disposition: State General Fund (97%)	\$78.3
County Revenue Fund (3%)	<u>2.7</u>
Total Fiscal Year 2011 (in millions)	\$80.7
Percent of Total State Tax Revenue	0.5%

Deed Transfer Tax

Tax Base. Tax is imposed when real estate is transferred by any deed, instrument, or writing.

Exemptions. Various exemptions apply, including:

- Executory contracts
- Mortgages, mortgage satisfactions, and so forth
- Wills
- Plats
- Leases
- Deeds of distributions by personal representatives
- Deeds for cemetery lots
- Deeds conveying permanent school lands
- Certificates of sales or redemptions in foreclosures
- Marriage dissolution decrees

Tax Rates. The rate is 0.33 percent of the consideration with a minimum tax of \$1.65.

Collection. The county treasurer in the county where the land is located collects the tax. The tax is paid when the deed is recorded (generally by the owner of the property).

Revenue

Fiscal Year 2011	Total Amount (in millions)
Disposition: State General Fund (97%)	\$43.7
County Revenue Fund (3%)	<u>1.4</u>
Total Fiscal Year 2011 (in millions)	\$45.1
Percent of Total State Tax Revenue	0.3%

Estate Tax

Tax Base

The estate tax is imposed on the taxable value of the estate. This is determined under the rules that apply under the federal estate tax. It generally means the fair market value on the date of death. Special rules can apply in setting the value in limited circumstances – in particular for farmland and small businesses if the personal representative and certain of the heirs elect. Transfers to a surviving spouse are deducted from the value of the estate. Thus, no tax applies if all of the estate (over the exemption amount) is left to the spouse. In additions, bequests to charities are deducted.

Exemption

The exemption amount is set by reference to federal law as it was in effect before enactment of the 2001 federal tax act (Economic Growth and Tax Relief and Reconciliation Act or EGTRRA). Starting with decedents dying in 2006 and later, the amount is \$1,000,000. Because transfers to surviving spouses are exempt, a \$1 million exemption allows a married couple with a joint net worth of less than \$2 million to avoid the tax by putting \$1 million into a family trust or similar arrangement on the death of the first spouse. (By comparison, the marital deduction or exemption under the new federal estate tax is “portable” and a transfer to a family trust or similar arrangement on the death of the first spouse is not necessary to preserve the exemption for the couple. The new portability rule is a result of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that was signed into law in December 2010.) Because of the exemption, the estate tax applies to less than 2 percent of estates. The exemption under the federal tax is larger than under the Minnesota tax. The federal exemption is \$5,000,000 for deaths in 2011 and 2012. The federal exemption is scheduled to return to a nonportable \$1,000,000 exemption for deaths in 2013, if Congress does not extend the current law.

Tax Rates

The tax rates are determined by reference to federal law (i.e., under the rates for the expiring credit for state death taxes). For decedents dying in 2011, the statutory rates range from 6.4% to 16%. However, because the Minnesota tax equals the amount of the old federal credit and because the value of the credit is a function of the old federal tax liability (including the old federal exemption amount), the effective marginal rates on estates just over \$1 million can be up to 41% (i.e., the rates under the federal estate tax, not the credit rates). These “bubble” rates return to the normal marginal rates for estate about \$1.1 million.

Relationship to federal tax

For the 16 years ending December 31, 2001, the Minnesota estate tax was directly linked to the federal tax as a “pick-up” or “soak-up” tax equal to the credit allowed under federal estate tax for state death taxes. As a pick-up tax, the Minnesota tax imposed no additional tax burden on estates. For each dollar of state tax paid, federal tax was reduced by an equal amount. However,

Congress phased out this credit in 2001. For decedents dying after December 31, 2004, the credit no longer applies. In 2001, the legislature chose to continue imposing the estate tax under the rules in effect before Congress repealed the credit. As a result, the Minnesota tax now is a stand-alone estate tax and imposes a real tax burden on estates and their heirs.

Revenues

Fiscal Year 2011 (in millions)	\$154.0
Percent of Total State Tax Revenue	0.9%

Revenues from the estate tax are deposited in the general fund. Revenues from the tax are very volatile, since they depend on the deaths of a few individuals. If one very wealthy individual dies, collections can soar. For example, in August 2005, the Department of Revenue received a tax payment for one estate of \$112 million (compared with estimated revenues for the year of \$86 million and total collections of \$72.7 million in fiscal year 2005). In other years, revenues may fall below estimates.

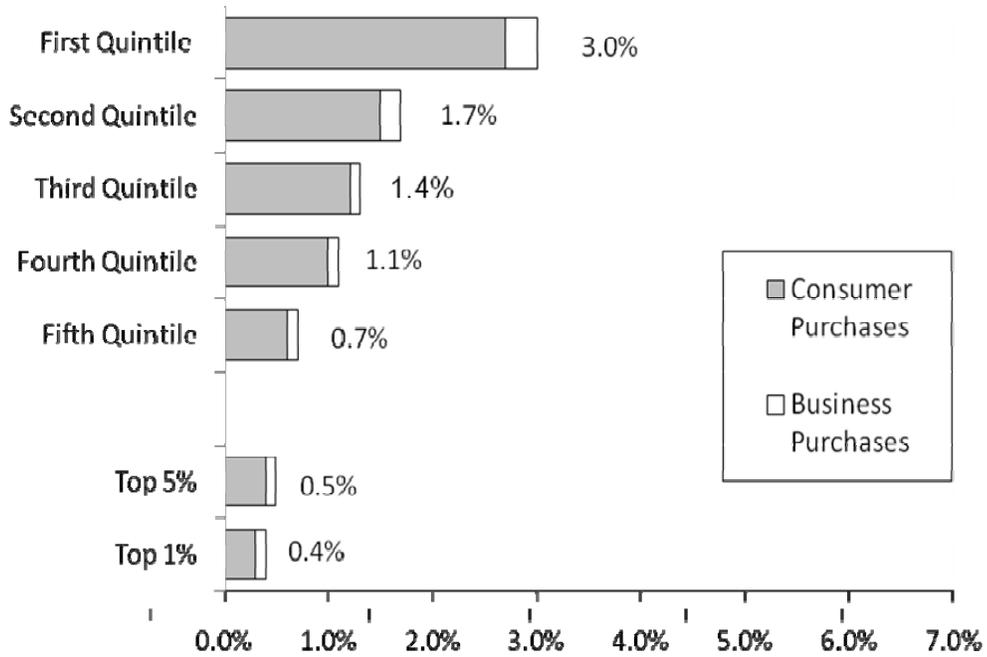
Other States – Effect of Repeal of Federal Credit

The repeal of the federal credit for state death taxes has changed the dynamics of state estate taxes considerably. When Minnesota imposed only a pick-up tax, the federal treasury paid the effective burden of the tax. As a result, Minnesota residents had no reason to change their domiciles to another state to avoid the Minnesota tax. Repeal of the federal credit makes the state tax a “real” tax that reduces the amount of money and other property that can be left to heirs. Affluent individuals may be willing to change their domiciles to avoid paying potentially multi-million state estate tax liabilities. At this point, most other states (unlike Minnesota) have allowed their estate or inheritance taxes to expire or have repealed them. As of January 2011, 29 states no longer have estate or inheritance taxes. The map on the next page shows the status of states’ estate and inheritance taxes as of January 2011.

State Estate and Inheritance Taxes

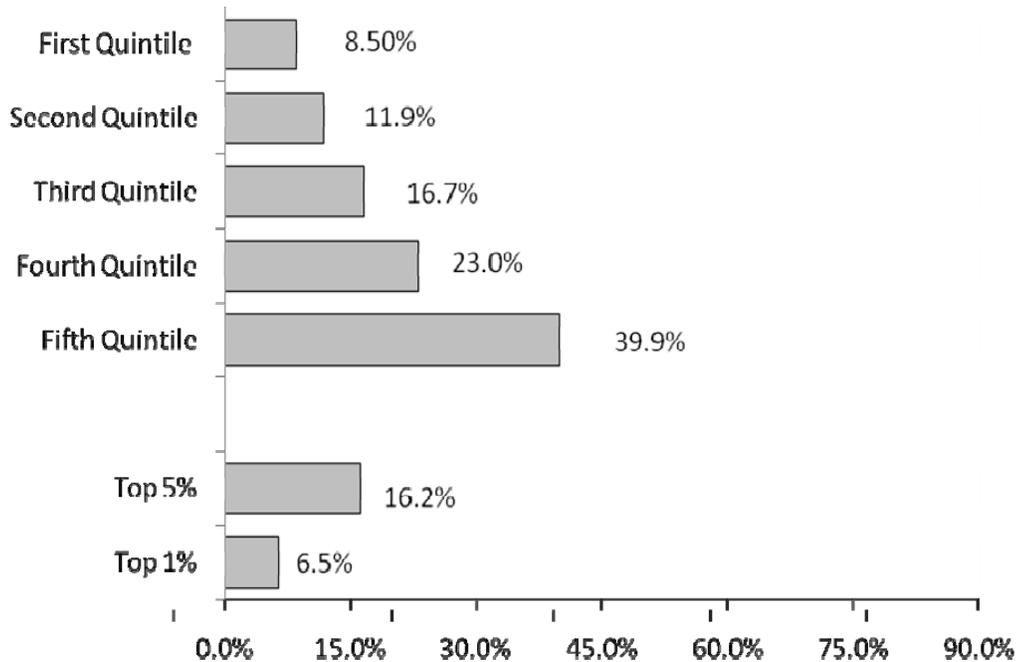


Other State Tax Burden Effective Tax Rates by Population Quintiles (2006)



Source: Department of Revenue, 2009 *Tax Incidence Study*

Other State Tax Burden Distribution by Population Quintiles (2006)



Source: Department of Revenue, 2009 *Tax Incidence Study*

Job Opportunity Building Zone (JOBZ) Program

In 2003, the legislature enacted the Job Opportunity Building Zone or JOBZ program. This program essentially is an enterprise zone program for rural Minnesota (it does not apply to areas within the 7-county Twin Cities metropolitan area). In December 2003, the Commissioner of the Department of Employment and Economic Development (DEED) designated 10 JOB zones. As originally designated, the 10 zones contained about 29,000 acres in 325 subzones. (The acreage now designated varies because of modifications made to the zones.) Subzones are noncontiguous parts of a zone, which may be located in different cities and counties from the rest of the zone. Nearly all of the counties outside of the seven-county metropolitan area contain designated JOBZ acreage. As of September 1, 2010, DEED reported 306 completed business subsidy agreements. (DEED updates these statistics on its website monthly.)

Qualified businesses operating in these zones receive special tax reductions. In order to qualify, however, they must enter a business subsidy agreement with the zone or subzone administrator (typically a city or county). Tax concessions that apply in the zone include:

- Individual income tax exemption for trade or business income, rents, and certain capital gain income
- Corporate franchise tax exemption for income attributable to the zone
- Sales tax exemption for business purchases for use in the zone, including motor vehicle purchases
- Property tax exemption
- Wind energy production tax exemption
- Refundable jobs credit

The table below shows the estimates of the tax reductions provided under JOBZ in the 2010 *Tax Expenditure Budget*.

Tax Reductions Under JOBZ Program				
(\$ amounts in thousands)				
	FY2012	% of total	FY2013	% of total
Individual income tax				
Income exclusion	\$7,000	30.2%	\$7,800	32.9%
Jobs credit	800	3.4%	900	3.8%
Corporate franchise tax				
Income exclusion	4,600	19.8%	5,200	21.9%
Jobs credit	1,300	5.6%	1,300	5.5%
Sales tax	9,300	40.1%	8,300	35.0%
Motor vehicle sales tax	200	0.9%	200	0.8%
Property tax	10,900	47.0%	11,700	49.4%
TOTAL	\$23,200		\$23,700	
Source: MN Dept. of Revenue, <i>Tax Expenditure Budget Fiscal Years 2010 – 2013</i> (January 2010).				

If the business stops operating in the zone or fails to satisfy the terms of the business subsidy agreement, “clawback” provisions apply requiring repayment of two years of tax benefits.

In addition, the law authorized designation of up to 5 agricultural processing zones. These zones provide essentially the same type of tax benefits as JOBZ. However, the benefits are limited to agricultural processing businesses, while JOBZ applies to any type of business. So far, DEED has designated one agricultural processing zone.

For more extensive information on JOBZ, see the House Research and DEED websites. The House Research site describes the program details, the tax provisions and how they are calculated or apply, and so forth. The DEED site also contains this type of information, as well as reporting on the actual experience under the program – areas designated, deals completed, department policies, and so forth. The Office of the Legislative Auditor (OLA) prepared a

program evaluation of JOBZ in 2007, which was published in 2008. This report, available on OLA's website, contains a large number of details on the program and evaluation of its use and policy issues with its design and implementation.