DEPARTMENT OF REVENUE

April 30, 2018

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

Dear Chair Davids:

I write to express concerns about HF 4385, the second engrossment, and its impact on Minnesota taxpayers and the state's general fund.

We appreciate that the bill as amended includes a number of items with which the Governor agrees, including:

- Moving to "adjusted gross income" for individuals while keeping "federal taxable income" for corporations
- Fully conforming to the 179 expensing provision in the 2017 Federal Tax Law
- The treatment of Bonus Depreciation
- Extending the Angel Tax Credit for one year
- Conforming to domestic income provisions of the 2017 Federal Tax Law

We are also pleased that the bill moves the Senior Property Tax Deferral application date. However, we believe we can provide this relief to senior citizens sooner than the bill allows. We believe that we could provide this relief for taxes payable in 2019, for applications in 2018 as included in the Governor's bill.

We also thank the committee for including many provisions from the department's policy and technical bills, including moving to more inclusive language for our tax code, updating certifications, clarifying definitions, and providing clear guidance for taxpayers and tax administrators.

The House Tax Bill increases business tax breaks
Unfortunately, like the Federal Tax Law passed last year, HF 4385, the second engrossment, favors businesses over working Minnesota families. While the bill changes income tax rates for both individuals and corporations, the rate cut for corporations (7.6%) is nearly double that for individuals (4.3%).

The bill includes a corporate tax rate cut of over 7.6% costing $60 million per year when fully phased in, the repeal of the corporate AMT costing $15 million when fully phased in, and Section 179 expensing with a first full year cost of $85 million.

These benefits are in addition to the 40% tax rate cut corporations already received from the 2017 Federal Tax Law.

This bill as amended shields multi-national corporations with foreign subsidiaries rather than focusing on Minnesota families. It provides a 100% subtraction for Global Intangible Low Tax Income (GILTI) of individuals and corporations. In addition, the bill decouples 100% from Foreign Derived Intangible Income (FDII) deductions for both individuals and corporations. The introduction of GILTI at the federal level was designed to curb the erosion of the U.S. tax base by multi-national corporations. For C-corporations, the GILTI provisions operate as a minimum tax that is intended to make sure U.S. corporations and their foreign subsidiaries pay corporate tax.

Although the bill as amended does bring to Minnesota some of its share of repatriated income, it first allows the federal preferred rate reduction, as well as the Minnesota Dividend Received Deduction (DRD). The Governor's approach – following established Minnesota policy – allows the DRD, but not the federal preferred rate reduction. Allowing corporations to claim both of these preferential treatments for this income reduces the revenue apportioned to Minnesota even further and treats it differently than other dividend income.

Little targeted tax relief for low and middle-income families

While the House bill provides significant benefits for corporations, Minnesota's low and middle-income families do not fare as well. Those with income less than $37,851 (married) and $25,891 (single) will see no rate decrease. The rate cut for the second tier will help wealthier families more than middle-income families. When fully phased in for married joint filers, those earning $40,000 will receive a $6 tax cut, those earning $80,000 per year will receive a $126 tax cut, and those earning $250,000 will receive a $338 tax cut.

In other words, Minnesotans earning $250,000 would receive income tax rate cuts that are larger both in amount and a higher percentage of their income than low and middle-income Minnesotans. Minnesotans earning the state's median income of $65,000 would receive an $82 tax cut – that is $256 less than the cut for those earning $250,000. The $82 tax cut is less than two tenths of one percent of the income for that median income family.

The Governor's approach would help low and middle-income families with the expansion of the Working Family Credit and a new Personal and Dependent Credit. The Governor's Working Family Credit proposal would expand the credit to filers who are 21 years old and would allow families with three or more children access to a larger credit and a higher income range. About 329,000 Minnesotans would see an average tax reduction of $160.

The Governor's new Personal and Dependent credit is a non-refundable $60 per person tax credit for individuals earning less than $90,000 and married tax filers earning less than $180,000 per year. About 2 million Minnesotans would get an average tax cut of $115. For example, a married couple with two children earning the sate's median income of $65,000 would see a tax credit of $240.

The House bill reduces and removes itemized deductions

Approximately 900,000 Minnesotans claim itemized deductions each year. Governor Dayton's proposal preserves these important benefits. However, just as the 2017 Federal Tax Law did, HF 4385 as amended reduces or removes many deductions. For many working Minnesotans the House's plan to increase the standard deduction by $1,000 will not make up for the loss of those itemized deductions, as it will translate to approximately $65 for a family.

For example, the Governor's proposal would protect a deduction for employees who have expenses related to their job that are not reimbursed by their employer, production of income, and tax preparation fees. These deductions help cut the costs many Minnesotans incur just to perform their job – including mileage between work sites, meals and housing, safety equipment, and work clothes – and can save Minnesotans, hundreds, or even thousands of dollars that many workers depend on as critical elements of their annual incomes. Under current state law, they can be deducted if they exceed 2% of income. About 111,000 Minnesotans benefit from the employee expenses deduction alone, saving an average $419 annually.

As noted in the Ways and Means committee, under the House plan, up to 148,000 Minnesotans will pay more in taxes as they lose deductions for work-related expenses, and other important tax breaks.

The list of expenses that taxpayers can deduct which are eliminated in the House bill is long and includes:

- Tax preparation expenses
- Business bad debt of an employee
- Business liability insurance premiums
- Damages paid to a former employer for breach of an employment contract
- Depreciation on a computer a taxpayer's employer requires them to use in their work
- Dues to a chamber of commerce if membership helps the taxpayer perform their job
- Dues to professional societies
- Home office or part of a taxpayer's home used regularly and exclusively in the taxpayer's work
- Job search expenses in the taxpayer's present occupation
- Laboratory breakage fees
- Legal fees related to the taxpayer's job
- Licenses and regulatory fees
- Malpractice insurance premiums
- Medical examinations required by an employer
- Occupational taxes
- Passport fees for a business trip
- Repayment of an income aid payment received under an employer's plan
- Research expenses of a college professor
- Rural mail carriers' vehicle expenses
- Subscriptions to professional journals and trade magazines related to the taxpayer's work
- Tools and supplies used in the taxpayer's work

- Purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer’s work
- Union dues and expenses
- Work clothes and uniforms if required and not suitable for everyday use
- Work-related education
- Repayments of Social Security benefits
- The share of deductible investment expenses from pass-through entities
- Appraisal fees for a casualty loss or charitable contribution
- Casualty and theft losses from property used in performing services as an employee
- Clerical help and office rent in caring for investments
- Depreciation on home computers used for investments
- Excess deductions (including administrative expenses) allowed to a beneficiary on termination of an estate or trust
- Fees to collect interest and dividends
- Hobby expenses, but generally not more than hobby income
- Indirect miscellaneous deductions from pass-through entities
- Investment fees and expenses
- Loss on deposits in an insolvent or bankrupt financial institution
- Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed
- Repayments of income
- Safe deposit box rental fees, except for storing jewelry and other personal effects
- Service charges on dividend reinvestment plans
- Trustee’s fees for an IRA, if separately billed and paid
- Educator expenses

There are still other deductions that the House plan would remove or reduce. For example, many people move to or within Minnesota each year. Significant expenses come with such a big transition. The Governor’s proposal would protect the moving expenses deduction to make it a less significant expense. About 61,000 Minnesotans benefit from this deduction with an average savings of $150. The House bill disallows this tax benefit.

There are other deductions that do not affect most Minnesotans, but make a big difference for families that do use them. One of the most essential examples of this is the casualty loss deduction. A family that suffers a major loss, such as a house fire, will still be able to deduct those losses under the Governor’s proposal. Only about 800 Minnesotans use the casualty loss deduction each year, but it is a very significant expense for them, with an average $16,000 benefit. The House bill will only allow this deduction in the event of a federally declared disaster.

This bill as amended also limits the property tax deduction for the amount of tax paid over $30,000 per year. In addition, it limits the mortgage interest deduction, disallows the Bicycle Commuting Expense Exclusion, and the Home Equity Loan Deduction.

House bill excludes Governor Dayton's proposed benefits for Minnesota families
There are a number of items in the Governor's bill that are not included in the House bill that would help low and middle income families, including the expansion of the Working Family Credit and a new Personal and Dependent Credit. The Governor's Working Family Credit proposal would expand the credit to filers who are 21 years old and would allow families with three or more children access to a larger credit and a higher income range.

The Governor proposed a new, non-refundable $60 per person tax credit for individuals earning less than $90,000 and married tax filers earning less than $180,000 per year.

This bill as amended does not include items from the Governor's bill including common sense provisions that would make our business taxes fairer. These provisions include limitions on the type of software that qualifies for the data center exemption, tobacco tax changes to improve public health and to cut down on tax evasion, and the Sustainable Forest Incentive Act Private Lands Timber Harvest Credit.

This bill as amended also modifies indexing. The House approach moves the indexing of brackets, and various tax attributes to chained CPI except for the property tax refund. This will mean that brackets will increase more slowly as well as increase taxes on individuals. In addition, because the other credits will increase more slowly, tax credits and other benefits will be less beneficial over time, also raising their taxes. These changes may seem technical but they will have real impacts on Minnesotans by raising their taxes over time compared to what they would pay under current law.

Impacts on Department of Revenue's work with customers
Another troubling aspect of this bill as amended is the provision that would have the Department of Revenue provide a notice to taxpayers on the loss of benefits found in this bill. Putting the burden on the Department of Revenue to develop and implement a plan to notify all property owners in Minnesota is outside our normal capacity. In addition, having county administrators share property owner information with the state is a duplication of effort and not necessary.

This bill as amended also takes funds from the Department of Revenue Service and Recovery Fund, which will impact our ability to increase any staffing or support funding for the local governments helping to administer local option sales taxes. Last year the number of local option sales taxes increased dramatically as a result of changes in the 2017 omnibus tax bill. This past year alone we added 17 local option sales taxes because of those changes, including one water and sewer district. The number of local option sales taxes are increasing and local governments are expecting quicker turnaround times in activating those taxes. By removing this fund, the bill makes the department less able to accommodate local governments. This is compounded by a nearly $4 million annual cut to the agency in the House State Government Finance bill that will reduce our services to taxpayers.

Repeal of the Political Contribution Refund
We are concerned with the elimination of the Political Contribution Refund (PCR), which has been a hallmark of Minnesota's campaign finance system for some time. The PCR provides an opportunity for more people to participate in our campaign finance system and encourages small dollar contributions.

Treatment of local governments
There are several troubling items within this bill as amended concerning the treatment of local governments.

First, the repeal of Minneapolis Library Aid is concerning – the state made this commitment and should keep it.

Next, while we are glad to see that this bill as amended removes a provision in the division report that would have reduced local government aid based on decisions made by local governments on how to serve their residents, including immigrants, there are provisions remaining that prohibit locally elected officials from making decisions on behalf of their constituents. This includes prohibiting any governmental unit from even studying the feasibility of a rail project between Rochester and the metro area, and a provision regarding fees on food containers.

The bill as amended also includes requiring elections on city, county, and school district referenda questions related to property taxes, debt, and spending be limited to one day per year as well as proposing reverse referendum policies. These proposals limit the flexibility of locally elected officials to meet the needs of their constituents. These proposals were rejected last year and we continue to have concerns about them.

In addition, we are concerned about the micromanagement of the local Hennepin County Sales Tax. If the legislature wants to fund a specific project in Hennepin County, it can do so, rather than tying a county's hands on the use of its own funds. This provision is an example of the many projects that demonstrate the need for a long-term solution for sustainable transportation financing that does not compete with the other general fund needs.

Fiscal responsibility
This bill as amended does not reflect the fiscal sustainability that Minnesota needs and would create a hole in the state's budget in the future.

The House bill does not show the full costs of the provisions in the current biennium. Instead, it phases in rate changes for individuals and corporations over time, obscuring their true costs until the last year of the 2020-21 biennium. The cost of the corporate and income tax rate cuts grow from $130.6 million in the 2018-19 biennium to $570 million in the 2022-23 biennium.

Minnesotans deserve transparency. If tax provisions are important enough to be included in the final bill, the full cost should be shown in the first year so that Minnesotans can understand who is benefited and by how much.

We also note that the bill as amended pre-pays about $14 million in local government aid. We anticipate this is needed to make the second biennium of the bill balance.

The Governor is committed to long-term fiscal responsibility, which is why he has proposed undoing three changes in last year's tax bill: the State General Levy Inflator, the Cigarette Inflator, and the $3 million Estate Tax exemption.

In addition, the bill as amended would reduce the sales tax rate based on an unissued federal Supreme Court decision, that will likely not be issued until June. Starting 15 months after the state begins collecting sales tax on marketplace providers and/or other remote sellers, the Commissioner of Revenue is instructed to reduce the general sales tax and the legacy sales tax rates by a revenue neutral amount to reflect increased sales collections from these remote sales.

The House bill anticipates what the Supreme Court may decide on the Wayfair decision. We do not know if the United States Supreme Court will cleanly overturn Quill, uphold Quill and leave it to Congress, or create a path in between. Legislation attempting to anticipate what the Supreme Court might do creates a high level of fiscal uncertainty.

The department is closely monitoring the Wayfair vs. South Dakota case at the Supreme Court. Once a decision is made public, we will provide information to Minnesota taxpayers about how that decision will be administered. At that time, the legislature will have concrete information – not speculation – upon which to base a decision about appropriate sales tax rates.

In addition, the bill as amended takes money from the stadium reserve account based on forecasted amounts rather than actual receipts. We should not deplete that fund until we know the actual revenue flowing into that account and, only then should we make changes.

Finally, as we know more about the long-term costs of the bill as amended, they must be balanced against the revenue sources in the bill. For example, deemed repatriation revenue will end after eight years but it seems to be built into the revenue stream to fund permanent rate changes.

In addition, several provisions, such as the historic tax credit, shift the year in which the cost is realized and do not represent new revenue.

Governor Dayton has been very clear about his commitment to fiscal sustainability for the State of Minnesota. As he expressed in his April 9 letter to legislative leaders, the long-term fiscal stability of the state is his highest priority. The Governor has worked over the past seven years to restore the state's fiscal stability. He will not support any bill that threatens that stability.

Moving forward

We look forward to working with you as this bill moves forward. There are areas of agreement but we have a great deal more to do if we are to put low-income and working families first in a tax bill, while protecting the State's fiscal health.

Sincerely,

Cynthia Bauerly
Commissioner

CC: Representative Paul Marquart
DFL Lead, House Taxes