SUMMARY OF THE FISCAL ACTIONS OF THE 2001 LEGISLATURE

Minnesota's General Fund Budget for the FY 2002-03 Biennium

This paper provides an overview and details of the enacted FY 2002-03 biennial budget. Part one summarizes the overall budget. Part two provides appropriation details organized according to the jurisdictions of the House of Representatives' fiscal committees. Part three discusses the sales tax rebate, property tax rate reductions and other changes to the tax laws.

The Overall Budget Picture

The Enacted Budget in Detail

- Family and Early Childhood
- K-12 Education
- Higher Education
- Health and Human Services
- Judiciary
- Environment, Natural Resources and Agriculture
- Jobs & Economic Development
- State Government
- Transportation
- Capital Investment

Tax Revenues, Local Aid and Credits

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Taxes, Tax Rebates, and Local Government Aids

Overview

Property tax reform and property tax reductions were the focus of the 2001 Omnibus Tax Act (*Laws of Minnesota, Special Session 2001, Chapter 5*). In addition, Chapter 5 provided a sales tax rebate for the third consecutive year. As illustrated by *Figure 1*, provisions associated with the property tax reductions accounted for 75 percent of the total General Fund costs for all tax provisions through FY2005. The sales tax rebate accounted for an additional 23 percent, with all other tax changes combining for only two percent of the total.

Figure 1

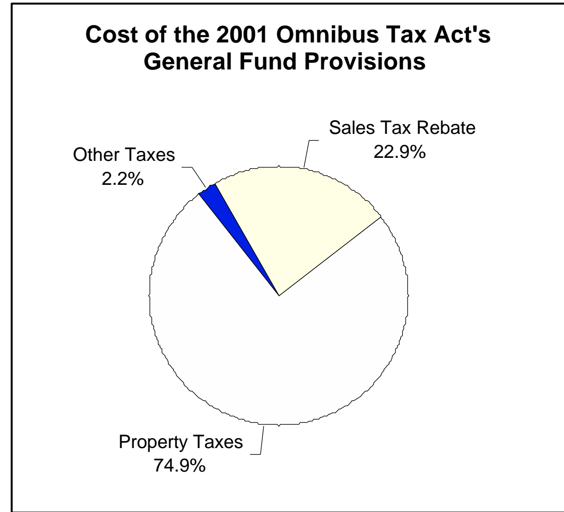

Figure 2 summarizes the cost of all General Fund tax provisions by type of tax and by biennium. Property tax provisions will increase General Fund expenditures by over $2.5 billion through FY 2005. By comparison, provisions contained in Chapter 5 will result in revenues from the income tax declining by $86 million, the sales tax increasing by $9 million (despite a $154 million one-time cut in FY 2003), and other General Fund taxes increasing by $11 million.

Figure 2

2001 Omnibus Tax Act Summary
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Tax Provision	FY 2001	FY 2002-03	FY 2004-05
Sales Tax Rebate	(781,499)	0	0
Property Taxes		(615,374)	(1,943,812)
Income Taxes (individual and corporate franchise)	(4,000)	(44,690)	(37,460)
Sales & Use Tax		(74,490)	+93,584
Other Taxes		+4,170	+6,365
Administrative & Miscellaneous Provisions		(18,694)	(374)
Total General Fund:	**(785,499)**	**(749,078)**	**(1,881,697)**

Note: Negative changes represent a cost to the state and positive numbers represent a gain to the state.

In addition, the Omnibus Tax Act also included several significant non-General Fund changes. Health care taxes (dedicated to the Health Care Access Fund) were reduced by a total of $156 million through FY 2005. The new law also creates two new funds and dedicates almost one-fourth of motor vehicle sales tax revenues to fund transit, replacing property taxes as the funding source for transit operating costs.

2001 Sales Tax Rebate

The Omnibus Tax Act included another one-time sales tax rebate of $791.3 million distributed during the Summer of 2001. The Act directed that the rebate be equal to the entire General Fund balance remaining at the end of FY 2001, as certified by the Commissioner of Finance on July 15th.[1] The Department of Revenue and State Treasurer received appropriations totaling $2.151 million to administer the sales tax rebate. As was true with previous rebates, these sales tax rebates were subject to "revenue recapture" provisions which allow certain tax debts or other General Fund debts to be deducted from rebate amounts before a rebate is paid. An estimated 1.5 percent, or about $12 million, of the total sales tax rebate was expected to be retained by the Department of Revenue, thereby reducing the net cost of the sales tax rebate provisions to $781 million. Although the rebates will be paid during the 2002 fiscal year, the act specifies that the dollars are counted in fiscal year 2001.

Figure 3

FY 2001 Sales Tax Rebate
(dollars in thousands)

	FY 2001
Sales Tax Rebate	($791,348)
Administrative appropriations:	
Department of Revenue	($1,750)
State Treasurer	($401)
Sales tax rebate recapture (@ 1.5%)	+$12,000
Sales Tax Rebate	**($781,499)**

Eligibility: Those eligible for the rebate fell into one of the following five groups:

Group One: *Residents who filed a 1999 Minnesota income tax return, who were not claimed as dependents on another return, and who either:*

- *paid Minnesota income tax (before credits) in 1999 or*
- *paid federal income tax (before credits) in 1999.*

The deadline for filing a 1999 Minnesota return is November 30, 2001. The amount of rebate depends on income, as shown in Figure 4. Part-year residents will receive a smaller rebate, based on the ratio of their Minnesota income to their total income.

Group Two: *Full-year residents receiving social security, railroad retirement, or a public pension in 1999 (and at least 18 years old at the end of that year).* Each qualifying individual will receive a rebate of $108 (if not eligible for a larger rebate under Group One). No Minnesota tax return need be filed, because the necessary information is obtained from the Social Security Administration, the

[1]The certified balance of $791.348 million did not take the $12 million in income tax recapture into account. If this had been taken into account – following the accounting rules used during the legislative session – rebate checks would have been 1.5 percent larger.

Railroad Retirement Board, or various public pension administrators.

Group Three*: Dependents who filed a 1999 Minnesota income tax return, who had wage income, and who either*:

- *paid Minnesota income tax (before credits) in 1999, or*
- *paid federal income tax (before credits) in 1999.*

The amount of the rebate depends on income, and will equal 35 percent of the amount shown in Figure 4. Part-year residents will receive a smaller rebate, based on the portion of their total income that is Minnesota income.

Group Four*: Credit-only income tax filers. Minnesota residents who are not dependents and who do not qualify as part of Group One or Group Two will qualify if they received a Minnesota income tax refund in 1999.* This includes those who:

- filed a Minnesota income tax only to receive a refund of withholding or of estimated tax payments; or
- filed a Minnesota income tax to receive the working family credit, child care credit, or education credit.

Full-year residents qualifying in Group Four will receive the minimum rebate of $108 (single filers) or $213 (joint or head of household returns). Part-year residents will receive a smaller rebate, based on the portion of their total income that is Minnesota income.

Group Five: *Property Tax Refund filers. Minnesota residents who are not dependents and who do not qualify as part of Groups One, Two, or Four will qualify if they received a property tax refund (PTR) in 1999.* The property tax refund is Minnesota's property tax "circuit breaker" program, providing refunds to both homeowners and renters whose property taxes are high relative to their income. Full-year residents qualifying in Group Five will receive the minimum rebate of $108 (single filers) or $213 (joint or head of household returns). Part-year residents will receive a smaller rebate, based on the portion of their total income that is Minnesota income.

Group Six*: Non-residents who paid Minnesota sales tax in 1999 (and have receipts)* can receive a rebate equal to 36.9 percent of the taxes they paid, but not more than the rebate paid to full-year residents with the same level of income. To receive a rebate, non-residents must file Form NRST, a copy of their federal tax return, and original copies of all receipts. Business purchases or purchases reimbursed by an employer do not qualify.

Except for the non-residents in Group Six, all eligible taxpayers should receive an automatic rebate. Those who would qualify but who have not yet filed a 1999 Minnesota income tax return (or a 1999 property tax refund return) have until November 30, 2001 to file those returns.

Amount of Credit: The proposed rebate amount would equal 36.9 percent of what the Department of Revenue estimates the household paid in sales tax in 1999. As in past years, rebate amounts were larger for those with higher incomes. Rebates were capped at a maximum of $1,484 for singles and $2,967 for others. As in past years, there was no adjustment for family size, but married taxpayers and heads of household received larger rebates than single persons with the same income. Income was defined as federal taxable income plus "Minnesota additions" (primarily state income taxes claimed as itemized deductions on the federal tax return). The 2001 rebate schedule is shown in *Figure 4*.

Figure 4

2001 Sales Tax Rebate

Eligible dependents will receiver 35 percent of amount shown in table. Part-year residents will receive a fraction of the table amounts based on the portion of their income apportioned to Minnesota.

Income	Single	Others	Income	Single	Others
Less than $2,500	$ 108	$ 213	$ 70,000 - $ 79,999	$ 588	$ 632
$ 2,500 - $ 4,999	113	264	$ 80,000 - $ 89,999	588	683
$ 5,000 - $ 9,999	151	277	$ 90,000 - $ 99,999	588	739
$ 10,000 - $ 14,999	179	305	$100,000 - $119,999	708	801
$ 15,000 - $ 19,999	207	346	$120,000 - $139,999	708	876
$ 20,000 - $ 24,999	231	373	$140,000 - $159,999	855	948
$ 25,000 - $ 29,999	278	398	$160,000 - $179,999	855	1,014
$ 30,000 - $ 34,999	300	433	$180,000 - $199,999	855	1,078
$ 35,000 - $ 39,999	300	471	$200,000 - $399,999	1,160	1,379
$ 40,000 - $ 44,999	331	511	$400,000 - $599,999	1,484	1,814
$ 45,000 - $ 49,999	331	543	$600,000 - $799,999	1,484	2,177
$ 50,000 - $ 59,999	425	556	$800,000 - $999,999	1,484	2,495
$ 60,000 - $ 69,999	425	581	Over $1,000,000	1,484	2,967

Note: "Income" is 1999 federal taxable income plus Minnesota additions to income – line 4 on the Minnesota income tax return. (This is not the same as total income; nontaxable income is excluded, and personal exemptions, the standard deduction, and any itemized deductions other than state income tax have all been subtracted.) "Others" include married couples filing joint returns, plus those filing as head of household or surviving spouse.

Comparing the 2001 Rebate to the 1999 and 2000 Sales Tax Rebates

The 2001 rebate was 25 percent larger than the 2000 rebate ($791 million compared to $636 million in 2000), but 40 percent smaller than the 1999 rebate ($1,300 million). The population eligible for the 2001 rebate was roughly the same as in 2000. The groups newly eligible in 2000 (social security recipients, dependents who paid income tax, and those receiving refundable tax credits) remained eligible in 2001. *Figure 5* on the next page compares the three sales tax rebates.

As in past years, taxpayers will pay no federal income tax on their sales tax rebate.

Figure 5

Comparison of the 1999, 2000, and 2001 Sales Tax Rebates

	2001 Rebate	2000 Rebate	1999 Rebate
Total dollars	$791 million	$636 million	$1,300 million
Total checks	2,480,000 (est)	2,392,000	1,956,000
Average check to core population			
Single filers	$232 (est)	$187	$412
Joint or head of household filers	$512 (est)	$377	$840

Comparison of 2000 and 2001 rebate tables. The 2001 tax rebate table in *Figure 4* is not just a "scaled up" version of the 2000 rebate table, because the Department of Revenue re-estimated the sales tax burden at each income level. As a result, a single person with the same income in both years could receive as much as 35 more or as much as 3 percent less in 2001 as in 2000. A married taxpayer with the same income in both years could receive anywhere between 19 and 30 percent more than last year, depending on the level of income.

Why did eligibility rules change in 2001?
Primarily because one significant method used to identify eligible household in past years could not be used this time. In previous sales tax rebates, those who had received a property tax rebate in the base year (claimed on the 1997 or 1998 income tax returns) were automatically eligible for a sales tax rebate. There was no property tax rebate in 1999, however, so some of the households who had only been identified in this way did not qualify for the 2001rebate. To identify some of these "missing" taxpayers, several new groups were added to the eligible population for 2001:

- those who received public pensions (some of whom do not qualify for social security);
- those who received a Property Tax Refund (PTR), Minnesota's property tax "circuit breaker," which provides property tax relief to those whose property taxes are high compared to their income; and
- those who paid federal income tax but not Minnesota income tax.

There are two reasons why some who pay federal income tax do not pay Minnesota income tax. First, they may have income that is taxed at the federal level but not by Minnesota, such (a) income earned on a reservation by a tribal member who lives on the reservation or (b) interest on federal bonds. Second, they may be part-year residents whose Minnesota income was below the filing requirement. Revenue Department data suggests that the second group far outnumbers the first. The Department of Revenue estimated that rebates would go to 9,600 who paid federal tax but not Minnesota tax. Of that group, 4,100 were expected to be dependents. Only five to ten percent were expected to be individuals with on-reservation earnings.

Property Taxes, Local Government Aids, and Credits

Comprehensive property tax reform is a key feature for the 2001 Omnibus Tax Act (*Laws of Minnesota, Special Session 2001, Chapter 5*). Overall, as shown in *Figure 6*, the property tax reforms enacted by Chapter 5 will increase General Fund expenditures by $795.8 million in FY 2003, the first year in which most provisions will have a state impact. The major reform provisions include:

- K-12 education financing changes that shift funding responsibility for the general education levy from local property taxpayers to the State General Fund, redefine the tax base for operating referendum levies, and provide additional operating referendum and debt service equalization aid;
- creation of a statewide general property tax on businesses and cabins;
- compression of class rates along with the creation of two new credit programs to shield low-valued homes and farms from shifts in tax burden; and
- elimination of Homestead and Agricultural Credit Aid (HACA) payments for cities, townships, school districts, and special taxing districts, with city HACA losses offset in part by an increase in Local Government Aid (LGA).

Figure 6
All Property Tax and Minerals Tax Reform Provisions
Summary of General Fund Revenue and Expenditure Changes
(dollars in thousands)

Provisions	FY 2002	FY 2003	FY 2002-03	FY 2004	FY 2005	FY 2004-05
K-12 finance reforms	0	($1,012,552)	**($1,012,552)**	($1,132,798)	($1,143,814)	**($2,276,612)**
New state property tax	296,000	599,400	**895,400**	614,385	629,745	**1,244,130**
Class rate reforms	(91,000)	(365,375)	**(456,375)**	(395,315)	(410,587)	**(805,902)**
Property tax refunds	0	(4,906)	**(4,906)**	(2,470)	(6,077)	**(8,547)**
Local government aids	0	121,000	**121,000**	115,615	109,763	**225,378**
County service takeovers	(8,701)	0	**(8,701)**	(8,622)	(5,645)	**(14,267)**
Out-of-home placement takeover	0	0	**0**	0	0	**0**
Transit levy takeovers	(5,000)	(121,631)	**(126,631)**	(137,091)	(141,259)	**(278,350)**
Minerals taxes	(10,900)	(11,700)	**(22,600)**	(11,500)	(11,600)	**(23,100)**
Other/Public Finance	0	(9)	**(9)**	(2,871)	(3,671)	**(6,542)**
Total for General Fund	$180,399	($795,773)	**($615,374)**	($960,667)	($983,145)	**($1,943,812)**

Note: Negative changes represent a cost to the state and positive numbers represent a gain to the state.

In addition:

- limited market value is phased-out by 2007;

- property tax levies for regional public transit operations in the metropolitan area are eliminated and both those levies and rural transit levies are replaced by General Fund revenues;

- funding is provided for completing the state assumption of the cost of trial court operations;

- up to 30 percent of the non-federal share of county out-of-home placement costs will be shifted to the General Fund if adequate data becomes available from counties; and

- the property tax refund program for homeowners is expanded.

Collectively, as summarized in *Figure 7* on the next page, the reforms enacted were estimated reduce property taxes from an estimated $5.380 billion to $4.392 billion[2], or $988 million (18.4 percent), statewide in 2002 relative to projected taxes under prior law. As a result, nearly all property owners were expected to pay lower property taxes in 2002 even though the proportion of their property taxes attributable to county and municipal taxes will increase relative to school property taxes. Further, differences in property tax burdens across different classes of property are expected to diminish over time. The projected reductions in property taxes may not be realized if the local levies exceed levels used in the end-of-session models.

[2]By comparison, property taxes totaled $5.036 billion statewide in pay 2001, or $644 million more than projected for pay 2002 (House Research Model Simulation #1W3).

Figure 7

Projected Pay 2002 Property Taxes by Class
Comparison of Previous Law to Final 2001 Tax and K-12 Omnibus Bills
Source: House Research Model Run #1W4
(dollars in thousands)

Property Class	Net Tax Baseline	Net Tax Alternative	Net Tax Change	Percentage Change
Residential Homestead	2,231,747	1,707,114	-524,633	-23.5
Residential NonHomestead (1Unit)	108,451	78,616	-29,835	-27.5
Residential NonHomestead (2-3 Units)	66,535	58,073	-8,462	-12.7
Regular Apartments	276,334	207,471	-68,863	-24.9
Low-income Apartments	32,814	28,057	-4,757	-14.5
Seasonal Recreational	131,292	116,025	-15,267	-11.6
Com/Ind Lo Tier	232,443	209,340	-23,103	-9.9
Com/Ind Hi Tier	1,533,113	1,368,320	-164,793	-10.7
Publ Utility: Elec Generation Equip.	66,431	42,012	-24,418	-36.8
Publ Utility: Other	197,138	172,560	-24,578	-12.5
Ag Homestead: House	82,115	59,468	-22,648	-27.6
Ag Homestead: Land	129,312	104,927	-24,385	-18.9
Ag NonHomestead	118,699	99,852	-18,848	-15.9
New Con: Res Homestead	67,193	49,116	-18,077	-26.9
New Con: Other	106,249	91,406	-14,843	-14.0
Total	**5,379,865**	**4,392,356**	**-987,510**	**-18.4**

It should be noted that Chapter 5 requires that the Public Utilities Commission reduce utility rates in order to pass on to consumers the portion of tax reductions attributable to reductions in the personal property taxes paid on electric generation machinery and equipment. Consequently, about $25 million of the $49 million in tax reductions for public utilities will be passed along to consumers of electricity purchased from Minnesota public utilities.

K-12 Finance Reform

As shown in *Figure 8* on the following page, Chapter 5 shifts over one billion of K-12 education costs from local school property taxpayers to the General Fund beginning in 2002 (FY 2003)[3]. Specifically:

- $788.1 million in new funding, combined with $456 million in General Fund savings from the elimination of the education homestead and agricultural education credits, is used to eliminate the $1.331 billion general education levy beginning in 2002 (FY 2003);
- $199.1 million is provided to increase the general education aid formula by $415 per pupil to reflect corresponding reductions in referendum revenues;
- $24.4 million is provided to equalize the first $126 of operating referendum revenue per pupil unit;
- $8.7 million is provided to replace the operating referendum revenues that would otherwise have

[3] Amounts described are after adjustments for the statutorily specified school aid metering system which results in 90 percent of aid amounts being paid in the current year and the remaining 10 percent being paid in the subsequent year.

been collected from agricultural and seasonal recreational properties for existing operating referendum levies since those properties are exempted from both existing and future referendum levies; and

- $13.0 million is provided in additional debt service equalization aid.

In addition, all growth in revenue from the new general property tax on businesses and seasonal recreational property after FY 2003 is to be deposited in an education reserve account. Based on the February 2001 forecast, approximately $15 million in FY 2004 and $30 million in FY 2005 is expected to be available for educational purposes. The educational purposes for which the funds can be used were not specified but amounts deposited into the reserve account remain in the account until spent.

Figure 8

K-12 Education Finance Provisions

General Fund Revenue and Expenditure Changes

(dollars in thousands)

Provision	FY 2002	FY 2003	FY 2004	FY 2005
General education levy appropriation	0	($1,331,208)	($1,331,000)	($1,331,232)
Eliminate Education Homestead Credit	0	399,830	406,084	410,400
Eliminate Ag Education Credit	0	55,705	56,335	56,405
90/10 metering adjustment	0	87,567		
Net cost for general education levy	**0**	**(788,106)**	**(868,581)**	**(864,427)**
Conversion of $415 referendum revenue	0	(199,132)	(199,132)	(199,132)
90/10 metering adjustment	0	19,913		
Net cost of $415 conversion to state aid	**0**	**(179,219)**	**(199,132)**	**(199,132)**
Referendum equalization aid	0	(24,423)	(28,358)	(29,775)
Referendum tax base replacement aid	0	(7,850)	(8,722)	(8,722)
Debt service equalization aid	0	(12,955)	(13,020)	(11,413)
Dedication of state tax growth to education	0	0	(14,985)	(30,345)
Subtotal: K-12 Education Finance	**0**	**(1,012,552)**	**(1,132,798)**	**(1,143,814)**

As a result of these reforms, as well as provisions in the K-12 Education Finance Bill, the state-funded portion of K-12 education is expected to increase from 72.4 percent in 2001-02 to 87.3 percent in 2002-03.

Elimination of General Education Levy

Beginning with property taxes paid in 2002, the $1.331 billion state-determined general education levy is eliminated. Of that $1.331 billion levy, $456 million had been funded by two state-paid property tax credits–the Education Homestead Credit and the Agricultural Education Credit–and $875 million was collected from property taxpayers. Savings from the elimination of the two credit programs, along with the effects of the statutorily established school aid metering system, reduce the net cost of the general education levy elimination, in FY 2003, to $788.1 million.

Operating Referendum Levy Reforms and Increased Equalization

Chapter 5 makes three changes to school operating referendums. First, the general education formula allowance is increased by $415 in FY 2003, and a corresponding reduction of up to $415 per pupil is made in each district's referendum, supplemental, and transition revenue, to reflect the conversion of voter approved operating referendum revenue to general education formula aid beginning with property

taxes payable in 2002[4]. In general, the conversion will reduce property taxes but will not result in a revenue change for the school district unless the formula increase for a district is greater than amount of revenue the district had been receiving in referendum revenue. For example, a district that had no referendum levy would receive new money approximately equal to the $415 per pupil increase in formula aid while a district with $200 in referendum revenue per pupil will receive new money approximately equal to $215 per pupil in increased formula aid. The $199.1 million cost of the provision comes from the increased general education formula aid payments as well as increased payments for other education formulas that key off the general education formula.

The conversion of $415 of referendum revenue also increases the capacity of all districts to adopt additional referendums. For example, under prior law, the amount of referendum revenue most school districts could levy was limited to a statutorily established cap of 25 percent of the formula allowance, or $1,017 per pupil in 2001. Beginning in 2002, the referendum levy cap will be equal 18.2 percent of a higher formula allowance for 2002, or $837 per pupil in 2003. Therefore, for example, a district that was at the referendum revenue cap of $1,017 for 2001 would have $415 of referendum revenue converted to general education formula aid, thereby reducing their referendum revenue to $602 per pupil, or $235 per pupil below the new referendum revenue cap.

However, the burden of paying for new referendum levies, particularly in greater Minnesota, will fall on a smaller group of taxpayers because agricultural land (not including the house, garage and one acre) and non-commercial seasonal recreational property[5] is exempted from both existing and future school district operating referendum levies beginning with property taxes payable in 2002. A sum-sufficient amount, estimated to be $8.7 million, is provided in FY 2003 to prevent the taxes from existing referendum levies from being shifted on to other classes of property. Actual payments will be equal to the amount of taxes cabins and farms would have otherwise paid for existing levies had they not been exempted. Because the aid applies only to existing referendums and ends when existing referendums expire or are renewed by voters, the annual cost of replacement aids is expected to decline each year.[6]

While the burden of funding referendum levies will fall on a smaller tax base, a two-tiered referendum equalization aid formula will provide additional aid. Specifically, the first $126 of referendum revenue per pupil (after the $415 per pupil conversion) is equalized using an equalizing factor of $476,000. All referendum revenue above $140 per pupil, up to the revenue cap, is equalized using an equalizing factor of $270,000 per pupil. That means that for a district with $300 in referendum revenue per pupil, $140 per pupil would be equalized at the first tier and $160 would be equalized at the second tier.

Debt Service Equalization Aid

Beginning with property taxes paid in 2002, aids paid in FY 2003, a sum-sufficient amount estimated to be $13 million is appropriated to create a two-tiered debt service equalization formula to provide a

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[4] Specifically, the general education formula will increase from $3,964 per pupil unit in FY 2001, to $4,068 in FY 2002 to reflect a $104 per pupil unit increase funded in the K-12 finance omnibus act, and then will be increased again to $4,608 in FY 2003 to reflect an additional $104 per pupil unit increase in the K-12 act, the $415 per pupil unit operating referendum conversion, and $14 per pupil unit in related changes.

[5]The exemption applies to all class 2 property (agricultural property), not including the house, garage, and one-acre of property, and all non-commercial seasonal recreational property (class 4c(1)) and post-secondary student housing owned by non-profits, such as that owned by fraternities and sororities (class 4c(4)).Commercial seasonal recreational property is still subject to school operating levies.

[6]The Governor's initial proposal to also exempt C/I property from operating referendum levies was not adopted.

higher level of equalization to districts that have unusually high debt service levies relative to their tax base. Under the change, debt service levy amounts exceeding 15 percent of the district's adjusted net tax capacity (ANTC), but less than 25 percent of ANTC, will continue to equalized at $3,200 per pupil[7]. However, levy amounts that exceed 25 percent of ANTC will now be equalized at $8,000 per pupil. In other words, a higher proportion of debt service levies exceeding 25 percent of ANTC will now be funded by state equalization aid rather than by property taxpayers.

General Property Tax on Businesses and Cabins

The increase in General Fund expenditures attributable to K-12 education finance reforms and other changes will be offset, in part, by revenue from a new general property tax on businesses and cabins[8]. Beginning with taxes payable in 2002, $592 million will be levied with the levy amount being increased annually by the implicit price deflator for state and local government services. The tax will be collected by counties, along with all other property taxes, and remitted to the State's General Fund.

As shown in *Figure 9*, collections from the first one-half of the property tax payments are required to be remitted prior to June 30 each year, resulting in initial revenues estimated at $296 million in FY 2002. Based on initial projections of the levy growth rates[9], collections from the final 2002 payments and the first 2003 payment, are expected to generate $599.4 million in FY 2003, $614.4 million in FY 2004, and $629.7 million in FY 2005. After FY 2003, growth in revenues from the tax are dedicated to a newly established education reserve account (see Figure 8 for expenditure).

Figure 9

General Property Tax: General Fund Revenue and Expenditure Changes

(dollars in thousands)

Provision	FY 2002	FY 2003	FY 2004	FY 2005
Statewide general property tax	$ 296,000	$599,400	$ 614,385	$ 629,745

The tax will be levied on the tax capacity of the relevant properties except that the first $76,000 of market value of cabins (class 4c(1)) has a tax capacity equal to only 40 percent of its original tax capacity. The effect of this exception is that cabins are taxed at a lower rate than business property because a portion of the cabin tax capacity is exempted. For taxes payable in 2002, the projected statewide tax capacity tax rate is 58.07. The tax will be levied at a uniform rate across the state, and within each county.

[7]Note that the 15 percent ANTC threshold and $3,200 equalization factor correspond to the 12 percent threshold and $4,000 equalization factor under prior law after mathematical adjustments to reflect changes in tax base resulting from class rate compression and other changes.

[8]Properties subject to the general tax include: all businesses, public utility real property, utility transmission and distribution lines, unmined iron ore, cabins, resort properties, golf courses, manufactured home parks, and selected other property types. Utility attached personal property and property located at the MSP International airport and the St. Paul airport would be exempt from the tax.

[9]The IPD for state and local government expenditures being used at the end-of-session was 2.5 percent after 2002.

Figure 10

Class Rate Reforms
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Provision	FY 2002	FY 2003	FY 2004	FY 2005
New Homestead Credit				
Non-school	0	(244,000)	(250,100)	(256,353)
School	0	(75,000)	(76,875)	(78,797)
90/10 metering	0	7,500	188	192
Net Homestead Credit	0	(311,500)	(326,787)	(334,958)
New Ag Land Credit*				
Non-school	0	(13,700)	(14,043)	(14,394)
School	0	(3,800)	(3,895)	(3,992)
90/10 Metering	0	380	10	10
Net Ag Land Credit	0	(17,120)	(17,928)	(18,376)
Rental Tax Base Replacement Aid	0	0	(14,100)	(20,753)
TIF Grant Aid	(91,000)	(38,000)	(38,000)	(38,000)
Eliminate TIF Aid Penalties	0	(5,400)	(5,400)	(5,400)
Tax Base Change Interactions:				
Disparity Reduction Credit*				
Non-school payments	0	2,250	2,250	2,250
School payments	0	750	750	750
90/10 metering adjustments	0	(75)	0	0
Disparity Reduction Aid*				
Non-school payments	0	2,100	2,100	2,100
School payments	0	1,800	1,800	1,800
90/10 metering adjustments	0	(180)		
Subtotal: Class Rate Reform	**(91,000)**	**(365,375)**	**(395,315)**	**(410,587)**

Class Rate Reforms

Chapter 5 includes significant tax base reforms–including class rate reductions, changes in tier breaks for residential and agricultural properties, and the phase-out of limited market value. As summarized in *Figure 10* on the previous page, $91.0 million in FY 2002 and $365.4 million beginning in FY 2003 is provided primarily to offset shifts in tax burden on to low-valued homes and agricultural properties caused by class rate changes, as well as to help replace lost TIF revenues due to class rate changes and the elimination of the general education levy.

As summarized in *Figure 12*, Chapter 5 continues tax base reforms begun in the 1990's by reducing class rates for most types of property beginning in 2002. Additional class rate reductions for apartments and non-homestead residential properties will be phased-in by 2004. In addition, the tier break for residential properties is increased from $76,000 to $500,000 and the lowest tier for homesteaded farmland is eliminated resulting in a higher class rate on the first $115,000 of homesteaded agricultural land.

Limited Market Value

Limited market value (LMV) was enacted in 1993 as a temporary program to limit annual increases in the taxable value of homesteads, cabins and farmland. While the program has been revised and extended several times since 1993, under prior law it would have ended after assessment year 2001, property taxes payable in 2002, and all captured value would have become subject to tax beginning with taxes

payable in 2003. The Governor had proposed allowing the law to expire but adding back all captured value in three equal amounts for taxes payable in 2003 through 2005. Under the changes enacted by Chapter 5, the program will instead be phased-out over six years so that by assessment year 2007, taxes payable in 2008, all properties will be at their full estimated market value. During the phase-out timberland is added to the list of property types covered by LMV.

Under prior law, annual increases were limited to 8.5 percent of the prior assessment or 15 percent of the total difference between the prior assessment and the current estimated market value, whichever was greater. As shown in Figure 11, phase-out of the program will be achieved by gradually changing the limitation parameters so that by end of the six-year phase-out period all of the captured value is added back. Therefore, eligible properties experiencing large valuation increases in the next few assessment years will continue to benefit from a temporary limitation but the captured value will be added back more rapidly in subsequent years than it would have been under prior law.

Figure 11

Schedule for Phase-out of Limited Market Value

The increase in taxable value is limited to greater of column 1 or 2:

Assessment Year	**(1)** Percent of Prior Assessment	**(2)** Percent of Difference between Prior Assessment and Full Market Value
2002	10 %	15 %
2003	12	20
2004	15	25
2005	15	33
2006	15	50
2007	0	100

Figure 12
Class Rate Schedule
Tax Payable Years 2001-2004

Property Type	Payable 2001	Payable 2002	Payable 2003	Payable 2004	State Tax
Residential Homestead-Single Family					
Up to $76,000[1]	1.00%	1.00%			
$76,000-500,000	1.65	1.00			
Over $500,000		1.25			
Residential Non-homestead:					
Single unit:					
Up to $76,000[1]	1.20	1.00			
$76,000-500,000	1.65	1.00			
Over $500,000		1.25			
2-3 Units and undeveloped land	1.65	1.50			
Up to $76,000[1]	1.20	1.00			
$76,000-500,000	1.65	1.00			
Over $500,000		1.25			
Seasonal Recreation Commercial:					
Homestead resorts (1c):		1.00			
Seasonal Resorts (4c):		1.00			
Up to $500,000		1.00			
Over $500,000		1.25			
Apartments					
Regular (4 or more units)	2.40	1.80	1.50	1.25	
Small City	2.15	1.80	1.50	1.25	
Low-income apartments Class 4d	1.00	0.90	1.00	Eliminated	
Agricultural Land and Buildings					
Homestead:					
Up to $115,000	0.35	0.55			
$115,000 - $600,000	0.80	0.55			
Over $600,000	1.20	1.00			
Non-homestead/Timber	1.20	1.00			
Commercial-Industrial-Public Utility					
Up to 150,000[2]	2.40%	1.50			1.50%
Over $150,000	3.40 [4]	2.00			2.00 [3]
Electric generation machinery		2.00			-

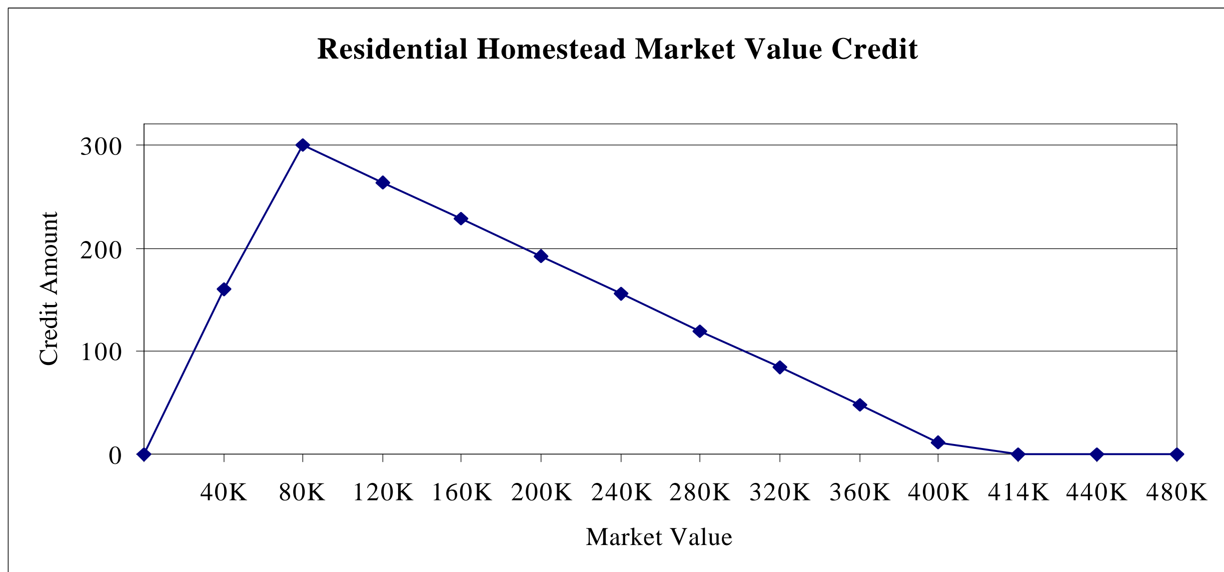
[1] *First tier limit was $72,000 for payable 1997, $75,000 for payable 1998 and 1999.*
[2] *First tier limit was $100,000 for payable 1997.*
[3] *Utility personal property moved from class 5 to class 3a, 2nd tier.*

Homestead Credit
As shown in *Figure 10* above, General Fund expenditures will increase by an estimated $311.5 million in FY 2003 for a homestead credit to offset the shift in property tax burdens on to low-valued homes

from most other classes of property, as well as to provide some tax relief to homeowners. The credit applies to all residential homesteads, including the house, garage, and one-acre of farm homesteads, and is equal to 0.4 percent multiplied by the market value of the property up to a maximum credit amount of $304 with the credit being phased out for home values over $76,000. As illustrated by *Figure 13*, the rate of phase-out is equal to .09 percent times the market value above $76,000 resulting in the credit being fully phased-out for homes valued at $414,000 or more.

The sum of the credit amounts for individual taxpayers will be reported to the Department of Revenue

Figure 13



for state reimbursement. Credit reimbursements will be distributed among local taxing jurisdictions in proportion that their tax rate is to the total local tax rate with the amounts to be paid to school districts being subject to the school aid metering system.

Agricultural Land Credit

General Fund expenditures will increase by $17.1 million beginning in FY 2003 for a new property tax credit for homesteaded farmland to offset the effects of consolidating the first and second tiers of agricultural land, as well as eliminating agricultural land from eligibility for the PTR program (see below) and providing some property tax relief to farmers. The credit is equal to 0.2 percent multiplied by the market value of the farm up to a maximum of $230. A farm would reach the maximum credit at a market value of $115,000. The credit will be administered in the same manner as the Homestead Credit.

Impact of Tax Reforms on Tax Increment Finance (TIF) District Revenues

Beginning in 2002, tax increment finance district revenues are expected to decline by an estimated $149 million statewide as a result of the reductions in tax rates and the elimination of the general education levy. Chapter 5 includes a variety of provisions to minimize expected revenue losses and to

help fund deficits that do result, including that:

- TIF districts will no longer be required to contribute a percentage of tax increment, commonly known as the "state-aid offset", to offset the impact captured tax capacity has on the distribution of state aids. As a result, revenue losses will be somewhat offset by allowing TIF districts to retain an estimated $5.8 million annually. The change will result in a corresponding decrease in General Fund revenues (contributions) of $5.8 million.

- TIF authorities with multiple TIF districts are permitted, and expected, to pool available increment from those districts to fund deficits that result in its districts due to the tax reforms.

- TIF authorities are authorized to take two actions to reduce increment shortfalls resulting from the tax reforms if necessary to pay binding obligations existing as of August 1, 2001. First, authorities may uncap the original tax rate to allow increment to be calculated based on the current tax rate rather than the originally certified tax rate. Second, districts that had originally opted to have the fiscal disparities contribution paid from tax increments may change that option and instead have that contribution spread to the relevant taxing districts.

- Finally, to the extent that deficits due to the property tax reforms exist after all of the above provisions have been taken to offset those deficits, the TIF authority may apply for a grant to replace those lost revenues. Specifically, $91.0 million in FY 2002 and $38 million annually thereafter is appropriated to a TIF grant aid fund. Local governments can apply to recoup lost increment attributable to the tax rate and tax base changes enacted as part of these reforms.

To maintain a consistent level of funding for the Office of State Auditor's tax increment enforcement responsibilities, the percentage of increment dedicated to the Office would increase from 0.25 percent to 0.34 percent of captured tax capacity to reflect the reductions in tax base.

Transit Levy Takeovers and Transit Funding

Chapter 5 also reforms the funding system for transit services in both the metropolitan area and Greater Minnesota by replacing local property tax revenues with state revenues. As summarized in Figure 14, the reforms will increase General Fund expenditures by $5 million in FY 2002, and decrease General Fund revenues by $114.5 million in FY 2003 and $129.8 million in FY 2004 as portions of motor vehicle sales tax (MVST) collections are dedicated to one of two newly created transit funds, as well as a special General Fund account.

Figure 14
Transit Levy Takeovers*
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Provision	**FY 2002**	**FY 2003**	**FY 2004**	**FY 2005**
Metropolitan Transit (Met. Council & Opt-outs)				
20.5% MVST dedicated to "Metro Area Transit Fund"	0	(116,621)	(120,144)	(123,742)
2.0% MVST dedicated to "Metropolitan Area Transit Appropriation Account"	0	0	(11,721)	(12,072)
Elimination of "Feathering Aid"	0	2,101	2,101	2,101
One-time cash flow transition funding	(5,000)	0	0	0
Total for Metropolitan Transit*	(5,000)	(114,520)	(129,764)	(133,713)
Rural Transit				
1.25% MVST dedicated to "Rural Transit Fund"	0	(7,111)	(7,327)	(7,546)
Subtotal: Transit Levy Takeovers	**(5,000)**	**(121,631)**	**(137,091)**	**(141,259)**

**In addition, the Public Finance Bill, which is considered by the tax committee but which is voted upon and enacted as a separate bill, contains provisions authorizing additional capital bonding authority for metro transit and these provisions are expected to result in an increase in state property tax refund payments of $90,000, beginning in FY 2004.*

Specifically:

- Beginning in FY 2003, 20.5 percent of MVST collections are dedicated to the metropolitan area transit fund, a new special revenue fund created to fund the operating costs of transit services delivered by the Metropolitan Council and opt-out communities. As shown in Figure 15, the fund is expected to receive revenues of $116.6 million in FY 2003 based on the February 2001 forecast for MVST collections. The metropolitan council is authorized to spend these funds on transit operations but the council's authority to levy a property tax for transit operations is repealed, except if certain revenue shortfall circumstances exist.[10] The Council may still levy property taxes for capital costs but the geographic area subject to transit levies, including for existing and new capital levies, is expanded to the entire metropolitan area.

  In addition, Chapter 5 provides a one-time appropriation of $5 million to Metropolitan Council in FY 2002, to ease the transition from the property tax revenue collection cycle to the MVST collection cycle. Further, the elimination of feathering aid, which was used to offset a portion of transit operating levies in metro areas which received fewer transit services, will reduce general fund expenditures by $2.1 million annually beginning in FY 2003 (property taxes payable in 2002).

[10]The council may issue certificates of indebtedness if revenues to the fund do not grow by at least the same percentage as the consumer price index and may then levy a property tax, one-time, to repay those certificates of indebtedness.

Figure 15

Metropolitan Area Transit Fund

	FY2002	FY2003	FY2002-03	FY2004	FY2005	FY2004-05
20.5% MVST collections*	**0**	**116,930**	**116,930**	**120,440**	**124,048**	**244,488**
Exempt transit vehicles from MVST**	**0**	**(309)**	**(309)**	**(296)**	**(306)**	**(602)**
Subtotal:	**0**	**116,621**	**116,621**	**120,144**	**123,742**	**243,886**

**Based on February 2001 forecast for motor vehicle sales tax collections.*
***Reflects an exemption from the motor vehicle sales tax for certain bus purchases that will reduce somewhat MVST revenues for all receiving MVST, including Metropolitan and Greater Minnesota Transit Funds, General Fund, and HUTDF.*

- Beginning in FY 2003, 1.25 percent is annually dedicated to the Greater Minnesota Transit Fund, a new special revenue fund to be used by the commissioner of revenue to fund property tax replacement grants to rural transit authorities in 2002 and 2003. As shown in *Figure 16*, the fund is expected to receive revenues of $7.1 million in FY 2003 based on the February 2001 forecast for MVST collections.

Figure 16

Greater Minnesota Transit Fund

	FY2002	FY2003	FY2002-03	FY2004	FY2005	FY2005-06
1.25% MVST collections*	0	7,130	7,130	7,345	7,565	14,910
Exempt transit vehicles from MVST**	**0**	**(19)**	**(19)**	**(18)**	**(19)**	**(37)**
Subtotal:	**0**	**7,111**	**7,111**	**7,327**	**7,546**	**14,873**

**Based on February 2001 forecast for motor vehicle sales tax collections.*
***Reflects an exemption from the motor vehicle sales tax for certain transit vehicle purchases that will reduce MVST revenues for all funds receiving MVST, including Metropolitan and Greater Minnesota Transit Funds, General Fund, and HUTDF.*

Each transit authority was required to report, by July 31, 2001, the amount of property tax revenues used to fund transit services in 2001. The grant amounts to be paid to each taxing district in 2002 and 2003 are equal to the projected total revenues to the rural transit fund distributed among the transit authorities in the proportion that their 2001 property tax contributions to transit are to the total for all rural transit authorities, but limited to a 6 percent increase over their 2001 property tax expenditures on transit.

Based on the information reported on July 31, the commissioner of transportation has certified, to the

commissioner of revenue, rural transit system property tax replacement aids totaling $6.5 million in 2002, or about $600,000 less than the projected revenues to the Greater Minnesota Transit Fund based on the February 2001 forecast. The levy limits for the relevant local governments will then be reduced by the grant amount they are certified to receive in 2002 and 2003. By January 1, 2003, the commissioner of transportation is directed to submit a report to the Legislature making recommendations for permanently integrating these replacement aids into the previously existing system of rural transit grants.

- Beginning in FY 2004, an additional 2.0 percent of MVST, estimated to be $11.7 million in FY 2004, is annually dedicated to the metropolitan area transit appropriation account, a new account within the General Fund to be used for funding transit systems in the metropolitan area subject to legislative appropriation.

Property Tax Refund Programs

Property Tax Refund (PTR) payments to homeowners will increase by $7.1 million in 2002 (FY 2003), from $77.4 million to $84.5 million. As summarized in *Figure 17*, the net increase in homeowner refunds is the result of a combination of factors, including enhancements to the refund schedules for homeowners, the elimination of property taxes paid on agricultural land from eligibility for the program, diminished PTR claim amounts due to the expected reduction in homeowner property taxes, the phase-out of the limited market value program, and other changes.

Changes to the schedule for homeowner property tax refunds include:

- an increase in the maximum refund from $530 to $1,500 at the lowest incomes but with the maximum refund amounts being phased down to $300 at the highest income levels;

- an increase in the maximum household income allowable to be eligible for a refund from approximately $74,000 to $80,000; and

- reductions in the income thresholds and co-payment percentages at lower levels, resulting in more generous refund payments by making larger proportions of homeowner property taxes eligible for refund.

No changes were made to refund payments for renters, which are expected to total $118.2 million in 2002 and $124.1 million in 2003.

Figure 17

Homeowner Property Tax Refund and Targeting Payments
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Provision	FY 2002	FY 2003	FY 2004	FY 2005
Estimated PTR Payments–Feb. 2000 Forecast	($ 72,455)	($ 77,352)	($ 81,631)	($ 83,619)
Eliminate agricultural land eligibility		8,600	8,900	9,200
Increase maximums; expand homeowner eligibility		(59,400)	(61,400)	(64,000)
Referendum cap adjustment		(270)	(277)	(284)
Adjust. for lower property tax liability due to:		43,900	45,400	46,100
property tax reforms				
phase-out of LMV			1,200	1,100
Adjust. for calculating targeting before PTR		64	407	407
Revised Estimate of Homeowner Payments	($ 72,455)	($ 84,458)	($ 87,401)	($91,096)
Difference (Net General Fund Change)	**0**	**(7,106)**	**(5,770)**	**(7,477)**
Estimated Targeting Payments–Feb. 2000 Forecast	(2,700)	($2,700)	($5,700)	($4,000)
Adjustments for lower property taxes due to:				
property tax reforms	0	2,200	600	700
phase out of LMV	0	0	2,700	700
Revised Estimate of Targeting Payments	(2,700)	(500)	(2,400)	(2,600)
Difference (Net General Fund Change)	**0**	**2,200**	**3,300**	**1,400**

In addition, as also summarized in *Figure 15*, General Fund expenditures for targeting program refunds will decrease by $2.2 million in FY 2003, due to the reductions in homeowner property taxes and the phase-out of limited market value. Specifically, relative to the February 2001 forecast, refunds are expected to decline from $2.7 million to $500,000 in FY 2003, as well as from $5.7 to $2.4 million in FY 2004 and from $4.0 to $2.6 million in FY 2005.

The phase-out of LMV results in lower than forecasted PTR and targeting payments because, under prior law, the LMV program would have ended after 2002 with homeowners being taxed on the full market value of their property beginning with property taxes payable in 2003. As a result, the phase out of LMV rather than the outright sun setting of the program actually extends the benefit of limited market value over six additional years until that benefit is fully phased-out and homeowners are taxed on the full market value of their property.

Non-County Local Government Aids

As summarized in *Figure 18*, beginning with aid payments in 2002 (FY 2003), the elimination of homestead and agricultural credit aid (HACA) payments to all non-county local governments, along with the elimination of local government aid (LGA) payments to towns and an increase in LGA payments to cities, will result a net reduction in General Fund expenditures of $121.0 million in FY 2003. Further, the low-income apartment aid program is repealed, effective for taxes payable in 2004, at which time lower apartment class rates are fully phased-in and there is no preference for low-income housing versus other apartments.

Figure 18

Local Government Aids
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Provision	FY 2002	FY 2003	FY 2004	FY 2005
Eliminate School HACA	0	9,319	5,973	3,944
90/10 metering adjustment	0	(1,347)		
Net cost for school HACA elimination	0	7,972	5,973	3,944
Eliminate City HACA	0	200,371	200,371	202,035
Eliminate Town HACA	0	29,290	29,270	29,343
Eliminate Special District HACA	0	28,713	28,713	28,713
Eliminate non-County mobile home HACA	0	5,177	5,172	5,177
90/10 metering adjustment	0	(392)	0	0
Net cost of mobile home HACA elim.		4,785	5,172	5,177
Eliminate Town LGA	0	3,869	3,966	4,065
Increase City LGA	0	(140,000)	(143,500)	(147,088)
LGA reform reserve account	0	(14,000)	(14,350)	(14,709)
Subtotal: Local Government Aids*	**0**	**121,000**	**115,615**	**109,763**

** Does not include school operating referendum and rental housing replacement aids (described above) to be paid to local governments as part of tax base reforms.*

Payments to Cities

Overall, aid payments to cities statewide will decline by about $60 million, or about 10 percent beginning in 2002 (FY 2003). The changes include the elimination of $200 million in city-HACA payments and a $140 million increase in LGA payments to cities, from about $420 million under prior law to about $560 million under new law. However, individual cities may experience aid changes of more or less than 10 percent due to both differences in the statewide distribution of the eliminated HACA payments relative to the distribution of LGA payments and due to changes made in the distribution formula for city LGA payments. See the House Research website for a city-by-city run of aid changes.[11]

Changes to the LGA formula for cities include:

- the grand-fathered aid base of non-metropolitan cities with a population of more than 10,000 was increased by the lesser of $60 per capita for population in excess of 5,000 or $2.5 million–this increase is in addition to the maximum increase under the following two bullets;
- for 2002 only, to allow distribution of the increased LGA appropriation, the maximum increase allowed for cities other than cities of the first class is increased to 40 percent of the sum of their 2001 levy plus HACA; and
- for 2002 only, the maximum increase allowed to the first class cities of Minneapolis, St. Paul, and Duluth is equal to 102.5 percent of the sum of their 2001 LGA and HACA.

In addition, LGA aid bases were increased for four cities to recognize unique circumstances, including: permanent increases of $50,000 each for Hopkins and Chaska beginning in 2002 (FY 2003); an increase

[11] www.house.leg.state.mn.us/hrd/issinfo/lga02fin.pdf

of $50,000 for Osseo for aids payable in 2002 through 2011; and an increase of $150,000 for Newport for aids payable in 2002 through 2011.

As also summarized in *Figure 18* above, beginning in FY 2003, $14 million plus accrued growth is annually appropriated to an LGA reform reserve account in the General Fund. The reserve account was established in anticipation of a review of and possible reform of the LGA program after complete census data becomes available.

Payments to Towns, Special Taxing Districts, and Schools
In general, Chapter 5 eliminates the payment of all general purpose property tax aids to schools, towns and special taxing districts, not including school aids or state payments to reimburse jurisdictions for tax credit amounts attributable to the new home and homesteaded agricultural land credits. Selected local governments may receive rental housing tax base replacement aids if the reductions in their tax base due to class rate reductions for apartments meet certain criteria.

In sum, beginning in 2002 (FY 2003) the elimination of general purpose state aids will reduce payments:

- to towns by $33.3 million, including $29.3 million in lost HACA and $4.0 million in lost LGA;

- to special districts by $28.3 million in lost HACA payments; and

- to school districts by $ in lost HACA.

Local governments are authorized to increase property tax levies by one dollar for each dollar lost in state aid, with the exception of reductions in mobile home HACA, without regard to levy limits. Overall, however, tax reductions are expected for most taxpayers since the reductions in property tax levies for K-12 education are expected to outweigh any increases in levies for other local governments in 2002. Note that the property tax simulation models of these changes completed by House Research Department (see *Figure 7*) assume that local governments will increase property tax levies by one-dollar for every dollar lost in state aid.

County Aids and County Service Takeovers

Chapter 5 provides for completion of the state takeover of trial court operations as well as for possible state assumption of up to 30 percent of the non-federal costs for out-of-home placement beginning with aids paid in calendar year 2003 (FY 2004). As summarized in *Figure 19*, the state appropriations required to fund these new state costs would be offset, in part, by reductions in county HACA payments, as well as by fine revenue that will now be collected by the General Fund rather than by counties. Overall, the net General Fund cost of the county takeovers will be $8.7 million in FY 2002, $8.6 million in FY 2004, and $5.6 million in FY 2005. It should be noted, however, that if the counties provide expenditure information required by Chapter 5 as prerequisite to the out-of-home placement takeover, the Legislature will likely be asked to provide additional resources in the next biennium.

Court Costs – The State has been gradually assuming funding and operational responsibility for trial court operations and services since 1989 and Chapter 5 provides for the completion of that process. Specifically, Chapter 5:

- Appropriates $8.7 million annually, beginning in FY 2002, to fund the takeover of various court services enacted by Chapter 243, 1999 Laws of Minnesota, for counties in judicial districts one through four, six, and ten, including costs for guardians *ad litem,* court interpreters, Rule 20, civil commitment examinations and hearings, and *in forma paupers* costs. Beginning in

FY 2003, that appropriation will be offset by an equal reduction in HACA payments to the relevant counties.

- directs base appropriation increases of $39.2 million in FY 2004, and an additional $17.3 million in FY 2005, as well as an additional $1.7 million annually beginning in FY 2004, to fund the state takeover of trial court operations in judicial districts 2 and 4 on July 1, 2003 and districts 1 and 3, on July 1, 2004. After the reductions in General Fund expenditures for the corresponding HACA reductions and the increases in General Fund revenues attributable to the fine revenue, the net cost of the takeover is expected to be $8.6 million in 2004 and $5.6 million in FY 2005. Additional state appropriations are expected in FY 2006 to fund the takeover of the final two judicial districts, districts 6 and 10, on July 1, 2005.

Out-of-Home Placement – The 2001 Omnibus Tax Act also provides for state assumption of up to 30 percent of the non-federal costs for out-of-home placement beginning with aids paid in 2003 (FY 2004). This is contingent upon the counties submitting accurate data on the total expenditures for all types of out-of-home placement, including correction related costs for both its corrections and its social services budgets. The data for calendar years 1998 through 2000 must be submitted to the commissioners of corrections and human services by January 1, 2002. If, by March 15, 2002, the commissioner of human services, in consultation with the commissioner of corrections, determines that the data submitted by the counties accurately reflects total out-of-home placement expenditures, then, beginning with aids payable in 2003, the state will assume up to 30 percent of non-federal costs. The actual percentage of non-federal costs assumed by the state will be based on the maximum percentage that will not exceed the amount of HACA available for offset in one of the seven metropolitan area counties, after accounting for HACA reductions related to the court takeover.

Figure 19

County Service Takeovers
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Court Takeover Provisions	**FY 2002**	**FY 2003**	**FY 2004**	**FY 2005**
County HACA Reductions				
Mandated Court Services	0	8,701	8,701	8,701
District 2 & 4 Takeover (75% first year)	0	0	21,181	28,242
District 1 & 3 Takeover (75% first year)	0	0	0	7,555
Adjustment for reduced HACA growth	0	0	139	478
Temporary HACA for maintenance of effort	0	0	0	(3,000)
Total County HACA Reductions	0	8,701	30,021	41,976
Court Appropriations				
Mandated Services	(8,701)	(8,701)	(8,701)	(8,701)
District 2 & 4	0	0	(39,240)	(39,240)
Districts 1 & 3	0	0	0	(17,316)
Equity Adjustment for cost transfer	0	0	(1,700)	(1,700)
Total Court Appropriations	(8,701)	(8,701)	(49,641)	(66,957)
Estimated Fine Revenue (6% growth)				
Districts 2 & 4	0	0	10,998	11,658
Districts 1 & 3	0	0	0	7,678
Total estimated fine revenue	0	0	10,998	19,336
Total for Court Takeover Provisions	**(8,701)**	**0**	**(8,622)**	**(5,645)**
Out-of-Home Placement Provisions	**0**	**0**	**0**	**0**
If a takeover occurs, HACA reductions are expected to equal initial appropriations, resulting in a net General Fund cost of zero.				
Subtotal: Local Government Aids*	**(8,701)**	**0**	**(8,622)**	**(5,645)**

** Does not include school operating referendum and rental housing replacement aids (described above) to be paid to local governments as part of tax base reforms.*

Local Government Levy Limits

Local government levy limits, which were allowed to expire for taxes paid in 2001, will be reimposed for two years for property taxes levied in 2001 and 2002, to be paid in 2002 and 2003. Limits will apply to all counties and cities with a population greater than 2,500 and will be calculated using one of two alternatives. A county or city's limit will be equal to the greater of:

- its levy limit base for 1999 (Pay 2000)–the last year in which levy limits were in place–increased for two years by the allowed growth factors; or
- its levy for 2000 (Pay 2001) plus 2001 aids increased by one year of growth in the allowed growth factors.

Two growth factors are allowed: the increase in the implicit price deflator for state and local government purchases; and 50 percent of the increase in the tax base attributable to new commercial and industrial property. In addition, in calculating the limits a variety of adjustments will be made to reflect related property tax reforms, including:

- for counties for which the state has not yet taken over judicial court funding, the levy limit base is reduced by the county's 2001 certified budget amount for courts;

- for counties for which the state assumed costs for mandated court services July 1, 2001, the levy limit base is reduced by one-half of their offsetting HACA loss in 2002;

- for metropolitan area cities that levied transit costs in 2000 for Pay 2001, the levy limit base will be reduced by the sum of their payable 2001 non-debt opt-out transit levy plus non-debt opt-out HACA; and

- additional aid payments to cities due to LGA aid base changes and any out-of-home placement aid payments are excluded when calculating levy limits.

In addition, Chapter 5 eliminated certain special levies authorized under prior law, such as levies for unreimbursed expenses due to the floods of 1997, abatements due to floods in 1997 and tornadoes in 1998, to fund certain correctional service retirement plans. Chapter 5 then authorized new special levies, including levies for increases in employer contributions to PERA effective after June 30, 2001; for counties for redistricting costs up to $1 per capita with a portion of the levies going to cities within the county; and for counties for court costs associated with the phase-in of the state takeover of judicial districts. In addition, local governments subject to levy limits may elect to exceed limits by passing a local referendum.

Other Property Tax Provisions

Chapter 5 will also increase General Fund expenditures by $9,000 in FY 2003 and $2.8 million beginning in FY 2004 for selected reforms effecting specific industries or classes of property, including:

- $9,000, beginning in FY 2003, for payments-in-lieu-of tax (PILT) for lands acquired by the Department of Transportation (DOT) from private owners to replace wetlands lost to transportation projects, provided that the county already contains more than 500 acres of this type of DOT-owned land. Payment amounts will be based on the per-acreage amount paid for "acquired natural resource land," or $3.56 per acre in 2001.

- $44,000, beginning in FY 2005, for exemptions from the personal property tax on electric generation machinery and equipment for two bio-waste electric generation plants[12]; and

- $2.8 million beginning in FY 2004 to fund reforms to forest land property taxation.

[12]While taxes paid on the real property owned by the proposed plants may reduce average property tax bills for homeowners in the relevant communities, the estimated cost arises from the fact that electric generation machinery and equipment is subject to personal property tax under existing law and, therefore, accepted cost estimating practices suggest that exempting the property will result in higher taxes for homeowners than if the property were not exempted. Thus, affected homeowners may be eligible for somewhat higher property tax refund (PTR) payments from the state than if the property were not exempted.

Figure 20

Other Property Tax Provisions
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Provision	FY 2002	FY 2003	FY 2004	FY 2005
PILT for certain DOT-owner lands	0	(9)	(9)	(9)
Forest Land Credit Program	0	0	(2,772)	(3,528)
Exempt biomass (poultry litter) electric generation	0	0	0	(30)
Exempt biomass (waste tire) electric generation	0	0	0	(14)
Subtotal: Other Property Tax Provisions	**0**	**(9)**	**(2,781)**	**(3,581)**

Sustainable Forest Tax Refund Programs
Chapter 5 also reforms the taxation of forest lands in an effort to encourage forestation and eliminate current perverse incentives related to tree growth and harvesting. In particular, the Tax Act:

- repeals the Tree Growth Tax Law;
- allows property currently enrolled in the auxiliary forest law to either remain enrolled through the current contract or transfer to the new sustainable forest land program if the conditions of that program are met;
- establishes a new forest land tax incentive program.

Under the new program, property owners of at least 20 contiguous acres, of which 50 percent must be forested, may apply to participate in a refund of property taxes paid if they have developed and are implementing a sustainable forest land management program developed by a qualified planner. All land enrolled in the program would be classified as timberland. The participating property owners would initially pay the property taxes levied locally but would then be eligible for a refund equal to the greater of: two-thirds of the per-acre ad valorem tax amount; or the difference between the ad valorem tax amount and the amount of tax that would be paid under an alternative calculation that reflects the productivity of the forest land.

General Law Property Tax Provisions With No State Cost

Chapter 5 contains a variety of provisions that apply throughout the state and may affect the level of property taxes owed by taxpayers in certain taxing jurisdictions, but which are not expected to have a state cost. Those provisions include:

Watershed Districts – the levy limit for general fund operations of watershed districts is increased from 0.02418 percent of market value or $125,000, whichever is less, to .048 percent of market value or $250,000, which ever is less. All special laws setting higher caps for particular watershed districts are repealed. Further, additional levies for basic water management projects initiated by petition can now be initiated by any political subdivision, or by a group of at least 50 resident owners in the district, rather than only by a municipality in the district.

Public Utility Emission Reduction Projects – public utilities may petition the Public Utilities Commission for approval of utility rate rider to recover the costs of a qualifying emission reduction project outside of a general rate case;

County Water Management Levies treated as Special Taxing Districts – county-set levy amounts for water management purposes are to be levied as a special taxing district rather than as part of the county levy so that such levy amounts are displayed on truth-in-taxation statement, consistent with the treatment of watershed districts levies for similar purposes;

Emergency Medical Service Special Taxing Districts – two or more political subdivisions, or parts of them, may by resolution establish a special taxing district for emergency medical services and may levy up to .048 percent of market value or $250,000, whichever is less. The districts may not incur debt.

Conversion of Market Value Levies to Tax Capacity Levies – counties, cities, and towns, with referendum market value levies approved prior to January 1, 2001, are authorized to permanently convert those levies to tax capacity levies no later than October 1, 2001, provided that agricultural land and seasonal recreational property exempted from referendum levies consists of at least 10 percent of the referendum market value tax base.

Exemption for Housing Owned by Indian Tribes – a general law property tax exemption is granted to housing located on fee land that is owned by a tribal housing entity. Such housing will be treated the same as low and moderate income housing owned by statutorily defined housing and redevelopment authorities which is exempt from property taxes but pays 5 percent or rents for housing as a payment-in-lieu-of-taxes. A specific exemption was granted for the White Earth Band in 2000.

Exemption for Certain Homes for Resale – certain newly constructed buildings intended for residential occupancy but located on temporary sites are exempt from property tax for one assessment year.

Exemption for Certain Historical Museums – certain property of a nonprofit charitable organization used primarily for storing and exhibiting historical items is exempt from property tax.

Wind Energy Producers – developers of new or certain existing wind energy conversion systems are allowed to negotiate a payment-in-lieu of property tax (PILT) with the municipalities or counties in which their facilities are located. If so, it would be exempt from the local property tax.

Classification of Land Used for Maple Syrup Production – maple syrup is added to the statutory definition of "agricultural products." This allows property used for maple syrup production to be classified as agricultural and benefit from a lower class rate, agricultural land credits, operating levy exemptions and other provisions pertaining to agricultural land.

Agricultural Homestead – additional changes were made to the existing special agricultural homestead law effecting homestead status when the owner or qualifying relative does not live on the property (see House Research Law Summary).

Special Law Property Tax Provisions Having No State Cost

Chapter 5 also contains a variety of special law provisions that affect taxpayers in certain taxing jurisdictions but which are also not expected to have a state cost. Those provisions include:

Minnehaha Creek Watershed District – is authorized to annually levy up to $50,000, in addition to their general fund levy (see above), for enforcing rules and permits.

Red River Water Management Board – is authorized to compensate counties and townships for property tax revenue lost when land is acquired by the Board for flood management reduction projects – payments may be made for up to 20 years but cannot exceed the taxes payable in the year prior to acquisition or $4 per acre multiplied by 20.

Nashwauk-Keewatin School District – is authorized to levy up to $25,000 per year to finance a joint school-community library project.

School Districts in Kittson, Roseau, Lake of the Woods, and Koochiching Counties – qualifying districts are authorized to levy for the net operating costs of a swimming pool. The levy amount is limited to the net actual costs of operation for the previous year, less any operating revenues and payments from other local governments.

Exemption for Certain Electric Generation Facility – a new biomass electric generation facility utilizing wood waste products intended to satisfy a portion of the biomass mandate imposed on Xcel Energy (Northern States Power) in 1994 is allowed to benefit from the exemption from the personal property tax on electric generation machinery granted by the 1994 legislative mandate[13].

Minerals Taxes

The 2001 Omnibus Tax Act creates a general law authorizing counties to impose the aggregate materials tax and increases General Fund expenditures by an estimated $10.9 million beginning in FY 2002 to fund a variety of reforms to the taconite production tax [14].

Aggregate Materials ("Gravel") Tax

Chapter 5 replaces special law provisions authorizing individually specified counties to impose the aggregate materials tax, commonly know as the "gravel tax," with a general law provision authorizing all counties to impose the tax by approval of the county board after a public hearing. Counties are allowed to set a tax rate up to a maximum of 10 cents per cubic yard or 7 cents per ton. Under prior law, individual counties needed to be specifically identified in statute in order to impose the tax and, if imposed, the tax rate was equal to a flat 10 cents per cubic yard or 7 cents per ton.

Taconite Production Tax

The taconite production tax generated about $93 million in 2000 and is the largest tax paid by taconite mining companies. Proceeds from the tax are distributed to local governments throughout a statutorily

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[13]Unlike other exemptions for similar biomass facilities, there is no additional state cost for this provision because it merely authorizes a new facility to meet a mandate in existing law and for which any additional state costs had already been accounted.

[14]Estimate is based on projections of 34.8 million taxable tons of taconite in 2001 (taxes paid in 2002) and 34.6 million in 2002, 33.2 million in 2003, and 33.2 million in 2004. These estimates are somewhat lower than end-of-session estimates, based on the February forecast, due to lower projected taxable tons of taconite.

defined taconite tax relief area (TTRA) to fund local government services typically funded by property taxes, as well as to fund economic development and environmental cleanup activities. As shown in *Figure 21*, Chapter 5 increases General Fund expenditures by about $10.9 million, beginning in FY 2002, to provide production tax relief and economic incentives to mining companies and to provide property tax relief to taxpayers located in the statutorily defined taconite tax relief area (TTRA).

Figure 21
Taconite Production Tax and Taconite Tax Relief Area Programs
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Provision	FY 2002	FY 2003	**FY 02-03**	FY 2004	FY 2005	**FY 04-05**
Revenue replacement tax rate reduction (7 cpt)	(2,500)	(2,400)	**(4,900)**	(2,300)	(2,300)	**(4,600)**
Investment grants (14.7 cpt)	(5,100)	(5,100)	**(10,200)**	(4,900)	(4,900)	**(9,800)**
Environmental Protection Trust Fund and Economic Protection Trust Fund (11.3 cpt in 2002, 0.3 cpt after)	(3,900)	(100)	**(4,000)**	(100)	(100)	**(200)**
Supplemental homestead credit		(4,100)	**(4,100)**	(4,200)	(4,300)	**(8,500)**
Change in aid payment dates	600	0	**600**	0	0	**0**
Total: Mining Taxes	**($10,900)**	**($11,700)**	**($23,200)**	**($11,500)**	**($11,600)**	**($23,100)**

The $10.9 million General Fund cost in FY 2002 reflects appropriations equal to 33 cents per ton (cpt) of taxable taconite in 2002. The appropriation will be distributed through the statutorily established formulas for taconite aids as if the General Fund monies were production tax revenues. Beginning in FY 2003 and thereafter, the appropriation falls back to 22 cpt and additional costs begin for an expansion of the existing supplemental homestead credit. Specifically, the 33 cpt appropriation in FY 2002, and 22 cpt in FY 2003 and thereafter, includes:

- $2.5 million in FY 2002 and thereafter to replace lost production tax revenue resulting from a permanent 7 cpt reduction in the production tax rate, from $2.173 per ton under prior law to $2.103, beginning with taxes paid in 2002. Further, annual indexing of the tax rate and the distribution amounts is temporarily suspended so that the tax rate will remain at $2.103 until production year 2004, taxes payable in 2005, at which time the rate will again be subject to annual indexing equal to the annual growth in the implicit-price deflator for local government services.

- $5.1 million in FY 2002 and thereafter to fund a permanent increase of 14.7 cpt in distributions to the Taconite Economic Development Fund, from 15.4 cpt in 2002 to 30.1 cpt in 2002. The increased distributions are to fund investment grants for mining companies. To access the investment grants, producers must provide a dollar-for-dollar investment match in plant and equipment. The list of qualifying investments is expanded to include the purchase of haulage trucks and equipment, mining shovels, and repairs.

  In addition. Chapter 5 establishes a spending priority for the IRRRB Commissioner and Board

to follow when making or approving any expenditures on programs or projects. The highest priority is to be given to programs or projects that target relief to areas that have experienced the largest percentage job losses and population losses directly attributable to the economic downturn of the iron mining industry, with specific emphasis on the losses in 2000 and 2001 resulting from the closure of LTV Steel.

- $3.9 million in FY 2002 to be distributed, through statutory formulas, two-thirds to the Taconite Environment Protection Fund and one-third to the Economic Protection Trust Fund. These monies are intended to help offset reductions in tax collections following the closing of LTV Steel and to fund the cost of increased municipal aid guarantees to cities with active mines. In FY 2003 and thereafter, any residual amounts, after the distributions identified above, will be distributed in the same manner.

As also shown in *Figure 21* changes to the statutorily established dates for reimbursement payments to counties for supplemental homestead credits issued to homeowners–specifically the May payment being moved to July to be consistent with other local government aid payments–results in a one-time General Fund savings of $600,000 in FY 2002.

Property Tax Relief Provisions

Chapter 5 also enhances property tax relief to property owners in the TTRA by shifting responsibility for funding some of that tax relief to the General Fund from the Taconite Tax Relief Account, which is funded by revenues from the taconite production tax.

General Fund Provisions

Beginning with property taxes paid in 2002, FY 2003[15], General Fund expenditures will increase by an estimated $4.1 million annually due to increased supplemental homestead property tax relief payments. The increase in payments results from the creation of an alternative definition of the taconite tax relief area (TTRA). Homeowners in the Aitken, Crosby-Fronton, and Grand Rapids school districts will no longer receive tax relief payments from the taconite property tax relief program. Instead, they will be eligible for the same level of property tax relief from the supplemental homestead program funded by the General Fund. Because fewer homestead credits will then be paid from that fund, the allocation of taconite production tax revenues into the fund is also reduced from 36.81 cpt under prior law to 33.9 cpt beginning in 2002.

Non-General Fund Provisions

In addition, Chapter 5 increases aid payments to municipalities in the TTRA by an estimated $10.2 million beginning in 2002 to allow reductions in local levies for those jurisdictions. In 2002 only, the increased aid payments are funded from the existing balance of the Taconite Property Tax Relief Fund. Beginning in 2003 and thereafter, at which time the K-12 education finance reforms will be implemented, the increased aid to cities and towns is achieved by permanently redirecting 95 percent of the taconite production tax general purpose school aids from school districts to the cities and towns in those same school districts. As a result, the aids will be distributed to the same tax base or group of taxpayers.[16]

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[15]State payments for reimbursement of credits for property taxes paid in 2002 occur in FY 2003.

[16]The remaining 5 percent is retained by the general fund but there is no net change in the general fund due to this provision since under prior law 5 percent of these taconite tax revenue distributions were used to

As referenced above, the municipal aid guarantee level for cities and towns containing taconite mines or quarries or concentrate production facilities is changed from the aid amount in production year 1983 to the aid amount paid in production year 1999. This will increase aid payments to those cities retroactive to aids paid in 2001 with amounts for the 2001 retroactive payments coming two-thirds from the Taconite Environmental Protection Fund and one-third from the Economic Protection Trust Fund. The additional payments by those funds will be offset, in part, by the General Fund contributions to those funds (see Figure 21).

Taconite Property Tax Relief Fund Balance

As illustrated by Figure 22, the combination of property tax relief provisions described above are expected to reduce the balance of the Taconite Tax Relief Fund. At the end of 2001 the fund balance was projected to be $27.6 million. Based on the estimated costs of the changes discussed above, that balance is likely to decline to about $17.2 million in 2002 due to: the $10.2 million one-time payment in 2002; reduced outflows due to a smaller TTRA for purposes of homestead credits; and reduced inflows due to both the reduction in the taconite production tax revenues deposited into the fund and the economic downturn in the industry resulting in lower taxable tonnages of taconite. Given the present downturn in the mining industry, the balance could be expected to decline further in future years to the extent credit payments exceed new revenues.

Figure 22

Taconite Property Tax Relief Account Fund Balance

(dollars in thousands)

Tax Payable Year	Payments-In	Interest	Payments-Out	Balance December 31
Prior Balance				$22,535
1999	$16,238	$1,145	($14,867)	25,051
2000	16,079	2,040	(15,041)	28,129
2001	13,851	1,000	(15,400)	27,580
Est. 2002 Regular	11,700	1,000	(12,900)	
Est. 2002 One-time			(10,200)	17,180
Est. 2003	11,700		(13,300)	15,580
Est. 2004	11,300		(13,700)	13,180
Est. 2005	11,300		(14,200)	10,280

reduce state aids.

Individual Income Taxes

Figure 23 summarizes the Omnibus Tax Act's changes to Minnesota's individual income tax.

Figure 23
Individual Income Taxes
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Tax Provision	FY 2002	FY 2003	FY2002-03	FY 2004	FY 2005	FY2004-05
S-corp banks – repeal 80% subtraction for stockholder's portion of corporate franchise tax *Note: See related provision under corporate franchise tax.*	+21,270	+23,410	**+44,680**	+25,210	+26,570	**+51,780**
Military pay – active military stationed outside MN considered non-residents for income tax	(4,400)	(4,400)	**(8,800)**	(4,400)	(4,400)	**(8,800)**
K-12 education credit – reduce credit rate from 100% to 75% (eff. 1/1/02)	0	+9,100	**+9,100**	+9,600	+10,100	**+19,700**
K-12 education credit and K-12 subtraction – make musical instrument purchases eligible	(610)	(640)	**(1,250)**	(670)	(710)	**(1,380)**
K-12 education credit – allow taxpayer to assign credit to financial institution or nonprofit organization	0	0	**0**	0	0	**0**
Modify credit for Canadian provincial income taxes paid; allow subtraction for similar income taxes in other countries	260	270	**530**	280	290	**570**
Federal update – federal tax bills enacted in 2000 **FY01 = (200)**	(700)	(1,200)	**(1,900)**	(1,600)	(1,800)	**(3,400)**
Federal update – federal tax bill enacted in 2001	(16,000)	(40,500)	**(56,500)**	(44,800)	(58,000)	**(102,800)**
Penalty reforms	0	(5,100)	**(5,100)**	(5,400)	(5,800)	**(11,200)**
Interaction effect: Property tax cuts	0	+35,000	**+35,000**	+36,800	+38,600	**+75,400**
Total: Individual Income Taxes **FY01 = (200)**	(180)	+15,940	**+15,760**	+15,020	+4,850	**+19,870**

All provisions effective 1/1/01 unless otherwise noted, except for a few provisions of the 2000 federal update which have earlier effective dates. Negative changes represent a cost to the state and positive numbers represent a gain to the state.

S-Corp Banks – The Omnibus Tax Act reduces taxes on S-corporation banks by fully conforming to the federal tax rules. S-corporations are generally taxed in the same way as partnerships – they pay no "corporate" tax, but each owner pays individual tax on that owner's share of business income in the year

it is earned (even if those profits are not distributed to the owners)[17]. Specifically, the 2001 Tax Act completed the move to full conformity by (a) exempting S-corp banks from the corporate tax (which will reduce *corporate* tax revenue) and (b) repealing the 80% individual income tax credit (which will raise *individual* income tax revenue). In1997, when federal law first allowed some banks to convert to the S-corporation form for federal tax purposes, Minnesota did not go along. In 1999, though, Minnesota went most of the way toward federal conformity by having S-corp banks continue to pay the corporate franchise tax but allowing their shareholders to claim a tax credit equal to 80 percent of that tax.

What was the net revenue loss from conforming to federal law for S-corp banks?
The *gain* in individual income tax revenue is more than offset by the *loss* in corporate franchise tax revenue. The net reduction in tax revenue – between $5 and $7 million per year – is the sum of the impact from both the corporate and individual income tax provisions.

Figure 24

Revenue Impact of Full Federal Conformity for S-Corp Banks
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Tax Provision	FY 2002	FY 2003	FY 2002-03	FY 2004	FY 2005	FY 2004-05
Individual income tax – repeal 80% subtraction for stock-holder's portion of corp. tax	+21,270	+23,410	**+44,680**	+25,210	+26,570	**+51,780**
Corporate franchise tax – exempt S-corp banks	(26,580)	(29,270)	**(55,850)**	(31,510)	(33,220)	**(64,730)**

Military pay – The Tax Act effectively exempts active duty military pay from tax for personnel stationed outside Minnesota. Such personnel benefit little, if at all, from Minnesota government services and they can quite easily change their official residency to another state. Rather than exempting this income by adding a line on the income tax return for a subtraction from income, the Act provides that such military personnel be considered nonresidents for income tax purposes. This provision will affect an estimated 7,400 tax returns with tax savings averaging $600 per year. Note that active military

[17]To qualify as an S-corporation, banks must satisfy requirements limiting total bank assets and the number of stockholders.

stationed overseas were already exempt under prior law, so only those stationed within the United States are affected.

Is this the same as an income tax subtraction for their military pay? In most cases, treating these taxpayers as nonresidents has the same effect as allowing them a subtraction for their active duty pay. However, some lower-income personnel would be better off with a subtraction, because nonresident status will eliminate or reduce their state refundable tax credits. In contrast, higher-income personnel with unearned income will generally be better off treated as nonresidents, because their total income will now be exempt from state tax, not just their military pay.

K-12 education credit – reduce credit rate to 75 percent (effective for the 2002 tax year). Under prior law, eligible expenses qualified for a 100 percent tax credit. Proponents of this change, which was included in the Governor's budget proposals, argued that a 100 percent credit results in careless spending because it reduces the cost of eligible items to zero. With a 75 percent credit, the taxpayer will have to pay 25 percent of the cost. The maximum credit amount of $1000 per child (and family cap of $2,000) remain unchanged. A taxpayer with at least $1334 dollars of eligible expenditures for one child would still receive the maximum, but the reduced credit rate will generally reduce the amount of credit received by 25 percent. (About $24 million of credit was claimed in the 2000 tax year, and participation will be higher in 2002.)

K-12 education credit and subtraction – make musical instrument purchases eligible. The Department of Revenue had interpreted prior law to allow a credit or deduction for *rental* payments on musical instruments used in the school curriculum (including rent-to-own agreements), but to deny the credit or deduction for musical instruments *purchased* for use in the school curriculum. It was argued that allowing a credit for the full purchase price could lead to abuses. Someone could receive a $500 tax credit for a $500 instrument, then sell it at a profit the next year. Despite such arguments, the Omnibus Tax Act ended this differential tax treatment, which provided an artificial incentive to rent rather than purchase those instruments.

K-12 education credit – assignment of credit to financial institution or nonprofit. The K-12 education credit is a refundable credit designed to benefit low- and moderate income families. Some families have failed to take advantage of the credit because the educational expenses had to be paid up front, while the tax credit could be received only after an income tax return was filed early the following year. Low-income families found it difficult to obtain loans from financial institutions to pay the original expenses. To address this liquidity problem, the Omnibus Tax Act allows a taxpayer to assign the right to the taxpayer's refund -- up to the amount of the tax credit -- to a financial institution or nonprofit organization that provides such a loan. By reducing the risk of default, the assignment of the credit should make it easier to obtain such loans. Before making the loan, the financial institution will be able to determine (from the Department of Revenue) whether the taxpayer met the income requirements during the previous year, and whether the taxpayer is currently subject to income tax recapture. Nevertheless, there remains some risk that a taxpayer's actual tax refund will be less than the amount of the loan.

The revenue impact of this provision is uncertain. If it significantly increases the number claiming the K-12 credit – or the amount of credit they claim – it could have a significant cost. Given (a) the uncertainty about how financial institutions will respond, (b) the fact that at least one nonprofit organization is achieving a similar result by requiring taxpayers to grant it power of attorney, and (c) the reduction in the credit rate from 100 percent to 75 percent starting in 2002, the Department of

Revenue has made no estimate of any change in participation. For this reason, Figure 23 shows a zero cost.

The Department of Revenue has estimated that this provision will have significant administrative costs, estimated at $40 per return with an assigned credit (or $1.2 million per year). No additional funding was provided to cover such costs, and no such costs is shown on Figure 23 or elsewhere.

Modify credit for Canadian provincial income taxes, and allow subtraction for similar taxes in other countries. To avoid taxing the same income twice, prior law allowed taxpayers a 100 percent non-refundable credit for income taxes paid to another U. S. state or Canadian province on income also taxed in Minnesota. (Taxes paid to *local* governments are not eligible.) The Omnibus Tax Act disallows the credit for taxes paid to Canadian provinces if those taxes have already been fully offset by the foreign tax credit at the federal level. This maintains the protection against double taxation without granting an additional windfall to some taxpayers. The change for Canada is estimated to raise revenue by about $300 thousand dollars per year.

The Omnibus Tax Act also for the first time allows a subtraction – but not a credit – for state-level taxes in countries other than Canada (to the extent not offset by the federal foreign tax credit). The value of a subtraction is equal to the taxpayers Minnesota tax rate (no higher than 7.85 percent), much less than the value of a 100 percent tax credit provided for Canada. This new subtraction is estimated to reduce tax revenue by about $40 thousand per year (partially offsetting the revenue gain from the Canada provision).

Federal update – bills enacted in 2000. See the discussion in the corporate tax section.

Federal update – bill enacted in 2001. The Omnibus Tax Act conforms Minnesota law with some of the provisions included in the Economic Growth and Tax Relief Act of 2001 (EGTRA), signed into law on June 7, 2001 (Public Law 107-16). It adopts all of the enacted changes in the definition of federal taxable income, and two of Minnesota's refundable tax credits are also changed to make them consistent with their restructured federal counterparts. The costs of these changes in law are summarized in Figure 25.

Figure 25

Provisions to Conform Minnesota Law to the Economic Growth and Tax Relief Reconciliation Act of 2001
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Tax Provision	FY 2002	FY 2003	FY 2002-03	FY 2004	FY 2005	FY 2004-05
EDUCATION PROVISIONS						
Deduction for higher ed expenses	(4,440)	(13,950)	**(18,390)**	(14,150)	(16,820)	**(30,970)**
Exclusion for employer-provided assistance	(1,500)	(4,720)	**(6,220)**	(4,940)	(4,760)	**(9,700)**
Education IRAs	(590)	(1,840)	**(2,430)**	(2,500)	(2,890)	**(5,390)**
Student loan interest	(490)	(1,550)	**(2,040)**	(1,680)	(1,640)	**(3,320)**
Prepaid tuition plans	(70)	(220)	**(290)**	(360)	(510)	**(870)**
Other education provisions	(10)	(20)	**(30)**	(170)	(280)	**(450)**
SUBTOTAL: EDUCATION	(7,100)	(22,300)	**(29,400)**	(23,800)	(26,900)	**(50,700)**
Pension and IRA provisions	(2,700)	(12,000)	**(14,700)**	(14,800)	(20,000)	**(34,800)**
Increase standard deduction for married couples (eff. 1/1/05)	0	0	**0**	0	(4,900)	**(4,900)**
Working family credit	(3,000)	(3,000)	**(6,000)**	(3,000)	(3,000)	**(6,000)**
Dependent care credit	(3,200)	(3,200)	**(6,400)**	(3,200)	(3,200)	**(6,400)**
TOTAL:	(16,000)	(40,500)	**(56,500)**	(44,800)	(58,000)	**(102,800)**

All provisions effective beginning with the 2001 tax year, unless otherwise noted. Negative changes represent a cost to the state and positive numbers represent a gain to the state.

Education provisions

- Allow deduction for higher education expenses – $3,000 starting in 2002, $4,000 starting in 2004 – for taxpayers with incomes under $65,000 (single) or $130,000 (joint). Income limits rise to $80,000 and $160,000 in 2004. (May not claim both this deduction and HOPE or Lifetime Learning Credit in the same year.)
- Extend exclusion for employer-paid tuition and fees for undergraduate classes until 2010, and make graduate classes eligible as well.
- Increase education IRA annual contribution limit from $500 to $2,000, and allow distributions to be used for elementary and secondary education.
- Increase income level at which student loan interest deduction phases out to $65,000 (single) and $130,000 (joint), and repeal 60-month limit.
- Allow private colleges to establish prepaid tuition plans, with distributions excluded from tax

if used for higher education.

Other provisions

- Pensions, deferred compensation, and IRAs – increase contribution limits and catch-up provisions; additional catch-up contributions allowed for women over age 50; increase plan portability.
- Increase standard deduction for married couples, starting in 2005, until the married couple standard deduction is twice the single filer standard deduction (in 2009).
- Working family credit – increase start and end of phase out for married couples by $1000 in 2002, an additional $1000 starting in 2005, and an additional $1000 staring in 2007.
- Child and dependent care credit – increase amount eligible for credit from $2,400 to $3,000 per child; increase maximum credit rate from 30 percent to 35 percent; and move the start of the phase-down of the credit *rate* from $10,000 to $15,000. However, the maximum Minnesota credit remains at $720 (one child) and $1,440 (two or more children), and the phase-out of the Minnesota credit remains unchanged as well.

Penalty reform – Penalties for not filing an income tax return and for late payment of tax were simplified. Generally, this resulted in a reduction in penalties.

Interaction effects – property tax cuts. The Omnibus Tax Act will reduce homeowner property taxes by a large amount. With lower property taxes, the amount of such taxes claimed as an itemized deduction on individual income tax returns will also fall. This will increase Minnesota income tax revenues by an estimated $35 million in the 2002 tax year (FY 2003), and slightly more in later years.

Corporate Franchise Tax

Figure 26 summarizes the Omnibus Tax Act's changes to Minnesota's corporate franchise tax.

Figure 26
Corporate Franchise Tax
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Tax Provision	FY 2002	FY 2003	**FY 2002-03**	FY 2004	FY 2005	**FY 2004-05**
S-corp banks – exempt from franchise tax (full federal conformity) *Note: See related individual income tax provision.*	(26,580)	(29,270)	**(55,850)**	(31,510)	(33,220)	**(64,730)**
Repeal franchise tax on insurance companies	(10,000)	(8,500)	**(18,500)**	(9,000)	(9,500)	**(18,500)**
Charitable deduction -- apportion federal deduction (replaces subtraction limited to contributions to MN charities)	+6,200	+5,300	**+11,500**	+5,600	+5,900	**+11,500**
Federal update – domestic provisions in federal tax bills enacted in 2000 **FY01=(3,800)**	(2,800)	(2,800)	**(5,600)**	(1,900)	(1,200)	**(3,100)**
Penalty reforms	0	(1,000)	**(1,000)**	(1,000)	(1,000)	**(11,200)**
Interaction effect: Property tax cuts	0	+9,000	**+9,000**	+9,500	+10,000	**+19,500**
Total: Individual Income Taxes	(33,180)	(27,270)	**(60,450)**	(28,310)	(29,020)	**(57,330)**

All provisions effective beginning with the 2001 tax year, except some federal update provisions that have earlier effective dates. Negative changes represent a cost to the state and positive numbers represent a gain to the state.

S-Corp Banks – See description in the section on individual income tax above, and Table 23. *Note that the net cost is much smaller than shown in the first line of Table 26 because the change will increase individual income tax revenues.*

Repeal franchise tax on insurance companies – Under prior law, Minnesota was one of only a few states to levy the corporate income tax on insurance companies. In most states, insurance companies pay the insurance gross premiums tax, but not a corporate income tax. By exempting these companies from Minnesota's corporate franchise tax, the Omnibus Tax Act increases the competitiveness of this increasingly footloose business sector in Minnesota. This provision was included in the Governor's budget recommendations.

Charitable deduction – apportion federal deduction. Under prior law, Minnesota corporations were allowed a deduction only for contributions to Minnesota charities. However, the eligible contributions were deductible from Minnesota taxable income *after* apportionment, so each dollar of eligible contribution reduced taxable income by a full dollar. The Omnibus Tax Act allows a deduction for all contributions deductible under federal rules, regardless of the location of the organization. This will generally increase the amount of contributions that are eligible, but the deduction will be made *before*

apportionment. If only 20 percent of a corporation's total income is apportioned to Minnesota, then each dollar of federally-deductible charitable contribution will reduce Minnesota taxable income by only 20 cents. If the fraction of a corporation's contributions made to Minnesota charities exceeds its apportionment factor, the corporation will pay more tax under the new law – and vice versa. As shown in Figure 26, the change results in a net increase in tax revenue.

Prior law provided an targeted incentive to make contributions to charities that did their work in Minnesota, but it also increased the complexity of the tax system. More importantly, some feared that this preferential treatment could be challenged on constitutional grounds. The enacted change was included in the Governor's budget recommendations.

Federal Update – Conform to new federal tax laws passed in 2000 – The Omnibus Tax Act of 2001 adopted the changes made in two of the three federal tax bills passed by the 2000 Congress.

- The Consolidated Appropriations Act of 2001 included the following: fair market deduction for donation of computers to schools; expensing of brown field cleanup costs; an increase in the volume of private activity bonds that can be sold by state and local governments; the creation of new empowerment zones; and dependent exemptions for kidnaped (and still missing) children.
- The Installment and Tax Correction Act of 2000 repealed a 1999 law that precluded accrual-based taxpayers from using the installment method of reporting sales.

The Act did not adopt the very significant tax changes made in the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. This federal act repealed the special tax preferences for Foreign Sales Corporations (FSCs), instead excluding from tax any net income attributable to sales made outside the U.S. This Act was in response to a trade dispute between the United States and the World Trade Organization (WTO). Failure to conform to the new federal provisions will complicate the state tax, but the new federal tax provisions have themselves been challenged before the WTO.[18] Given the significant impact these changes will have on some of Minnesota's multinational corporations – and the uncertainty of future federal law – the decision was made to delay conforming to these international tax provisions.

Penalty Reform – Penalties for not filing business tax returns and for late payment of tax were simplified and made more consistent across tax types. Generally, this resulted in a reduction in penalties.

Interaction effects – property tax cuts. The Omnibus Tax Act will reduce business property taxes by a substantial amount. With lower property taxes, business costs will fall and taxable income will rise. This will increase corporate franchise tax revenues by an estimated $9 million in the 2002 tax year (FY 2003), and slightly more in later years.

[18] The WTO ruled against the new federal provisions in October 2001. The U.S. government is appealing that ruling.

Figure 27
Sales and Use Tax
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Tax Provision	FY 2002	FY 2003	FY 2002-03	FY 2004	FY 2005	FY 2004-05
Repeal June accelerated payments (eff. June 2003)	0	(154,230)	**(154,230)**	(8,590)	(9,050)	**(17,640)**
Streamline sales tax (eff. 1/1/02)	9,300	23,000	**32,300**	24,100	25,200	**49,300**
Telecommunications reform	47,880	59,180	**107,060**	62,740	66,500	**129,240**
Exempt telecomm equipment	(24,480)	(30,190)	**(54,670)**	(31,320)	(32,580)	**(62,900)**
Exempt equipment for nursery plants	(373)	(460)	**(833)**	(480)	(490)	**(970)**
Exempt stationary feed bunks	(95)	(105)	**(200)**	(110)	(115)	**(225)**
Exempt sales to ambulance services (including petroleum products)	(30)	(36)	**(66)**	(37)	(38)	**(75)**
Exempt certain energy-efficient appliances and products (eff. 8/1/01 to 7/31/05)	(480)	(600)	**(1,080)**	(630)	(650)	**(1,280)**
Exempt Met Council purchases of light rail transit vehicles & parts	0	(180)	**(180)**	(4,200)	(180)	**(4,380)**
Exempt certain transit vehicles	(847)	(1,023)	**(1,870)**	(983)	(1,017)	**(2,000)**
Clarify exemption for admissions to artistic events sponsored by nonprofit organizations	2,180	2,390	**4,570**	3,190	3,810	**7,000**
Exempt admission to Minnesota Zoo	(175)	(215)	**(390)**	(217)	(220)	**(437)**
Use tax – allow credit for local sales taxes paid in other states	(100)	(200)	**(300)**	(200)	(200)	**(400)**
Expand border city credits (eff. 7/1/01)	(1,558)	(58)	(1,616)	(59)	0	(59)
Exempt construction materials for low-income housing (non-profits & government)	(300)	(330)	**(630)**	(350)	(360)	**(710)**
Exempt construction materials for certain specific projects (various effective dates)	(1,030)	(1,440)	**(2,470)**	0	0	**0**
Subtotal: Sales and Use Taxes	31,505	(104,379	**(72,874)**	42,973	50,670	**93,643**

Note: Negative changes represent a cost to the state and positive numbers represent a gain to the state. All provisions are effective starting August 1, 2001 unless otherwise noted. Columns may not add to totals due to rounding.

Sales and Use Tax.

The cost of individual provisions are summarized in Figure 27 and described more fully below.

- **Repeal June accelerated payments** – Since 1983, venders with annual sales and use tax liability of $120,000 or more have been required to make an early payment of a portion of their June tax liability (62 percent beginning in June 2002). Because payment is due two business days before the end of June – rather than the 14th of the following month, as is typical for these taxpayers – these payments are shifted to an earlier state fiscal year. This "fiscal year shift" was originally used to balance the state budget in years when tough budget choices were required. The Omnibus Tax Act will reverse that fiscal shift by repealing this requirement, effective for June 2003.

  The cost of repeal is largely a one-time cost in FY 2003, because $154.23 million of sales tax revenues would be received in the first month of FY 2004 rather than the last month of FY2003. However, there is also an ongoing cost in later fiscal years, because the size of the existing fiscal shift grows slightly larger each year (with the growth of sales tax revenues).

  The net revenue loss for FY 2004 (the first of the out-years) would be calculated as follows:

  Gain: $154.23 million in July 2003 (shifted from June 2003 in FY 2003)
  Lose: $162.82 million in June 2004 (shifted to July 2004 in FY 2005)
  Net loss: $ 8.59 million for the 2004 fiscal year.

- **Streamline sales tax provisions** – As authorized in the 2000 Tax Act, Minnesota has joined 26 other states as an official "participant" in the Streamlined Sales Tax Project (SSTP), a national effort to radically simplify state sales taxes. The Omnibus Tax Act of 2001 adopted a set of standardized rules and definitions agreed upon by the SSTP. Some items that were taxable under prior law will become non-taxable, and some previously non-taxable will become taxable. Figure 28 summarizes the major changes. With two exceptions, these provisions are the same as those proposed in the Governor's budget. The differences: The prior law exemption for sewing materials was maintained; and a new 6.5 percent gross receipts tax on fur clothing was enacted (as described under "other taxes") to fully offset the exemption of fur clothing from the sales tax.

  The Omnibus Tax Act also repeals the special higher sales tax rates on alcoholic beverages and on rental vehicles, effective 7/1/05. The SSTP will not allow such differential rates after 2005. The Department of Revenue is instructed to propose substitutes for these taxes. The state will also take over administration of Duluth's local sales tax (the only one not already administered by the state), as required by the simplification effort.

  The potential long-term impact of the Streamlined Sales Tax Project is discussed further at the end of the sales tax section.

Figure 28
Streamline Sale Tax Provisions
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Tax Provision	FY 2002	FY 2003	FY 2002-03	FY 2004	FY 2005	FY 2004-05

Tax installation & delivery charges	7,800	19,700	27,500	20,400	21,100	41,500
Tax more prepared food, baking chips, and mini marshmallows	2,500	6,100	8,600	6,400	6,800	13,200
Tax drinks with between 15% and 50% juice	700	1,700	2,400	1,800	1,800	3,600
Exempt ice, bottled water, unsweetened tea, single servings of ice cream treats, snack food served in bars and restaurants, and near beer	(1,400)	(3,500)	(4,900)	(3,700)	(3,900)	(7,600)
Tax some clothing accessories	600	1,200	1,800	1,300	1,400	2,700
Exempt fur clothing. [NOTE: While exempt from the sales tax, these items will be subject to a new and equivalent gross receipts tax.]	(600)	(1,600)	(2,200)	(1,700)	(1,800)	(3,500)
Change sourcing rules	(300)	(600)	(900)	(400)	(200)	(600)
Subtotal: Sales and Use	9,300	23,000	32,300	24,100	25,200	49,300

Note: Negative changes represent a cost to the state and positive numbers represent a gain to the state. All provisions are effective starting January 1, 2002.

- **Telecommunications reform –** The Omnibus Tax Act adopted language developed by the National Telecommunications Tax Reform Initiative, a joint state-industry working group. The changes also make Minnesota law consistent with the recently-enacted federal Mobile Telecommunications Act.
  Under prior law, international phone calls were never taxed and interstate phone calls were taxable only if they originated in Minnesota and were billed to a Minnesota address. Under the new law, all international and interstate phone calls – including mobile phone charges – are taxable if they are billed to an address in Minnesota. (Special exemptions remain, though, for incoming toll-free calls and for calls made by certain telemarketing firms.) The changes will increase tax revenue by $48 million in FY 2002 and $59 million in FY 2003. This provision was included in the Governor's budget recommendations.

- **Exempt telecommunications equipment from tax –** Telecommunications machinery and equipment (including repair and replacement parts) will be exempt from tax if it is used to produce a taxable service. This follows the pattern of recent changes to exempt inputs into producing taxable goods and services. This provision offsets about half of the revenue gained through telecommunications reform (($24 million in FY 2002 and $30 million in FY 2003). It was included in the Governor's budget recommendations.

- **Exempt machinery and equipment for nursery plants** – In 2000, the definition of exempt farm machinery was expanded to include machinery used to grow trees and shrubs. The 2001 Omnibus Tax Act expands the definition to include flowering plants as well.

- **Exempt stationary feed bunks** – Prior law included automatic feeding systems in the definition of exempt farm machinery, but not stationary feed banks.

- **Exempt sales to ambulance services** – Prior law exempted repair and replacement parts for ambulances and supplies and equipment used to provide medical care if purchased by a public ambulance service. The Omnibus Tax Act extended this exemption to private ambulance services (which account for 55 of the 309 ambulance services registered in the state). Motor oil and other petroleum products were also made exempt from sales tax if purchased by an ambulance service.

- **Exempt certain energy-efficient products** – Chapter 5 exempts the products listed in Figure 29 from sales tax for five years (August 2001 through July 2005). Each item's share of the total cost is shown in the right-hand column.

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Figure 29

Requirements for Exempted Energy Efficient Products

Appliance or product	Efficiency requirement	% of total estimated revenue impact
Natural gas furnaces	Fuel efficiency over 92 percent*	66%
Natural gas water heaters	Energy factor of 0.62 or more*	14%
Compact fluorescent light bulbs	Energy star label	11%
Residential lighting fixtures	Energy star label	6%
Photovoltaic cells	All	3%
Electric heat pump hot water	Energy factor of 1.9 or more*	–

**As shown on "energyguide label" mandated by the federal government.*

- **Exempt Met Council purchases of light rail transit vehicles and parts** – Cost estimate assumes that 24 light rail vehicles will be purchased in FY 2004 and one each in FY 2003 and FY 2005.

- **Exempt transit vehicles from the motor vehicle sales tax** – The more limited exemption for Met Council purchases under prior law was extended to include transit vehicles purchased by rural, opt-out, and special transportation service providers, as well as small Met Council buses. Because portions of the motor vehicle sales tax are dedicated to other funds, this exemption will also reduce revenues for the Metropolitan Area Transit Fund (see Figure 15), the Greater Minnesota Transit Fund (see Figure 16), and the Highway Users Tax Distribution Fund (see Figure 35).

- **Clarify exemption for admissions to artistic events sponsored by nonprofit organizations** – Prior law had been interpreted to exempt admissions to concerts presented by for-profit promoters if the concert were co-sponsored by a nonprofit organization, regardless of the share of profits that were donated to the co-sponsoring organization. The Omnibus Tax Act restricted

the non-profit arts admissions exemption by requiring that:

- all receipts for ticket sales are recorded on the books of the nonprofit arts organization;
- all profits are used only to finance arts activities; and
- charitable contributions account for more than a prescribed minimum percentage of the nonprofit organization's revenues. That required percentage rises from three percent for sales made in FY 2002 and FY 2003 to four percent in FY 2004 and five percent in FY 2005 and later years.[19]

- **Exempt admissions to the Minnesota Zoo** – for events sponsored and conducted exclusively by the zoo or its employees.

- **Use tax – allow credit for local sales taxes paid in other states**. Under prior law, a credit has been granted for sales tax paid to another state. The Omnibus Tax Act makes local sales taxes eligible for the credit as well.

- **Expand border city credits** – Border city credits generally fund exemptions from the state sales tax for businesses located within enterprise zones in designated border cities. The Omnibus Tax Act provides an additional $1.5 million in border city credits for border cities located on the western border of the state, distributed in proportion to each city's population. The cost is all shown in FY 2002.

  The City of Luverne also received $175 thousand in border city credits, which are assumed spread evenly over three years (FY 2002 to FY 2004).

- **Exempt construction materials for qualified low-income housing projects –** To be eligible, the housing project must be owned by a public housing agency, housing and redevelopment authority, or nonprofit organization. It must also satisfy statutory definitions for low-income housing. Materials are exempt whether purchased by the owners or by contractors.

- **Exempt construction materials for certain specific projects** – as summarized in Table 30 below.

Figure 30

Sales Tax Exemptions for Construction Materials for Specific Projects
General Fund Revenue and Expenditure Changes
(dollars in thousands)

Construction Project	Location	Effective dates	FY 2002	FY 2003	**FY 2002-03**
Poultry litter electric generating facility	Benson	7/1/01 to 12/31/03	(425)	(425)	(850)
Waste tires electric cogeneration plant	Preston	6/1/01 to 12/31/03	(270)	(220)	(490)
Soybean oilseed processing co-op facility	Brewster	7/1/01 to 6/30/04	0	(775)	(775)

[19]This reflects changes made in the Revisor's Bill (Chapter 13).

Wood biomass electric generating plant	Koochiching County	Extend two years to 6/30/03	(180)	(20)	(200)
Pork processing facility	Dawson	Extend one year to 12/31/01	(100)	(0)	(100)
Yellow Medicine County law & family service center (tornado aid)	Granite Falls	7/1/00 to 12/31/02	(55)	(0)	(55)
Total for specific projects:			(1,030)	(1,440)	(2.470)

Note: Negative changes represent a cost to the state and positive numbers represent a gain to the state. Statutory language does not mention specific projects, except for Yellow Medicine County law and family service center. No costs are assumed to occur after FY 2003.

Implications of sales tax changes

Streamlined Sales Tax Project – As authorized in the 2000 Tax Bill, Minnesota has joined 26 other states as an official "participant" in the Streamlined Sales Tax Project, a national effort to radically simplify state sales taxes. Participating states include all of Minnesota's neighboring states. An additional 14 states are represented as "observer" states. The project is supported by the National Conference of State Legislatures, the National Governors Association, and the Federation of Tax Administrators.

The project's goal is to radically simplify payment of sales and use taxes by multistate companies. Companies that pay sales in multiple states now face high administrative costs. They must file separate returns in each state, and the definitions used to identify taxable purchases vary greatly. Tax exemption certificates issued by one state are not recognized by other states, and the treatment of bad debts and rounding rules differ from state to state. Adopting uniform definitions and uniform administrative rules would greatly simplify tax filing while still allowing tax rates and the tax base to vary by taxing jurisdiction.

The Streamlined Sales Tax Project hopes to move toward a "zero burden" sales tax system. It is largely a response to the rapid growth of e-commerce, which has substantially increased sales by out-of-state sellers who are not legally required to collect tax. In *Quill v. North Dakota* (1992), the court ruled that out-of-state companies can only be required to collect sales tax if they have employees or property in the state (thus creating *nexus*). Given the complexity of the tax system now facing multistate sellers, requiring those without such nexus to collect sales tax would impose an "excessive burden on interstate commerce." When taxes are not collected by an out-of-state seller, those buying such products (businesses or consumers) are legally required to pay "use tax". However, few consumers pay use tax on purchases from out-of-state companies, and compliance rates for businesses are less than 100 percent.

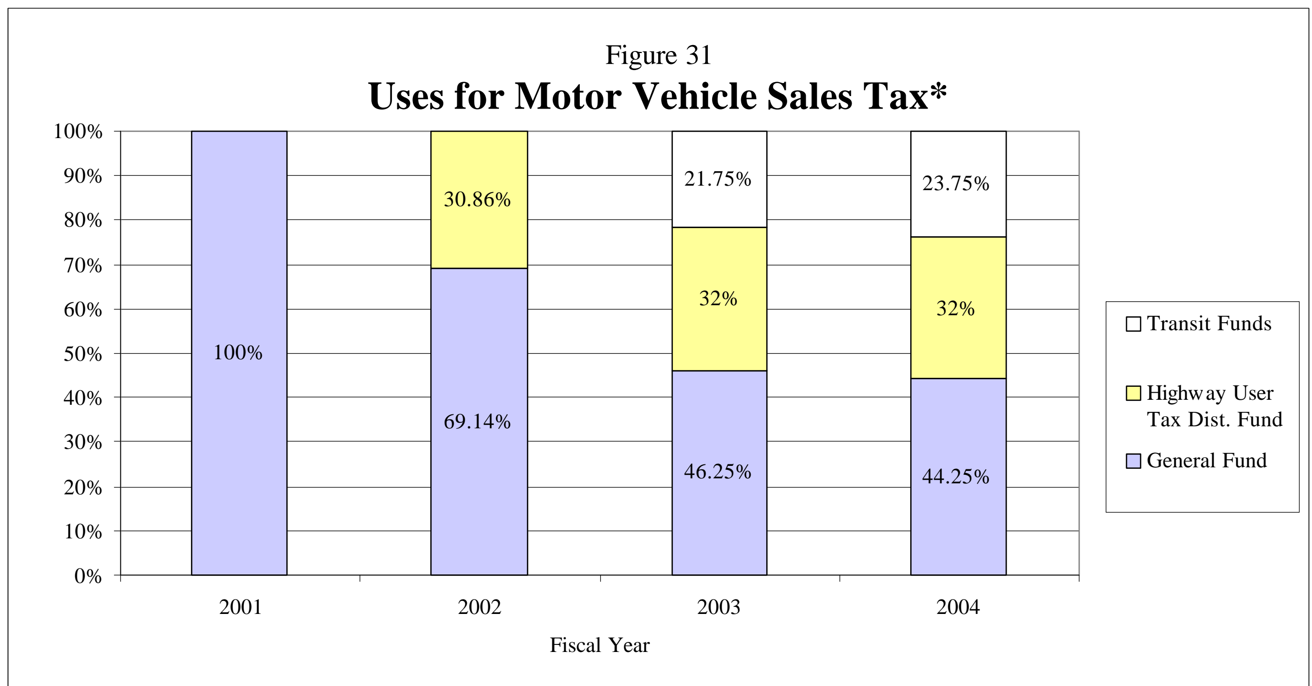
The ability of some e-commerce and other remote sellers to avoid withholding sales tax puts main street businesses at a competitive disadvantage. It also significantly reduces sales tax revenues. A recent study by the United States General Accounting Office (GAO) estimated that Minnesota's total revenue loss from all remote sales (e-commerce along with catalog, telephone, and home shopping network sales) in 2003 will be between $129 million (3.0 percent of general sales tax revenues) and $489 million (11.5 percent of general sales tax revenues).

If the Streamlined Sales Tax Project significantly reduces the administrative costs for multistate

companies, some out-of-state companies might agree to pay the tax voluntarily. More importantly, either the courts or Congress might be willing to require out-of-state companies to withhold taxes if the sales tax system is radically simplified.

The simplification provisions required of participants in the SSTP will somewhat restrict Minnesota's ability to define our own sales tax base and administrative rules. It is also likely that the state will be required to bear a higher share of the cost of administering the sales tax system, either through vender credits or other reimbursement mechanisms. These may be the necessary costs of creating a fairer and simpler sales tax system and slowing the erosion of the tax base due to increased popularity of remote sales.

Increased Dedication of the Motor Vehicle Sales Tax (MVST) to Transportation: As shown in Figure 31, the share of the MVST dedicated to highway and transit will rise from zero in FY 2001 to 55.75 percent in FY 2004. In the 2000 Tax Act, the MVST was used to replace tax revenue cut from the Highway Users Tax Distribution Fund when motor vehicle registration taxes were reduced. In a similar manner, the 2001 Tax Act used the MVST to replace the property tax as a source of funds for transit. Beginning in FY 2003, The 2001 Tax Act dedicates a portion of MVST revenues to two new transit funds. (See property tax section above for a full description.) Beginning in FY 2004, an additional 2% of the MVST is dedicated to transit funding, resulting in the share of the MVST revenues dedicated to highway and transit funding rising to 55.75 percent by FY 2004. Between FY 2001 and FY 2004, the share of MVST going to the (undedicated) General Fund has fallen from 100 percent to 44.25 percent.



These replacement revenues are dedicated by law, but not by constitutional amendment.

**The 32 percent dedication to HUTDF beginning in FY 2003 was enacted in the 2000 Tax Act. The 30.86 percent dedication to HUTDF in FY 2002 was enacted in the 2001 Transportation and Public Safety Act, replacing a General Fund appropriation enacted by the 2000 Tax Act. The transit dedications were enacted in the 2001 Tax Act.*

Other General Fund Taxes

Figure 32

Other Taxes

General Fund Revenue and Expenditure Changes

(dollars in thousands)

Tax Provision	FY 2002	FY 2003	**FY 2002-03**	FY 2004	FY 2005	**FY 2004-05**
Mortgage tax – switch liability to mortgagor (borrower) and repeal exemption for fraternal organizations	+2,200	+2,565	**+4,765**	+2,670	+2,740	**+5,410**
Mortgage tax – exempt certain agricultural loans	(945)	(1,100)	**(2,045)**	(1,150)	(1,200)	**(2,350)**
Insurance premiums taxes – change due dates	(500)	(20)	**(520)**	0	0	**0**
Repeal automobile self-insurance tax	(100)	(100)	**(200)**	(100)	(100)	**(200)**
Enact solid waste management use tax	75	95	**170**	100	105	**205**
Solid waste management tax -- allow commissioner to waive tax for disaster construction debris	(100)	(100)	**(200)**	(100)	(100)	**(200)**
Levy 6.5% gross receipts tax on clothing made of fur (no longer subject to sales tax under streamline sales tax provisions) (1/1/02)	600	+1,600	**+2,200**	+1,700	+1,800	**+3,500**
Subtotal: Other Taxes	+1,230	+2,940	**+4,170**	+3,120	+3,245	**+6,365**

Note: Negative changes represent a cost to the state and positive numbers represent a gain to the state. All provisions are effective starting August 1, 2001 unless otherwise noted.

Mortgage tax – switch liability from mortgagee to mortgagor, and repeal exemption for fraternals. Under prior law, the mortgagee (lender) was required to pay the tax. Because states are prohibited from taxing the federal government, federal credit unions and certain organizations that issue farm loans were exempt from paying the tax. The Omnibus Tax Act switched the legal incidence to the mortgagor (the borrower). This change removed the competitive advantage enjoyed by federal credit

unions under prior law.[20]

Mortgage tax – exempt certain agricultural loans. The Omnibus Tax Act exempts all agricultural loans, defined as loans whose proceeds are used to acquire or improve real property for the production of agricultural or forest crops. This includes both the loans made by agricultural credit organizations (which had already been exempt under prior law) and the loans made by commercial banks and businesses (which were previously subject to tax).[21]

Mortgage and deed taxes – change to percentage tax. Under prior law, the mortgage tax rate was 23 cents per $100 or fraction of $100. The deed tax rate was $1.65 per $500 or fraction of $500. These were changed to percentage tax rates of 0.23 percent and 0.33 percent respectively. This simplification had no impact on tax collections.

Insurance premiums taxes – change due dates. Taxes will be paid quarterly, rather than three times a year, on the same schedule as most other taxes. The delayed payment date results in a one-time cost to the General Fund.

Repeal automobile self-insurance tax – for simplification. This tax was a roughly equivalent substitute for the insurance premiums tax on insured automobiles.

Solid waste management tax – levy use tax. Under prior law, the solid waste management tax could be avoided by disposing solid waste in another state. The new use tax ends this tax incentive for out-of-state disposal.

Solid waste management tax – allow commissioner to waive tax on construction debris in disaster areas. This provision is permanent and will apply to any presidentially declared disaster area in the state. Note that half of the cost of this provision will be borne by the General Fund and half by the Solid Waste Management Fund. Agency fees may also be waived.

Levy 6.5 percent gross receipts tax on fur clothing. Fur clothing will be exempt from the general sales tax, because the new definitions adopted as part of the streamline sales tax project do not allow Minnesota to continue taxing fur clothing while exempting other clothing. This new tax fully offsets this new sales tax exemption for fur clothes.

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[20]The revenue gain shown in Figure 32 includes revenue from taxing previously-exempt agricultural loans, even though those loans are again exempted under the next provision in Figure 32. In technical terms, the switch in liability is "stacked first"; the agricultural exemption is "stacked last." The net gain from the two provisions combined is unaffected by the stacking order.

[21]The total cost of this provision includes the exemption of some agricultural loans that would have been exempt under prior law, as explained in the previous footnote. The revenue loss from only the newly-exempt agricultural loans is estimated to be: $565 thousand in FY 2002, $660 thousand in FY 2003, $690 million in FY 2004, and $720 million in FY 2005. So about 40 percent of all agricultural loans were exempt under prior law.

Other Miscellaneous Provisions

Figure 33

Miscellaneous Omnibus Tax Act Provisions

General Fund Revenue and Expenditure Changes

(dollars in thousands)

Tax Provision	**FY 2002**	**FY 2003**	**FY 2002-03**	**FY 2004**	**FY 2005**	**FY 2004-05**
DOR Admin. Appropriations:						
Streamlined sales tax provisions	(1,702)	(1,125)	**(2,827)**	0	0	**0**
Penalties reform	0	(545)	**(545)**	(25)	(25)	**(50)**
Sustainable forest incentive Act	0	(194)	**(194)**	0	0	**0**
Other property tax provisions	(503)	(505)	**(1,008)**	(462)	(462)	**(924)**
Grants for low-income taxpayer assistance by non-profits	(200)	0	**(200)**	0	0	**0**
Business tax study	(150)	0	**(150)**	0	0	**0**
Biomedical investment grant	(10,000)	0	**(10,000)**	0	0	**0**
One-year appropriation to MnDot to cover sales taxes in FY 2002	(4,370)	0	**(4,370)**	0	0	**0**
Modify petroleum inspection fee	300	300	**600**	300	300	**600**
Subtotal: Miscellaneous Provisions	(16,625	(2,069)	**(18,694**	(162)	**(162)**	**(324)**

Note: Negative changes represent a cost to the state and positive numbers represent a gain to the state.

Appropriations to Department of Revenue. Appropriations for administering provisions of the tax bill were all one-time appropriations except for $25,000 per year for penalty reform and $462,000 per year for long-term staffing needs to improve the state's support and oversight of local property tax assessors. Although it was acknowledged that there will be ongoing costs from the streamlined sales tax provisions, funding beyond FY 2003 will be determined later, as part of the normal review of the department's budget, when better information will be available.[22]

Grants for low-income taxpayer assistance – $200,000 in grants to one or more non-profit organizations to help low income taxpayers, seniors, and the disabled complete income tax and property tax refund returns. This is similar to the $100,000 appropriation provided in the 1999 Omnibus Tax Act. Tax returns for low-income households include complicated calculations for Minnesota's refundable income tax credits (working family credit, K-12 education credit, and child care credit) and the property tax refund.

Business tax study – appropriation to the legislative coordinating commission for the business activity tax (BAT) study. Although funded at the same $150,000 level in earlier years, the study was delayed by difficulties in obtaining IRS approval to allow a consultant to use the federal corporate tax data. These problems have now been solved and a contract with a University of Minnesota economics professor is pending to complete the study in the next two years.

Biomedical investment grant – $10 million one-time appropriation for the Biomedical Innovation Commercialization Initiative (BICI), a for-profit joint venture by the state, the University of Minnesota, Minnesota's medical technology community, and private investors. The state's $10 million will be matched three-to-one by $30 million from private investors, with any future profits distributed in proportion to the amount invested. The BICI board will include seven members – one chosen by the governor, one by the University of Minnesota, and five chosen by private sector investors. BICI's goal is to use its business and financial expertise to add commercial value to technologies developed by university faculty and staff.

One-year appropriation to the Department of Transportation – A law passed in the 2000 legislative session prohibited the use of trunk highway funds to pay sales tax. The Omnibus Tax Act repealed that prohibition, but it also provided a one-year General Fund appropriation to pay MnDot's sales taxes in FY 2002.

Modify petroleum inspection fee – collect fee from first licensed distributor receiving the product in Minnesota. Prior law collected the fee only if petroleum was stored in Minnesota, allowing some out-of-state suppliers to avoid the fee. The fee funds petroleum-related inspections of the weights and measures program.

Increase in Budget Reserve

[22]The Department of Finance included an additional $2.441 million in administrative costs for FY 2004-05 in their "End of 2001 Legislative Sessions Fund Balance Analysis." Those additional funds were not authorized by the 2001 legislature, and are not shown in Figure 33.

The Omnibus Tax Act increased the budget reserve by $31 million for FY2002 (from $622 million to $653 million) and by another $31 million (to $684 million) for FY 2004. This is in addition to the $350 million in the cash flow account, which remained unchanged.

State Tax Changes Affecting Other Funds

Figure 34

Highway User Tax Distribution Fund (HUTDF)

Provision	FY 2002	FY 2003	FY 2002-03	FY 2004	FY 2005	FY 2005-06
Exempt ambulances from	**(80)**	**(97)**	**(177)**	**(97)**	**(98)**	**(195)**
Exempt transit vehicles	**(378)**	**(342)**	**(720)**	**(462)**	**(478)**	**(940)**
Modify shrinkage allowance	**+2,500**	**+2,540**	**+5,040**	**+2,590**	**+2,640**	**+5,230**
Potential loss due to MVRT	**(6,500)**	**(7,500)**	**(14,000)**	**(8,500)**	**(9,500)**	**(18,000)**
Close MVRT lease loophole	**+6,500**	**+7,500**	**+14,000**	**+8,500**	**+9,500**	**+18,000**
Admin. costs -- Dept of	**(140)**	**0**	**0**	**0**	**0**	**0**
Subtotal: HUTDF	**+1,902**	**+1,961**	**+3,863**	**+2,031**	**+2,064**	**+4,095**

Exempt ambulances from motor fuels tax – private as well as municipal ambulance services, and gasoline as well as diesel fuel. Prior law exempted municipal ambulances on purchases of diesel fuel.

Exempt transit vehicles from the motor vehicle sales tax – as described above (sales tax provisions). A portion of the motor vehicle sales tax (30.86 percent in FY 2002 and 32 percent in later years) is dedicated to the HUTDF, so part of the cost of this motor vehicle sales tax exemption is borne by this fund.

Modify shrinkage allowance – from 3 percent to 2.5 percent, to more accurately reflect the actual rate of shrinkage. By making a slightly larger proportion of petroleum subject to tax, this raises revenue.

Motor vehicle registration tax loophole for leased vehicles – The tax reductions enacted in 2000 inadvertently allowed some leased vehicles to pay lower registration taxes than otherwise identical vehicles owned vehicles. By leasing vehicles for three months at a time, the calculated tax was only 3 months at the first-year's tax rate ($10 plus 1.25 percent of the base value x 1/4 year) and 3 months at the second year's tax rate ($189 x 1/4 year) before reaching the third year's tax rate ($99 x 1/4 year). The tax paid in the first two years on a vehicle with a base value of $30,000 could be as low as $257 if leased, or less than half as much as the $574 in tax on the identical vehicle if purchased.

The new law fixes the language to match the intent of the 2000 law. ***Because the February 2000 forecast did not adjust the forecast registration tax revenues for this problem, Figure 34 shows first the downward revision in the forecast revenues and then an equal revenue gain from closing the loophole.***

Administrative costs to the Department of Revenue – a one-time appropriation to the department of revenue to modify computer systems needed for the petroleum tax reforms.

Figure 35

Solid Waste Management Fund (SWMF)

Provision	FY 2002	FY 2003	FY 2002-03	FY 2004	FY 2005	FY 2005-06
Enact solid waste management use tax	75	95	**170**	100	**5**	**5**
Commissioner may waive SWMT for disaster	(100)	(100)	**(200)**	(100)	(100)	**(200)**
Subtotal:	(25)	(5)	**(30)**	(0)	5	**5**

Enact solid waste management use tax. Under prior law, the solid waste management tax could be avoided by disposing solid waste in another state. The new use tax ends this tax incentive for out-of-state disposal.

Allow commissioner of revenue to waive tax on construction debris in disaster areas. This provision is permanent and will apply to any presidentially declared disaster area in the state.

Note that half of the cost of each of these provisions will be borne by the General Fund and half by the Solid Waste Management Fund.

Figure 36

Health Care Access Fund (HCAF)

	FY 2002	FY 2003	**FY 2002-03**	FY 2004	FY 2005	**FY 2005-06**

Maintain provider tax at 1.5%	(19,700)	(60,100	**(79,800)**	(41,520)	0	**(41,520)**
Delay 1% HMO premiums tax	0	(17,594	**(17,594)**	(15,395)	0	**(15,395)**
Exempt adult day care	(300)	(380)	**(680)**	(400)	(420)	**(820)**
Subtotal: HCAF	(20,000)	(78,074	**(98,074)**	(57,315)	(420)	**(57,735)**

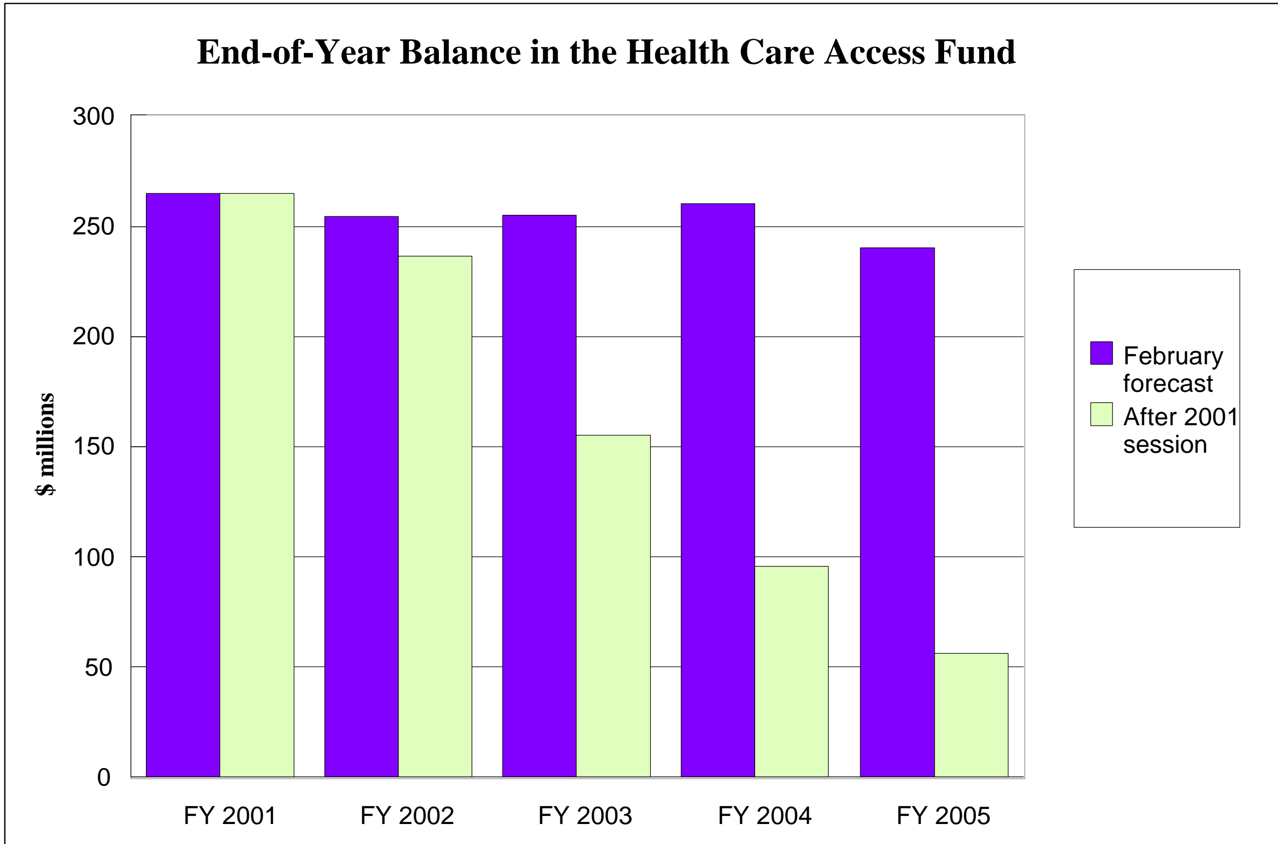
Maintain provider tax at 1.5 percent until January 1, 2004. Prior law would have raised the tax rate to two percent on January 1, 2002, so this is a two-year delay.

Delay one percent HMO premiums tax until January 1, 2004. Prior law would have imposed this tax starting January 1, 2003, so this is a one-year delay.

Exempt adult day care centers from the provider tax – effective 8/1/01.

Implications for the balance in the Health Care Access Fund: No new revenues were provided for the Health Care Access Fund to replace these lost revenues, so each of the changes noted above will reduce the fund's end-of-year balances. Figure 37 shows how the changes enacted in the 2001 legislative session – mostly tax changes, though there were some spending as well – reduced the end-of-year balances in the HCAF, as projected by the Department of Finance. These numbers show the total balance, including any reserves, but the Omnibus Tax Act also repealed the $150 million reserve required by previous law.

Figure 37



Source: Department of Finance. Includes impact of both tax and spending changes enacted during the 2001session. Balances include any required reserves.

For additional information on income, corporate, sales, and health care taxes contact Paul Wilson at 651-296-8405 or paul.wilson@house.leg.state.mn.us. For additional information on property aids and credits, motor vehicle taxes, and other taxes contact Matt Massman at 651-296-7171 or matt.massman@house.leg.state.mn.us.