

March 29, 2017

Representative Greg Davids  
Chair, House Taxes  
585 State Office Building  
100 Rev. Dr. Martin Luther King Jr. Blvd.  
Saint Paul, Minnesota 55155

Representative Paul Marquart  
DFL Lead, House Taxes  
261 State Office Building  
100 Rev. Dr. Martin Luther King Jr. Blvd.  
Saint Paul, Minnesota 55155

Dear Mr. Chairman and Representative Marquart:

As House File 4 moves toward floor consideration, I write to express my views on the bill's overall cost and content. As I shared with you in committee, HF 4 takes a markedly different approach than the Governor's bill which maintains a fiscally responsible budget while investing in our future workforce and providing targeted tax relief for those most in need.

First, I do want to thank you for including several items found in the Governor and Lt. Governor's tax bill. The Child and Dependent Care Credit expansion, although not as generous as the provision in the Governor's bill, will help 60,000 families across the state pay for childcare. The School Building Bond Agricultural Credit will help farmers by paying half of their property taxes attributable to that levy. Several other items from the Governor and Lt. Governor's tax bill are also included in HF4:

- County aid related to out-of-home placements under ICWA;
- property tax exemption for the St. Paul Soccer Stadium;
- Minnesota State High School League Exemption;
- Estate Tax Recapture Related to Eminent Domain;
- Madelia Rebuild Sales Tax Exemption;
- aligning the definition of compressed natural gas with the industry standard; and
- a number of the Department's policy and technical provisions.

We also appreciate the inclusion of a federal conformity account so that the Department can continue to do our work around individual income tax filing even during years the legislature begins session well after filing season has started.

Unfortunately, HF4 does not include a number of priorities in the Governor and Lt. Governor's tax bill. The Governor's tax bill prioritizes tax cuts for middle class families and those struggling to get into the middle class. His bill, even given its size will help over 450,000 people and it ensures significant investment in education and leaves money for contingencies that are facing our state.

Most importantly, the expansion of the Working Family Credit is not included in HF4. This credit helps working families across Minnesota pay for basic needs and is a proven tool to fight poverty. This credit has enjoyed bipartisan support at the federal level since studies have shown it is one of our most

effective methods of reducing poverty and improving outcomes for families. Its absence from HF4 is disappointing.

Local Government Aid and County Program Aid helps provide essential services while taking the pressure off property taxes. School Debt Service Equalization Aid will help ensure good school facilities across Minnesota. The Governor and Lt. Governor's bill provides significant investments in these programs to help keep property taxes down.

It is also unfortunate that two programs to smooth the transition for the buffer requirements in current law – buffer compensation payments and riparian aid to counties and watershed districts -- were not included.

Finally, a number of other important provisions from the Governor and Lt. Governor's bill are not included, among them:

- reforms to level the playing field for all businesses by closing loopholes, and updating assessment practices;
- railroad property tax modernization;
- increasing the military service credit for lower income veterans that served for 20 years or have a service-related disability;
- sales tax exemption for a siding facility;
- Angel Investment Credit expansion;
- expanding the sales tax to more nonprofits;
- updates to sustainable forest incentive act; and
- an update to vapor products and tobacco tax provisions.

#### **Overall priorities:**

When Governor Dayton took office in 2011, Minnesota faced a \$6 billion budget deficit. Now, after six years of making tough, responsible choices, Minnesota is finally on sound fiscal footing. Our state has \$1.65 billion on its bottom line and nearly \$2 billion in reserves to protect Minnesota from future economic downturns. This bill will cost the state over \$1.7 billion this biennium and \$2.2 billion in the next and grow significantly in the future, setting the state up for fiscal uncertainty. This bill prioritizes unsustainable tax cuts now and into the future over investments in prekindergarten, higher education and economic development that will grow opportunities for hard working Minnesotans in our state.

Upon comparison of several provisions, the composition of the bill is concerning. For example, in the area of property tax: compare the impact of the changes to the C/I levy changes and those to individual taxpayers. In the near term, the C/I levy changes will allow all businesses to reduce their property taxes with the exclusion of the first \$200,000 of value. The freeze to the levy amount, over time, will disproportionately benefit large building owners like the IDS and the Mall of America. At the same time, HF4 cuts the property tax refund for renters – largely in greater Minnesota. While Minnesota renters are

getting their refunds cut permanently and homeowners are getting a one-year only increase, the changes to business property taxes reflect a substantial cut and are on-going.

Another example can be found in the income tax changes: it provides significant tax relief to some of the most fortunate in our state with the social security and estate tax changes but provides little to families across the state working hard and struggling to pay the rent, buy groceries and raise their kids. The working family credit has proven to reduce poverty – kids who grow up in homes with more economic stability do better in school. This is a place where we should be investing to help ensure our future prosperity. Minnesota's economy depends on its most valuable asset – our people – and we need to invest in all of them across all areas of the state.

### **Specific areas of concern:**

#### *Education-related credits*

We have previously shared with you a number of concerns about the changes being made to existing education related credits and the creation of a new credit for contributions to foundations related to scholarships. This provision in particular lacks accountability – unlike public schools, which are obligated to serve all children including those with special needs, private schools would be funded by this diversion of public resources. In addition, the provision to expand the K-12 subtraction and change the K-12 Credit to allow private school tuition as an eligible expense is similarly concerning as it also provides public financing of private schools through the tax code. Governor Dayton and Lt. Governor Smith are opposed to these provisions.

Governor Dayton and Lt. Governor Smith, in their budget, prioritized Minnesota's students by investing in our public schools. Their budget expands voluntary pre-K by doubling the enrollees from 3,300 to 8,300 in FY 18, invests over \$600 million more dollars to provide better schools for students and families everywhere in Minnesota, and as part of that increases our investment in special education by \$40 million as well as many other investments that will improve education in Minnesota.

#### *Cigarette tax reductions*

The elimination of the inflator on cigarette taxes is concerning. The purpose of the cigarette tax increase and inflator in 2013 was to balance the budget, make strategic investments in health care, education and jobs, and to reduce smoking in Minnesota, in particular among its youth. Since the increase took effect, smoking has declined, most notably among high school students.

Eliminating the inflator on this tax will make cigarettes more affordable for our youth – who are more price sensitive – years down the road. Removing the inflator would lower the cost of cigarettes over time in real dollars. The Governor is also concerned with provisions that would lower the rate for premium cigars.

The cost of this proposal is a concern as well. It will cost \$10 million in this biennium but grow to \$36 million in the out biennium, and will continue to grow more after that. For these reasons, the Governor and Lt. Governor have been critical of this proposal in the past and continue to oppose it.



### *Reducing the Property Tax Refund for Renters*

The rent credit is an important benefit that helps hundreds of thousands across Minnesota – particularly seniors and people with disabilities. About 30% of rent credit recipients are seniors or people with disabilities. If adopted, HF4 will mean that 94,000 seniors and people with disabilities will see a reduction in their refund. The new approach to calculating the refund will reduce the credit particularly for greater Minnesota where rents are lower. By doing so will reduce property tax refunds by \$40 million each year. It will also add increased complexity by removing the percentage on the return and put the responsibility on the landlord to report it as part of the Certificate of Rent Paid.

### *Estate tax*

The concerns about the estate tax provision focus on the significant cost relative to impact. During Governor Dayton's time in office, Minnesota has already made important changes to the estate tax. For example, thanks to your leadership, the small business and qualified farm deductions passed in 2011 already provide relief to family farms and small businesses passed down through families. About 300 estates claim the small business and/or farm property subtraction per year. Fewer than ten estates annually claim the maximum subtraction, meaning fewer than ten are paying the estate tax each year.

In addition, in 2014 the Governor also signed an estate tax exemption increase into law, raising the exempt amount from \$1 million to \$2 million over five years. The exemption is already at \$1.8 million and will increase to \$2 million next year. That change has cut the number of estates that pay tax by about one half.

This provision in the bill will cut \$162 million in estate taxes in the next biennium for about 1,100 annually, most of whom would no longer be required to pay any estate taxes. Reducing the estate tax will make our tax system more regressive, which means that middle and lower income Minnesotans will be paying for a larger share of the services we all depend on.

### *Private Letter rulings and assessment limitations*

The provisions in article 11 on private letter rulings and assessment limitations will have significant effects on how the agency currently does its work and would have a number of negative impacts, including:

- Specialized guidance program – at a significant cost to the state – that only serves those who can afford it
- Increased burdens during audit – longer audits, more document reviews, more auditors in more business locations disrupting the ongoing business activities of our customers
- Changes to the penalty system that creates unfairness by treating those who file and pay on time the same as those who file and pay late

- Significant increases in litigation – today, only 4% of all administrative appeals heard at the Department go on to Tax Court – this bill will increase litigation costs for both the department and the State

This section carries significant costs – loss of penalty revenue of about \$20 million and administrative costs of over \$14 million. At a time when other legislative committees are making cuts that will dramatically reduce service to Minnesotans and threaten revenue streams, these changes will only exacerbate those challenges.

#### *Transportation*

The next area of concern deals with the shifting of revenue from sales tax on auto repair and parts to fund transportation. The Governor remains committed to reaching common ground to fund a long-term, comprehensive transportation solution that builds a better Minnesota for everyone, everywhere in our state. Governor Dayton remains concerned, however, that a solution that shifts funding from education and health care to transportation is not a sustainable solution.

Governor Dayton has proposed a transportation plan to help bridge the \$6 billion state highway transportation funding gap over the next ten years with dedicated funding for roads and bridges, and increased funding for transit across the state. Road and bridge construction will be funded by a 6.5 percent sales tax on gasoline, increasing the current 1.25 percent base tax on vehicle registration fees to 1.5 percent, and increasing car registration fees by \$10. Governor Dayton would also require MnDOT to spend taxpayer money in an accountable and responsible way, by finding savings of 15 percent for all new revenues, allowing the Department to do \$6 billion of work for \$5.46 billion in new revenue.

#### *Social Security*

The concern around the social security provisions relate to their cost and who benefits from them. In terms of cost, the growth rate on the subtraction increases very quickly. This expensive item needs to be evaluated in light of the fact that in 2014, only 35 percent of social security benefits received by Minnesotans were taxable. Nearly half of all Minnesota households with social security income paid no tax on any of that income. In addition, other seniors who have teachers, police, or nurse pensions would not have the same benefits available. HF 4 includes two increases to the exemption income cap, one for tax year 2017 and the second for tax year 2019. The second is outside the current biennium. If the higher threshold is the intended change, it should be paid for in the first biennium to fully account for it in the budget.

#### *Research and Development Credit*

As the committee takes on changes to the R&D credit, we remind you of the recent Office of Legislative Auditor report, which made several recommendations to the legislature on providing more detail on the purpose and measurement of outcomes of these provisions. This may be particularly important with the change that makes the credit refundable. We are concerned that without additional legislative direction on purpose, measurements, or results, this program will face similar results in a future OLA review.

#### *Local Government Control*



This bill contains several proposals taking decision making power away from local governments, or penalizing them based on how they choose to spend their money. These provisions place limitations on the local budgeting decisions of cities, counties, and the Destination Medical Center, creating a potential barrier to infrastructure and job growth. This includes prohibiting imposing fees or taxes on merchant-provided bags, disallowing any public money for a zip rail project between Rochester and the Twin Cities, and reducing LGA for money spent on promoting a world's fair. This bill unnecessarily micromanages local governments and takes decisions out of their hands.

The bill also treats metro and greater Minnesota counties differently by requiring voter approval for county-wide sales tax increases greater than one-quarter cent in metro counties. This requirement is not in place for counties outside the metro, and there is no clear policy reason for this distinction. These counties should be able to make their own decisions in the same way that they can in the rest of Minnesota, without the legislature throwing up various barriers to block spending at the local level that it does not agree with.

Another item of concern in the bill has to do with the proposed reverse referendum. This proposal would cause instability for local governments, and make their budgeting process unpredictable. The reverse referendum may have the opposite of its intended effect. Local governments may raise their base level budget higher than needed early on, so later if the referendum reduces the budget, it will reset to the higher base amount. We have already seen this happen when the legislature enacts levy limits. There are existing methods to involve voters in keeping their property taxes low, such as truth in taxation hearings. Increasing interest and awareness of these hearings may be a better, more stable method of achieving the goal of more citizen involvement in setting local budgets.

### **Implementation costs**

A number of the provisions in this bill have fiscal costs for the Department to implement and administer. We are currently stretched to our very limit keeping up with increased demands in term of cost, volume of work, and new threats such as fraud. Plus, the department has about 200 fewer employees to serve the public than just a few years ago.

If the provisions in this bill were adopted, we would need additional resources to implement these changes well and give them full effect – forms changes; updating our integrated tax system; education and outreach for customers; work with software vendors; modifying our training materials for employees and customers; updating fact sheets, industry guides and revenue notices; and administering compliance with the provisions.

Of course, the nature of the policy change dictates the level of work involved. As you can imagine there is a significant difference in the amount of work related to an income threshold change relative to an entirely new credit.

We have previously been asked to provide fiscal notes on only a handful of the provisions in the omnibus bill. We have begun the process of gathering the information necessary to provide you with the administrative costs for the remaining provisions.

### **Fiscal responsibility**

This bill will cost the state over \$1.7 billion in this biennium and \$2.2 billion in the next. This includes the provisions that divert \$450 million in FY18-19 and \$707 million in FY20-21 to transportation, further reducing the general fund. Costs will go up dramatically in the out years. That is because items like eliminating the inflators and the change to social security grows significantly beyond the budget window.

For example, it is important to note that the full impact of the levy freeze cannot be reflected in the window: removing the inflator would not be a significant cost in the first year. However, in five years it will cost \$100 million (by FY2022) and \$247 million per year by FY2027. The freeze will cost over \$1.2 billion over 10 years.

Particularly as we look at significant uncertainty in our state's forecast and from federal policy changes, we need to take a cautious approach to our budget outlook and freezing the levy puts Minnesota's fiscal health at risk.

The Governor and Lt. Governor are committed to sound budgeting that maintains Minnesota's fiscally responsible financial state. HF4 does not meet that standard.

### **Moving Forward**

The Department is eager to continue the conversation about the size and content of a tax bill that the Governor can sign. We look forward to discussing the above provisions and other provisions in the bill that may have limited effectiveness or create unintended consequences. We welcome any opportunity to discuss these issues so that we can best serve Minnesota.

Sincerely,

A handwritten signature in black ink, appearing to read 'Cynthia Bauerly', written in a cursive style.

Cynthia Bauerly  
Commissioner