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

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

January 15, 2013

by

Andrew Biggerstaff
Nina Manzi
Joel Michael
Pat Dalton
Research Department

and

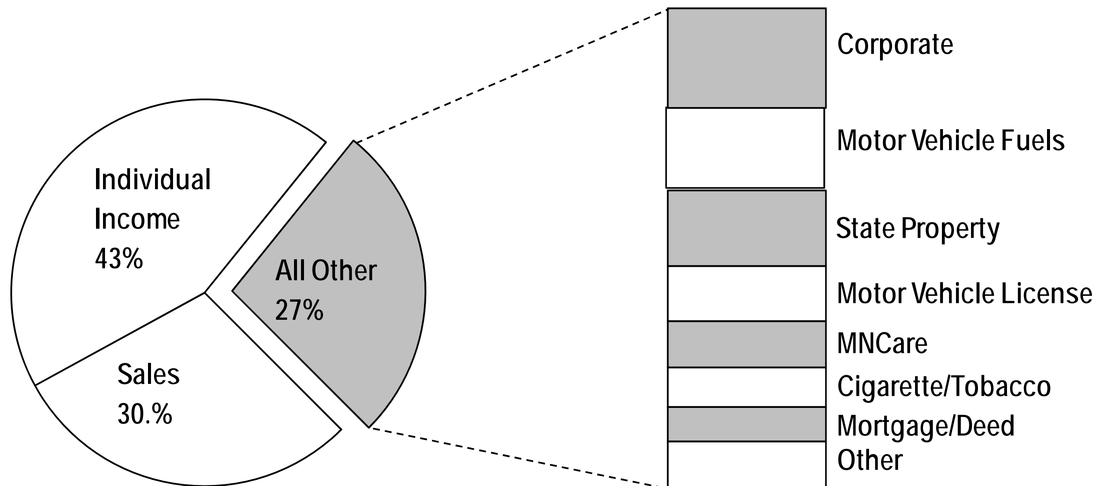
Cynthia Templin
Fiscal Analysis Department

Minnesota House of Representatives

# State Taxes

| Minnesota State Tax Collections ($19,690 million in FY 2013) | | | |
|---|---|---|---|
| Individual Income | $8,521 | Cigarette/Tobacco | $421 |
| Sales | 5,983 | Insurance Premiums | 377 |
| Corporate Franchise | 1,080 | Mortgage and Deed | 194 |
| Motor Vehicle Fuels | 880 | Estate | 140 |
| State Property | 817 | Alcoholic Beverages | 79 |
| Motor Vehicle License | 593 | Gambling | 55 |
| MNCare Taxes | 509 | Other | 41 |

Most state taxes are credited to the General Fund. Some, however, are dedicated in whole or in part to other funds. For example, the Motor Vehicle Fuels tax is constitutionally dedicated to the Highway User Trust Fund. The data shown here lists the full amount of projected collections for all state taxes in fiscal year 2013, including those that do not go to the General Fund.

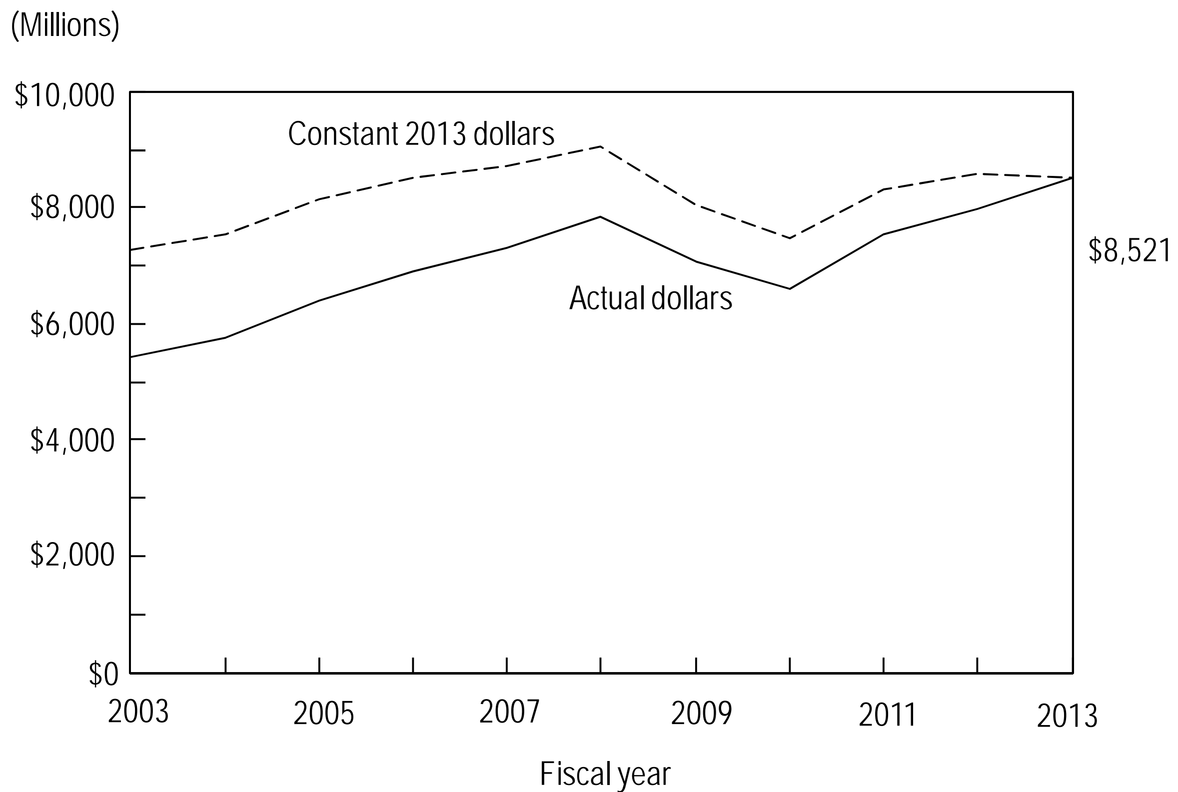


# The Individual Income Tax

1. Individual Income Tax Revenues and Distribution of Tax Burden

   a. **Revenues.** The individual income tax is projected to raise $8.5 billion in revenue in fiscal year 2013. Since the reciprocity agreement with Wisconsin terminated after tax year 2010, this does not include any projected payments from the state of Wisconsin on behalf of Wisconsin residents who work in Minnesota. Instead, Wisconsin residents who work in Minnesota are subject to Minnesota withholding and filing requirements. A new income tax reciprocity benchmark study, prepared jointly by the Minnesota and Wisconsin Departments of Revenue, is due to be submitted to the legislature by March 1, 2013.

**Individual Income Tax Revenues, 2003-2013**




2. **Distribution of the individual income tax burden.** The Department of Revenue's *2011 Minnesota Tax Incidence Study* estimated how the income tax burden was distributed across Minnesota households in 2008. Updated estimates (based on a newer tax sample and the November 2012 economic forecast) will be released in early March 2013. (See http://www.revenue.state.mn.us/research_stats/research_reports/2011/2011_tax_incidence_study_links.pdf). Because the income tax burden as a percent of income rises steadily from *negative* 0.8% of total income for the poorest fifth of Minnesota households to 5.1%

of income for the richest fifth of Minnesota households (and 6.1% for the richest 1%), economists describe the income tax as a *progressive* tax.

The richest fifth of Minnesota households (with 57.8% of total income) were estimated to pay 72.8% of the total individual income tax in 2008.

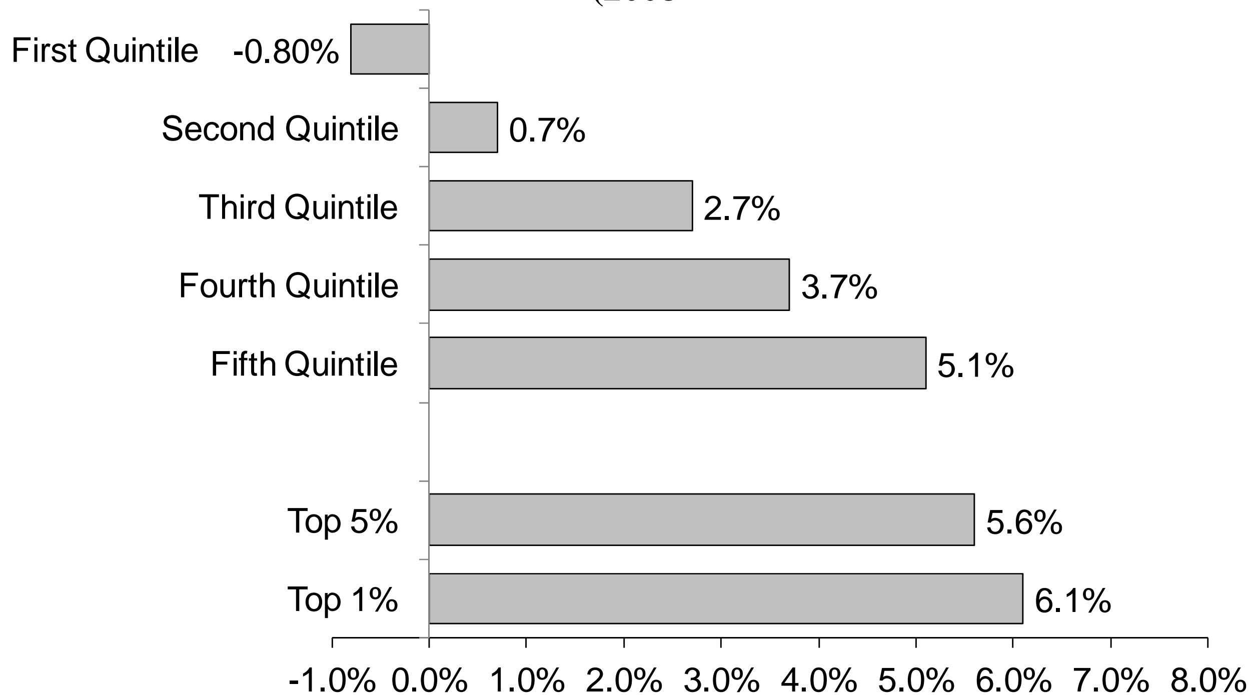
The Department's *2013 Minnesota Tax Incidence Study* will include data on the distribution of the federal income tax burden across Minnesota households.

## Distribution of Individual Income Tax by Population Quintiles (2008)

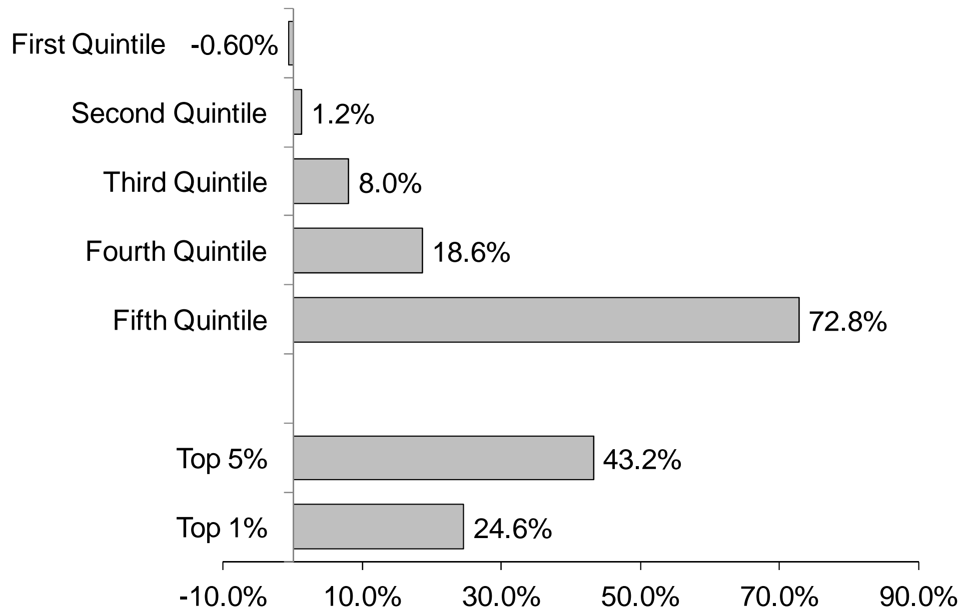
| Quintile | Income Range | Percent of Total Income | Tax Paid (000s) | Percent of Total Tax | Effective Tax Rate |
|---|---|---|---|---|---|
| First | $16,278 or less | 2.8% | -$40,599 | -0.6% | -0.9% |
| Second | $16,279 – 31,689 | 6.9% | 84,700 | 1.2% | 0.7% |
| Third | $31,690 – 53,314 | 12.2% | 564,178 | 8.0% | 2.7% |
| Fourth | $53,315 – 89,936 | 20.4% | 1,313,525 | 18.6% | 3.7% |
| Fifth | Over $89,936 | 57.8% | 5,139,579 | 72.8% | 5.1% |
| | | | | | |
| Total | All incomes | 100% | $7,061,383 | 100% | 4.1% |
| Top 5% | Over $182,829 | 31.2% | 3,053,819 | 43.3% | 5.6% |
| Top 1% | Over $429,354 | 16.2% | 1,733,589 | 24.6% | 6.1% |

Source: MN Dept. of Revenue, 2011 Tax Incidence Study, page 27.

## Income Tax Burden Effective Tax Rates by Population Quintiles (2008




Source: Department of Revenue, 2011 *Tax Incidence Study*




Source: Department of Revenue, 2011 *Tax Incidence Study*

3. **Reliance on the federal tax.** The Minnesota individual income tax closely follows the federal individual income tax. It applies a progressive tax rate structure to taxable income, a measure of net income that is adjusted for family size (by allowing deduction of personal and dependent exemption amounts) and is reduced by a variety of deductions.

   a. Taxpayers do much of the calculation of the tax base in filling out the federal form.

   b. The law incorporates federal law by reference.

   c. Federal compliance and enforcement efforts generally flow through to the state and vice versa.

   d. **Policy implications.** The heavy reliance on the federal tax has some important policy implications.

      i. Reliance on the federal tax makes it relatively easy for taxpayers to comply with and for the state to administer the tax.

      ii. The state must regularly (usually annually) adopt changes made by congress to keep in close step with the federal tax.

      iii. Minnesota’s policy options are limited on basic issues of the tax base; the state is in a sense captive to congressional decisions.

iv. Federal tax legislation enacted while the 2012 Legislature was meeting or after it adjourned may result in a separate schedule (M-1NC) for Minnesota taxpayers to make adjustments to federal taxable income for (among other items):

(1) itemized deduction for mortgage insurance premiums

(2) exclusion from adjusted gross income of IRA distributions to charities

(3) depreciation of restaurant property and certain leasehold improvements

(4) increased AGI limits on charitable deduction of contributions of capital gain real property for conservation purposes, with more generous rules for farmers and ranchers

(5) extension of various provisions related to depreciation and expensing of property and equipment

v. Federal tax legislation enacted after the 2012 Legislature adjourned resulted in extension to tax year 2012 of several items to which Minnesota has not always conformed in the past. The Department of Revenue may add lines to form M-1M for these items, including:

(1) increased section 179 expensing – for tax years 2012 and 2013 Minnesota has required addition of 80% of the difference between the pre-2003 allowance and the increased federal allowance in the current tax year, with one-fifth of the amount added back then subtracted in each of the five following tax years

(2) bonus depreciation – Minnesota has required addition of 80% of bonus depreciation in the current tax year, with one-fifth of the amount added back then subtracted in each of the five following tax years

(3) above-the-line deduction for classroom educator expenses

(4) above-the-line deduction for college tuition and fees

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

a. **Rates.** Minnesota’s income tax rates for tax year 2012 are 5.35, 7.05, and 7.85%

**Minnesota Tax Rates and Brackets, 1998-2013**

| Brackets for married joint filers* | 1998 | 1999 | 2000 and after |
|---|---|---|---|
| $0 to $35,480 | 6% | 5.5% | 5.35% |
| $35,481 to $140,960 | 8% | 7.25% | 7.05% |
| Over $140,960 | 8.5% | 8% | 7.85% |

* Brackets shown are at 2013 levels; and are adjusted for other filing statuses

b. **AMT.** Minnesota also has an individual alternative minimum tax (AMT) that uses a broader tax base and has a lower rate (6.4%). If an individual's tax is higher under the AMT than under the regular tax, the individual must pay the AMT. The AMT typically affects taxpayers with large amounts of certain deductions or preference items. The itemized deductions for property taxes and home mortgage interest and accelerated depreciation are the tax preferences that most often subject taxpayers to the Minnesota AMT. The 2006 tax law substantially increased the AMT exemption amounts, and reduced the number of taxpayers subject to the AMT to about 8,00 projected to pay about $17.2 million in AMT for tax year 2013.

## 5. Minnesota deductions and credits

### a. Difference between deductions and credits

i. **Deductions.** A deduction (also called a "subtraction") is a subtraction from taxable income. The value of a deduction equals a taxpayer's marginal tax rate multiplied by the amount of the deduction. As an example, a taxpayer in the 7.85% bracket who qualifies for a $1,000 deduction receives a tax benefit of $78.50 from the deduction. Low-income taxpayers may not benefit from a deduction. A taxpayer whose taxable income is reduced to zero by federal deductions and exemptions would not benefit from the same $1,000 deduction.

ii. **Credits.** A credit is a subtraction from tax liability. A nonrefundable credit can be used to reduce liability to zero. A refundable credit, in contrast, is paid to the filer as a "refund" if the credit amount exceeds liability. As an example, a taxpayer who has $500 of liability and qualifies for a $1,000 nonrefundable credit has his or her liability reduced to zero. In effect, this taxpayer only benefits from the first $500 of the credit. If the credit were refundable, the filer would receive a $500 refund in addition to having liability reduced to zero.

b. **Minnesota additions**

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

(1) Interest from municipal bonds of another state or political subdivision of another state (also federally tax-exempt dividends from mutual funds that invest in other states' municipal bonds)

(2) Expenses deducted federally that are attributed to income not taxed by Minnesota

(3) Additions resulting from explicitly not conforming to federal law:

a. Difference between federal and state standard deductions for married filers

b. State limitation on itemized deductions (adjusted for different federal limitation)

c. State phase-out of personal and dependent exemptions (adjusted for different federal phase-out)

d. Bonus depreciation deduction

e. Section 179 expensing deduction

f. Domestic production activities deduction

g. Federal subsidies received by employers for providing prescription drug coverage to retirees

h. net operating loss carryover adjustments

(4) Additions resulting from federal law changes enacted since the end of the 2012 session

a. Distributions made directly from IRAs to charities, and basis adjustments to other charitable contributions

b. Accelerated depreciation for various kinds of property

c. S corporation donations of appreciated property

d. Higher education tuition expense deduction (extended to tax years 2012 and 2013)

e. Classroom educator expense deduction (extended to tax year 2012 and 2013)

f. mortgage insurance premiums itemized deduction (extended to tax years 2012 and 2013)

g. discharge on indebtedness on principal residents (TY 2013 only)

c. **Minnesota Subtractions (deductions)**

i. Minnesota conforms to federal itemized deductions, including deductions for mortgage interest, property taxes, charitable contributions, investment interest, casualty and theft losses, various business expenses, and medical expenses that exceed a percentage of the taxpayer's adjusted gross income (7.5% for those 65 and older, 10% for younger taxpayers). Minnesota requires taxpayers to add back the federal itemized deduction for state income of sales taxes paid. This addition is limited to the amount that exceeds the state standard deduction, so as to preserve the standard deduction amount for all filers.

ii. Minnesota allows various state deductions. These include:

(1) Subtractions required by federal law:

a. Interest on U.S. government obligations

b. Railroad retirement benefits

c. On-reservation earnings of members of an Indian tribe

d. pay for active service performed in Minnesota by nonresident members of the military

(2) Subtractions required by not conforming to federal law:

a. Portion of bonus depreciation added to MN taxable income in previous years

b. Portion of section 179 expensing added to MN taxable income in previous years

c. Net operating loss carryover adjustments

(3) K-12 education expenses (discussed more under the K-12 credit)

(4) Charitable contributions: taxpayers who do not itemize at the federal level may deduct 50% of charitable contributions that exceed $500.

(5) Military pay

a. for active duty performed by Minnesota residents

b. for National Guard and reserve active service and training, other than certain administrative statuses

(6) Elderly subtraction

(7) Up to $10,000 of unreimbursed expenses related to organ donation

(8) JOBZ business and investment income

(9) Gain on sale of farm property if taxpayer insolvent

(10) Foreign tax payments that exceed the federal foreign tax credit

(11) Post-service education awards for service in AmeriCorps

(12) Reciprocity subtraction (residents of Michigan, and North Dakota)

d. **Nonrefundable Minnesota Credits**

i. **Marriage penalty credit.** Designed to offset the penalty implicit in Minnesota's rate and bracket structure. As an example, in tax year 2013 single filers pay 5.35% on the first $24,270 of taxable income, while married joint filers pay 5.35% on the first $35,480 of taxable income. Without the marriage penalty credit, two people each with taxable income of $24,270 would pay lower tax as single filers than if they married. As in this example, the rate and bracket structure imposes the largest penalty on married couples with relatively equal incomes; these couples qualify for the largest credit. Taxpayers determine their credit using a look-up table in the tax instructions. The credit amount depends on the couple's taxable income, and the earned income of the lesser-earning spouse. Earned income is defined to include taxable pension and social security income, since those types of income are tied to an individual's earnings history.

The maximum credit depends on the income tax rates in effect in a given year; for tax year 2012 the maximum credit is $361. Total marriage penalty credits for fiscal year 2013 are projected at $64.5 million with approximately 398,000 filers qualifying for credits annually.[1]

ii. **Credit for taxes paid to other state.** Resident taxpayers pay tax on all of their income, even if it is taxable in another state. If they pay tax on some of their income in another states (e.g., they earned income in another state or had investment income sourced to another state), they are allowed a

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[1] Projections of the cost of this and other credits are taken from the Minnesota Department of Revenue's *2012-2015 Tax Expenditure Budget*, available on-line at *http://www.revenue.state.mn.us/research_stats/research_reports/2012/2012_tax_expenditure_links.pdf.*

credit against their Minnesota tax for taxes paid to the other state. The credit is intended to prevent this income from being subject to double taxation.

iii. **Long-term care credit.** Taxpayers may claim 25% of long-term care insurance premiums paid as a credit, up to a maximum of $100 per beneficiary ($200 for married couples filing joint returns). The credit is only allowed for premiums that are not claimed as an itemized deduction for medical expenses at the federal level. Before tax year 2000, policies had to include inflation protection in order to qualify for the credit. For tax year 2000 and following years, a taxpayer only has to have been offered inflation protection when purchasing the policy in order for the policy to qualify.

About 60,000 filers are projected to claim $8.4 million in long-term care credit in fiscal year 2013.

iv. **Transit pass credit.** Taxpayers may claim a credit equal to 30 percent for the cost of transit passes provided to their employees. The credit applies to the employer's subsidy in providing the passes (e.g., the difference between the cost the employer incurs versus what it charges the employee). This credit is estimated to reduce revenues by $100,000 for FY 2013.

v. **Credit for past military service.** Retired members of the military with at least 20 years of service or who separated due to a disability are allowed a $750 credit. The credit is phased out for taxpayers with adjusted gross income (including military retirement income) in excess of $30,000. About 1,600 filers are projected to claim about $1 million in credits in fiscal year 2013.

e. **Refundable Minnesota Credits.**

i. **Working Family Credit.** The working family credit, like the federal earned income credit, provides a wage supplement equal to a percentage of the earnings of low-income individuals. Up until tax year 1998, the working family credit equaled a percentage of the federal earned income tax credit. In 1998, Minnesota *decoupled* the working family credit from the federal credit, in order to structure the state credit to decrease the work disincentive faced by low-income filers leaving the state's cash public assistance program. Income eligibility for the federal and Minnesota credits are the same; everyone eligible for the federal credit is also eligible for the Minnesota credit.

The maximum credit in tax year 2013 is $1,879 for claimants with two or more children; $973 for claimants with one child; and $122 for claimants with no children. The credit is subject to an income-based phaseout. Filers become ineligible for the credit when their incomes exceed:

$42,963 for claimants with two or more children; $37,815 for claimants with one child; and $14,350 for claimants with no children. Both the maximum credit amount and the credit phaseout are indexed annually for inflation. Through tax year 2011, the phase-out was higher for married filers than for other filers ($5,210 higher in tax year 2011).

In tax year 2010, about 330,000 recipients claimed credits with an average credit amount of $586. A total of $186.7 million in working family credits are projected to be paid in fiscal year 2013.

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

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

In tax year 2008, 56,776 recipients claimed the credit with an average credit amount of $269. A total of $14.4 million in K-12 education credit is projected to be paid in fiscal year 2013.

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

iii. **Dependent care credit.** Minnesota's dependent care credit is tied to the federal credit, which equals a percentage of qualifying dependent care expenses paid to others so that the parent can work or look for work. The maximum Minnesota credit is $720 for one child, and $1,440 for two or more children. The credit is subject to an income-based phaseout that for tax year 2013 begins when income reaches $24,920; taxpayers with incomes over $38,570 are not eligible for the credit. The income phaseout is indexed annually for inflation, but the maximum credit is not. The dependent care credit uses the definition of qualifying expenses under the federal dependent care credit. The Minnesota credit differs significantly

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

In tax year 2010, 36,544 recipients claimed the credit with an average credit amount of $395. A total of $14.0 million in dependent care credits are projected to be paid in fiscal year 2013.

Federal legislation enacted since the close of the 2012 legislative session that extended and made permanent increased federal credit parameters, beginning in tax year 2013. Absent state legislation to conform to the federal changes, Minnesota taxpayers will be eligible for smaller state credits beginning in 2013; the overall decrease in the amount paid will be about $1.8 million per year.

i. **JOBZ jobs credit**. A refundable credit applies to proprietorships, S corporations, and partnerships (including LLCs) operating in Job Opportunity Building Zone (JOBZ) areas who hire additional higher paid employees. The credit effectively applies, at a 7% rate, to wages paid over $30,000 and below $100,000 (amounts are indexed for inflation since 2003).

iv. **Military service credit.** Allows a refundable credit of $120 for each month served in a combat zone or qualified hazardous duty zone during the tax year. An estimated 2,500 taxpayers will qualify for $1.9 million in credits in fiscal year 2013, for an average credit of $760.

v. **Bovine tuberculosis testing credit.** Allows a refundable credit equal to half the cost of testing cattle for bovine tuberculosis (25 percent for farms organized as corporations). Because bovine tuberculosis is not currently present in Minnesota, there is no anticipated cost for this credit in fiscal year 2013. The credit would be available in the event of a future outbreak and implementation of testing requirements by the federal or state government.

vi. **Research credit.** The 2010 Legislature extended the longstanding research credit (often referred to as the research and development credit) under the corporate franchise tax to shareholders of S corporations and partnerships (including LLCs taxed as partnerships) subject to the individual income tax. The legislation also made the credit refundable. The credit's calculations are based on the similar federal credit, which applies to increases in expenditures for qualifying research over a base amount. The credit rate is 10 percent of the first $2 million of qualifying expenditures and 2.5 percent of the amount over that. Qualifying expenses are largely for cost of paying employees (and for their supplies) who are engaged in qualifying research. (Purchases of long lived equipment does not qualify.) The estimated cost of credit for S corporations and partnerships in FY 2013 is $8.0 million.

vii. **Small business investment credit.** The 2010 Legislature enacted an angel investment credit, allowing qualifying investors in qualifying small Minnesota businesses to receive a credit equal to 25 percent of their equity type investments up to a maximum of $125,000 ($250,000 for a married joint filer). No business may receive investments qualifying for more than $1 million in credits. To qualify businesses must be certified by the Department of Employment and Economic Development (DEED) and must be involved in specified technology fields. They also may not be involved in certain prohibited lines of business. The credit sunsets in 2015 and is limited to $12 million per year ($11 million for tax year 2010), administered through the DEED certification process.

viii. **Historic structure rehabilitation credit.** The 2010 Legislature also enacted a historic rehabilitation credit equal to the similar federal credit. Investors have the option of claiming this credit as a grant instead. The credit is equal to 20 percent of the qualifying costs of rehabilitating historic structures, with the grant equal to 90% of the credit that would otherwise be allowed. The estimated cost of the credit and grant combined for FY 2013 is $17.4 million; to date all credit claims have been under the corporate franchise or insurance premiums tax, with no claims under the individual income tax.

6. **Modeling capabilities.** Both House Research and the Fiscal Analysis Department use the House Research Income Tax Simulation (HITS) model to prepare estimates of the effect of changes to the income tax system. The model uses a sample of income tax returns and the growth assumptions made in the most recent economic forecast prepared by Minnesota Management and Budget. The Minnesota Management and Budget, the Department of Revenue and the Minnesota Senate use the same model to estimate the impact of income tax changes and in preparation of state revenue forecasts. Types of changes that can be modeled include changes to the rates, exemption amounts, deductions, and changes to the various credits.

7. **Historical Highlights**

a. **1933: Enactment.** Tax was first enacted in 1933 with rates ranging from 1% to 5%. Minnesota was one of the first states to enact an individual income tax. (Wisconsin was the first state to do so.) Some features:

i. One rate schedule was used, i.e., no separate filing statuses for married couples, singles, and so forth. Each individual paid tax on his or her own income.

ii. Federal income taxes were deductible.

iii. A large number of itemized deductions were deductible.

iv. Personal credits were provided, rather than the exemption amounts.

b. **1961: Withholding tax.** Withholding tax was imposed in 1961. Before enactment of the withholding tax, all filers were required to directly pay the tax.

c. **1961: Tying tax to the federal tax.** In 1961, the tax was first directly linked to the federal income tax by adopting federal adjusted gross income as the starting point in computing the tax base.

d. **1970s: Rate Changes.** Various surtaxes and rate increases were imposed over the years. The "Minnesota Miracle" in 1971 was financed with a significant increase in the rates. At one point during the 1970s the top rate was increased to 18%, although this rate was repealed before it went into effect. A top rate of 17% applied for a period of time in the 1970s; federal taxes were deductible, though.

e. **1979: Indexing.** The 1979 Legislature indexed the tax bracket, standard deduction, and personal credit amounts for inflation.

f. **Early 1980s: Temporary rate increases.** Temporary surtaxes were imposed and repealed during the recessions in the early 1980s, to help make up for downturns in state revenues.

g. **1985: Closer conformity to federal tax.** The 1985 Legislature made major changes, including:

   i. Substantial rate reduction

   ii. Federal filing status rules (Before 1985, the Minnesota tax applied on an individual bases; with the adoption of federal filing status rules, the possibilities of marriage penalties and bonuses were created)

   iii. Optional rate schedule with lower rates and no federal tax deduction

h. **1987: Tax reform.** In the wake of the 1986 federal tax reform, the 1987 Legislature dramatically restructured the tax. The changes included:

   i. Adopted FTI as the starting point for the Minnesota calculations. This had some important effects:

      (1) Eliminated personal and dependent credits in favor of personal and dependent exemptions

      (2) Eliminated the federal income tax deduction (at this point, the deduction was an option that subjected the taxpayer to a higher rate schedule)

      (3) Adopted all the federal rules for itemized deductions

      (4) Eliminated a number of state deductions, such as the pension exclusion, the deduction for military pay, and unemployment compensation exclusion

(5) Adopted federal tax reform changes, including the new passive loss rules, and the repeal of the 60% exclusion for capital gains and the sales tax deduction

(6) Major simplification – the tax was now reported on one page form with considerable "white space"

ii. Reduced tax rates – top rate was now 8% (with "bubble" applying marginal rate of 8.5% to some taxpayers)

i. **1991: Working family credit and rate increase.** In 1991, the legislature increased the top rate to 8.5% ("bursting the bubble") and adopted the working family credit (Minnesota's earned income credit). This credit began at 10% of the federal earned income credit. It has been increased in later legislative sessions so that the average working family credit claimed in Minnesota is about 33% of the average federal earned income credit claimed in Minnesota.

j. **1997-1998: Property tax rebates.** In 1997 and 1998, the individual income tax system was used to provide large (about $500 million each) property tax rebates.

k. **1997: K-12 credit.** In 1997, the refundable credit for K-12 education expenses was provided, effective in 1998. In 2001 (effective for tax year 2002), the credit was limited to 75 percent of qualifying expenses.

l. **1999-2000: Rate reduction.** In 1999 and 2000, the legislature enacted substantial across-the-board cuts in the tax rates. The bottom rate was reduced from 6% to 5.35% and the top rate from 8.5% to 7.85%.

m. **1999: Marriage penalty credit.** The 1999 Legislature enacted the marriage credit to address the "marriage penalty" that results from the difference in widths between the married and single rate brackets (as described above under 5.d.i)

n. **2000: Transit pass credit.** The 2000 Legislature enacted this credit to encourage employers to subsidize transit passes for their employees.

o. **2006: Bovine Tuberculosis Testing Credit and Military Service Credit.** The 2006 Legislature enacted the Bovine Tuberculosis Credit in response to the appearance of Bovine TB in the state; feeder cattle must be tested before being shipped out of state until the federal government declares the state free of the disease. The military credit equals $59 for each month of service in a combat zone of qualified hazardous duty area, retroactive to September 11, 2001.

p. **2008: Credit for past military service, motor fuels credit, and expansion of military pay subtractions (all effective in tax year 2009)**. The 2008 Legislature enacted a new credit for military retirees, phased out for those with income over $30,000. It included in the Transportation Finance Law a credit intended to at least partially offset the motor fuels tax increase on taxpayers in the first income

tax bracket. It also provided new subtractions for military pay for training in Minnesota, and for active service performed by Minnesota residents in Minnesota.

q. **2009**: **Section 125 health insurance credit.** The 2009 Legislature enacted the section 125 health insurance credit for moderate income individuals who enrolled in these plans and did not previously have health insurance.

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

s. **2011: Mixed messages on federal conformity.** The 2011 legislature chose not to conform to the federal extension of the increased standard deduction for married joint filers, or to the extension at the federal level of the elimination of both the phaseout of personal and dependent exemptions and the limitation on itemized deductions. But the legislature did come back into conformity on the higher education tuition deduction and the educator classroom expense deduction, and, for tax year 2011 only, modified the working family credit parameters to match the federal extension of the earned income credit phaseout for married filers.

## 8. Recent Trends in Policy Changes to Tax

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

a. **Major reform and simplification early in the period.** During the 1985-87 sessions, the governor and legislature undertook major efforts to simplify and "reform" the tax. The pre-1985 tax was quite complex. It was out of step with federal tax in some respects (e.g., in using individual, rather than married couple, filing and using personal credits rather than exemptions). Furthermore, it reflected an accumulation of many policy decisions to use the tax system to further non-tax goals (e.g., encouraging solar energy, pollution clean-up, and conservation tillage, to name a few) and to make micro adjustments to achieve equity goals (e.g., personal credits, rather than exemptions). The 1985 and 1987 changes are quite remarkable in clearing the underbrush and ending up with a very simple tax that closely followed the federal tax with only a few unimportant differences.

b. **Growing use of the tax to administer transfers and payments to businesses.** A second trend, particularly during the 1990s, was the cooption of the tax as a mechanism for delivering income transfers and program payments. Policymakers have discovered that the tax provides a relatively efficient way make modest payments to large numbers of recipients using refundable credits. These credits

are paid to recipients as refunds, when they exceed the recipient's tax liabilities. Minnesota has long provided a refundable dependent care credit (since 1977), but this was a modest enterprise (few affected taxpayers and small cost). The 1990s saw the addition of two much larger transfer programs with the working family credit and the education credit. In 2006 Minnesota added two new refundable credits, for bovine tuberculosis testing costs and a credit analogous to a bonus for military service in combat zones since September 11, 2001. In 2008 Minnesota added two more credits (past military service and motor fuels for lower-income taxpayers, both effective in tax year 2009 with the first cost appearing in FY 2010). In 2009 another credit (the section 125 health insurance credit) was added, although this credit was nonrefundable. 2010 saw a net increase of two refundable credits with the enactment of three new credits (angel investment, historic rehabilitation, and research) and repeal of one refundable credit (motor fuels). In 2011, the section 125 health insurance credit was repealed.

Below are the numbers claiming these credits in tax year 2010 and their projected costs in FY 2013. The costs include both the offset against tax and refund amounts.

| Refundable Credit | Number Claiming* | FY 2013 Cost** |
|---|---:|---:|
| Dependent Care | 36,544 | $14,000,000 |
| K-12 Education | 55,776 | 14,400,000 |
| Working family | 330,040 | 186,700,000 |
| Bovine testing | | 0 |
| Military service (combat zone) | 2,500 | 1,900,000 |
| Angel investment | NA | 12,000,000 |
| Historic rehabilitation (including grants) | NA | corporate only |
| Research | NA | 8,000,000 |

* Dept. of Revenue, 2010 income tax processing data.
** Dept. of Revenue, *Tax Expenditure Budget FY 2012-15;* and estimates prepared during 2012 session.

c. **Creeping complexity.** The 1987 Act was the high-water mark for simplification. Since then, the legislature has slowly been adding features to the tax for many of the same policy reasons that underlay the provisions that were repealed in 1985 and 1987. Some of these include:

i. Elderly exclusion

ii. K-12 education credit

iii. Charitable contribution subtraction for nonitemizers

iv. Credit for long-term care insurance

v. Transit pass credit

vi. Marriage penalty credit

vii. Subtraction for disposition of farm property

viii. Subtraction for foreign taxes in excess of the federal foreign tax credit

ix. Subtraction for organ donation expenses

x. Bovine tuberculosis testing credit

xi. Subtractions for various categories of military pay

xii. Failure to conform to special federal rules relating to bonus depreciation, section 179 expensing, and recognition of net operating losses.

xiii. Failure to conform to the increased standard deduction for married filers, and the extension of the elimination of the phaseout of personal and dependent exemptions and the limitation of itemized deductions.

# Sales Taxes

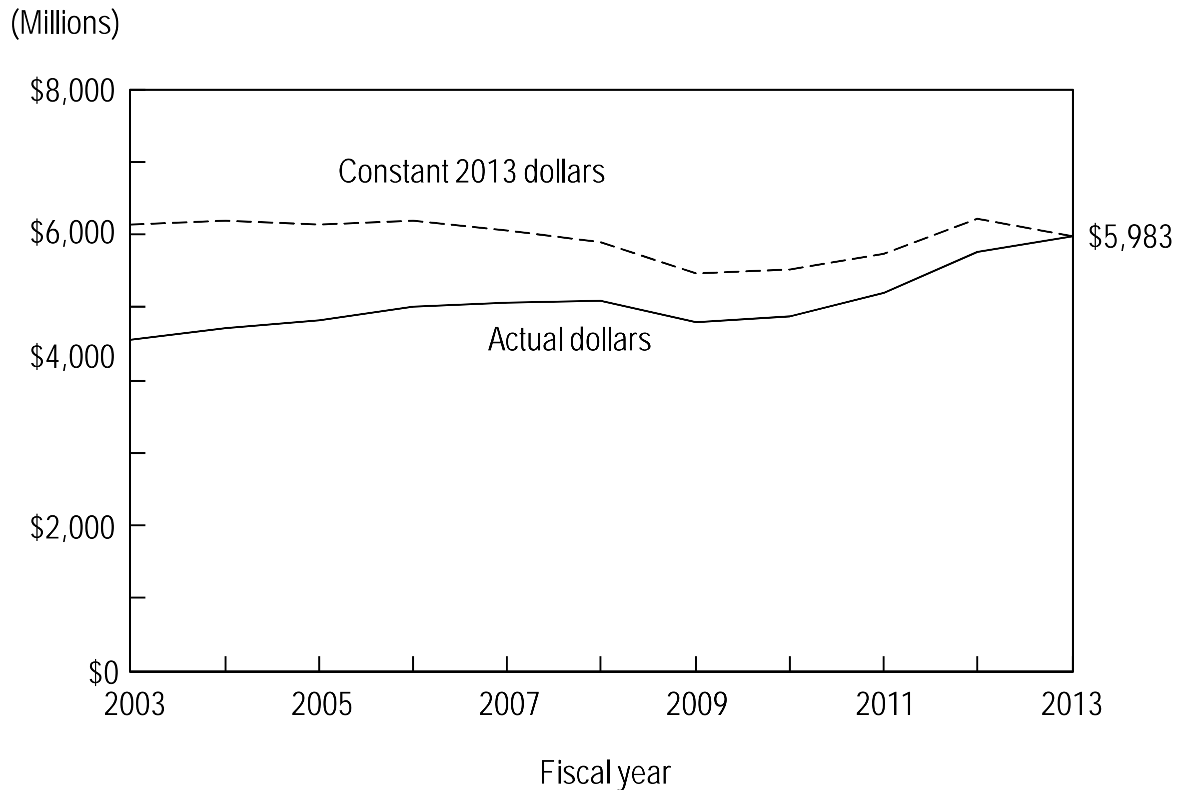
Minnesota is one of 46 states (plus DC) that levies a sales and use tax.

**Amount of State Revenue Generated**

The general sales tax, motor vehicle sales tax, and payments in-lieu of sales tax on lottery tickets will raise a combined $6.0 billion in fiscal year 2013. $5.1 billion is from the general sales tax, $275 million from the rate under the Legacy Amendment (0.375% rate), $565 million from motor vehicles sales tax and $35 million from lottery tickets. Sales taxes account for slightly less than 1/3 of total state tax revenue.

**Sales Tax Revenues**

**Sales Tax Revenues, 2003-2013**




**Distribution of the Sales Tax Burden**

The *Minnesota Tax Incidence Study* estimates how the sales tax burden is distributed across Minnesota households. (See http://www.revenue.state.mn.us/research_stats/research_reports/2011/2011_tax_incidence_study_links.pdf.)

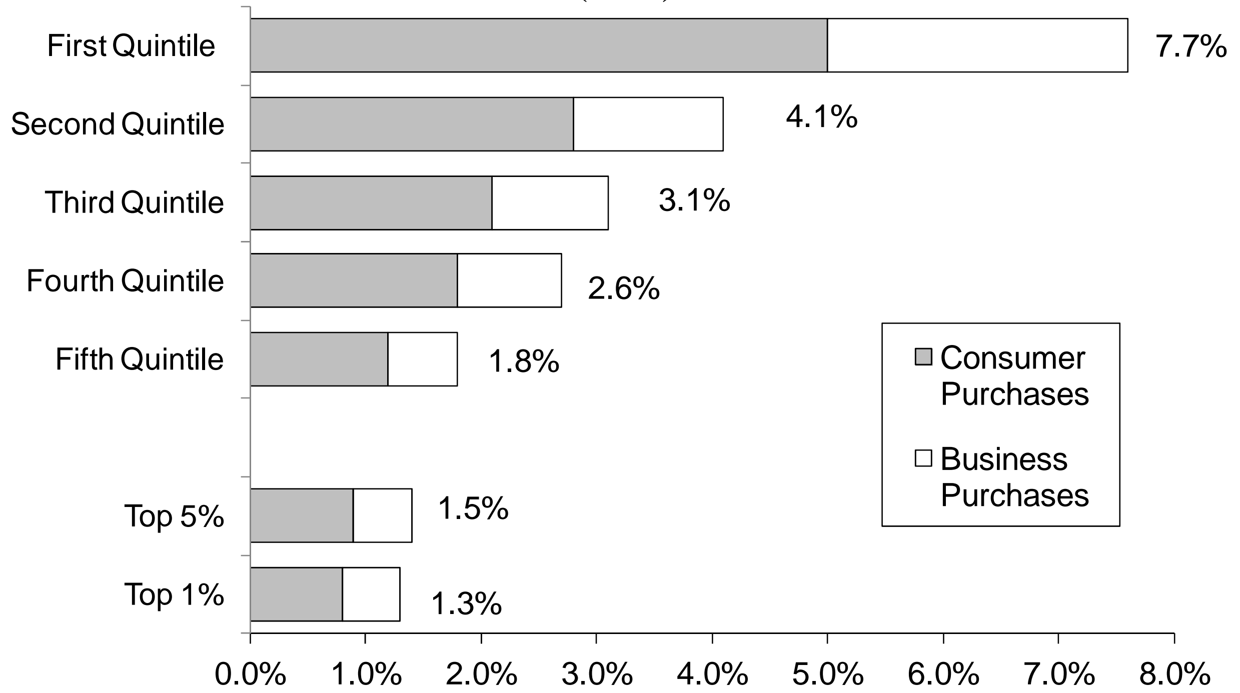
Because the sales tax burden as a percent of income falls steadily from 7.7% of total income for the poorest fifth of Minnesota households to 1.3% of income for the richest fifth of Minnesota households, economists describe the sales tax as a *regressive* tax.

The richest fifth of Minnesota households (with 57.8% of total income) are estimated to pay 42.1% of the total sales tax.

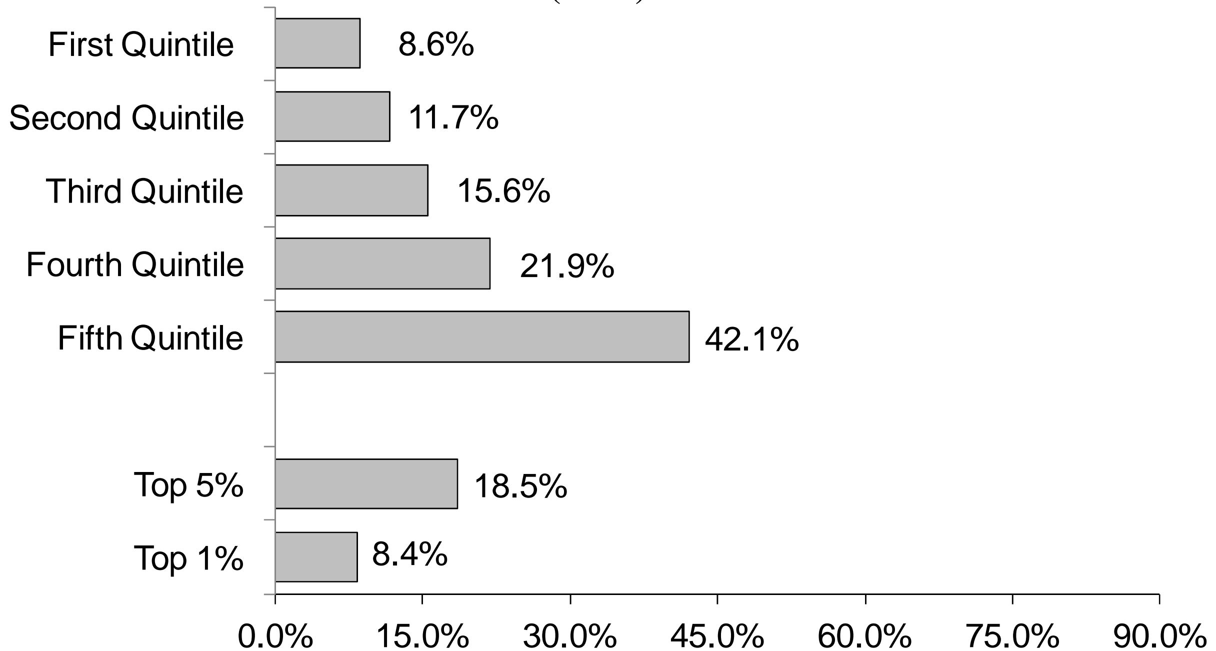
**Distribution of Sales Tax Burden**
**by Population Quintiles**
**(2008)**

| Quintile | Income Range | Percent of Total Income | Tax Paid (000s) | Percent of Total Tax | Effective Tax Rate |
|---|---|---|---|---|---|
| First | $16,278 or less | 2.8% | $367,380 | 8.6% | 7.7% |
| Second | $16,279 – 31,689 | 6.9% | 499,875 | 11.7% | 4.1% |
| Third | $31,690 – 53,314 | 12.2% | 663,664 | 15.6% | 3.1% |
| Fourth | $53,315 – 89,936 | 20.4% | 931,711 | 21.9% | 2.6% |
| Fifth | Over $89,936 | 57.8% | 1,793,686 | 42.1% | 1.8% |
| | | | | | |
| Total | All incomes | 100% | $4,256,316 | 100.0% | 2.4% |
| Top 5% | Over $182,829 | 31.2% | 789,131 | 18.5% | 1.5% |
| Top 1% | Over $429,354 | 16.2% | 358,281 | 8.4% | 1.3% |

Source: MN Dept. of Revenue, 2011 Tax Incidence Study, page 27




Source: Department of Revenue, *2011 Tax Incidence Study*




Source: Department of Revenue, *2011 Tax Incidence Study*

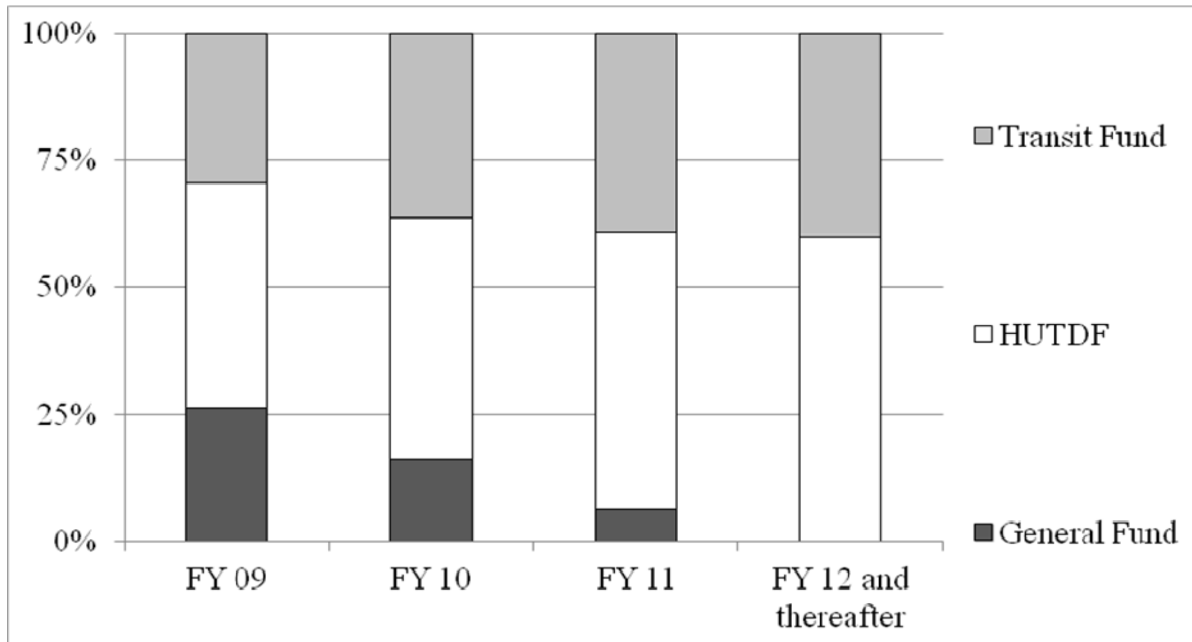
**Dedication of Revenue**

**Motor Vehicle Sales Tax (MVST).** A constitutional amendment providing for the phase-in of a complete dedication of MVST revenues to transportation and transit funding passed at the 2006 general election. The phase-in was completed in FY 2012 and now 100% of these revenues are dedicated to transportation and transit funding.

The constitutional amendment required that "no more than 60 percent" of the dedicated revenue go to the highway user trust distribution fund (HUTDF), and "not less than 40 percent" go towards public transit assistance (Minn. Const. art. XIV, § 13). The final distribution codified in statute is 60 percent to HUTDF and 40 percent to transit. Of the 40 percent dedicated to transit – 36 percent goes to transit in the metropolitan area and 4 percent goes to the Greater Minnesota transit fund. The estimated loss in revenues to the general fund is about $565 million in FY 2013.

The current distribution of MVST revenues as well as the distribution during the transition is shown in the table below.

[2] Includes indirect effect of tax paid by businesses.




**Revenue from motor vehicle leases.** Unlike motor vehicle sales, motor vehicle leases are subject to the general sales tax of 6.875% and are not subject to the constitutional dedication. During the 2008 session, most revenues from the sales tax on motor vehicle leases were statutorily dedicated to transportation. The dedication, when fully phased in, was to equal the revenue from the tax on motor vehicle leases, minus $32 million. 50 percent of the net revenues after the subtraction go to the Greater Minnesota transit account and the remaining 50 percent go to the county state-aid highway fund. The portion going to the state-aid highway fund is distributed to the counties in the seven county metropolitan area except for Hennepin and Ramsey Counties, based on county population. The $32 million retained in the general fund was to fund a new low income motor fuel credit, but that credit was repealed in the 2010 legislative session.

For FY 2013, the estimated sales tax revenues on leased motor vehicles is $54.93 million. Of this, $11.465 million will go to the county state aid highway fund and $11.465 million will go to the transit assistance fund.

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

**The legacy amendment sales tax increase.** In 2008, voters approved a constitutional amendment to increase the general state sales tax by 3/8th of one percent (0.375%). The additional rate was imposed for twenty years, beginning July 1, 2009. The revenue raised by the additional tax is estimated to be $275 million in FY 2013. The revenue is dedicated as follows:

**Forecasted Legacy Amendment Fund Receipts**
(in millions)

| Fund | FY 2012 | FY 2013 | FY 2012-13 | FY 2014 | FY 2015 | FY 2014-2015 |
|---|---|---|---|---|---|---|
| Outdoor Heritage (33%) | 87.7 | 90.7 | 178.4 | 93.4 | 96.7 | 190.1 |
| Clean Water (33%) | 87.7 | 90.7 | 178.4 | 93.4 | 96.7 | 190.1 |
| Parks & Trails (14.25%) | 37.8 | 39.2 | 74.7 | 40.3 | 41.8 | 82.1 |
| Arts & Cultural Heritage (19.75%) | 52.0 | 54.3 | 104.5 | 55.9 | 57.9 | 113.8 |
| Total All Funds (100%) | 265.2 | 274.9 | 536.0 | 283.0 | 293.1 | 576.1 |

Source: Minnesota Management and Budget Department, November 2013 forecast.

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

## Rates

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

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

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

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

**Minnesota's state sales tax rate is relatively high**. Only the following six states have state rates as high as Minnesota (6.875%), as of January 1, 2013:[4]

California (7.5%)[5] Indiana (7%) Mississippi (7.0%)
New Jersey (7.0%) Rhode Island (7.0%) Tennessee (7.0%)

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

[4] Source: Sales Tax Institute (wwwsalestaxinstitute.com/resource/rate). Nevada has a rate of 6.85%, almost as high as Minnesota.

[5] California's rate includes a mandatory county rate of 1.0 percent.

However, many states have a number of *local* sales taxes and their combined state and local tax rate are in the 6% to 13% range. The maximum state and local combined sales tax rate in Minnesota is 7.875% (in Duluth and Cook County). At least 21 other states have a maximum combined state and local tax rate of 8.0% or higher.

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

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

## Tax Base

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

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

**A major share of the sales tax is paid by businesses rather than consumers.** In theory, the sales tax is a tax on final consumption but the reality is that the tax is applied to a number of business purchases. According to the Department of Revenue's 2011 *Tax Incidence Study*, about 44 percent of the general and motor vehicle sales taxes are paid on purchases by business.

## Exemptions

**There has been a cumulative erosion of the tax base over time.** When the tax was enacted in 1967 there were 14 exemptions in the exemption section of the statute (§ 297A.25). By 1990 there were 46 exemptions in § 297A.25 and other exemptions in separate sections or buried in definitions. The 2000 sales tax recodification effort identified 104 exemptions. There are currently 115 exemptions to the tax base listed in statute, although a sizable number of these are exemptions of business purchases. Major sales tax exemptions include:

General exemptions:

- Food for home consumption
- Clothing
- Home heating fuels
- Motor fuels subject to the per gallon motor fuels tax
- All drugs for human consumption
- Newspapers and subscription magazines
- Cigarettes[6]

Business exemptions:

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

Exemptions for certain entities:

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

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

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

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

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

| *Change in taxation of the selected business inputs* | *Session enacted* |
|---|---|
| Reduce the rate on new and expansion capitol equipment from 4% to zero* | 1987 |
| Exempt mining equipment | 1990 |
| Began a phased reduction of the tax on replacement capital equipment from 6.5% to 2.0% | 1994 |
| Exempt special tooling | 1994 |
| Phase out the tax on replacement capital equipment from 2% to zero* | 1996 |
| Exempt inputs to the "1987" taxable services (similar to the existing exemption for inputs to agricultural and industrial production) | 1997 |
| Phase out the tax on farm machinery from 2.0% to zero by June 30, 2000 | 1998 |
| Telecommunications equipment | 2001 |
| Purchases by qualifying businesses in JOBZ | 2003 |
| Construction materials and electricity for large data centers | 2011 |

| *Change in taxation of the selected business inputs* | *Session enacted* |
|---|---|
| Miscellaneous construction exemptions for various agricultural and other processing facilities** | Various |
| * These exemptions are administered as refunds.<br>** A number of the miscellaneous construction exemptions are also administered as refunds. | |

**Minnesota could broaden its sales tax base.** Minnesota has a narrow base and there are a number of goods and services that could be added to the tax base. With a broader tax base, the same revenue could be raised with a lower tax rate. The following list of exempt goods and services (and the estimated revenue impact in FY 2013) is taken from a more complete list in the latest *Minnesota Tax Expenditure Budget*.

| *Selected Examples of Potential Base Expansion* | *Revenue impact at 6.875% rate FY 2013 ($ millions)* |
|---|---|
| Goods | |
| Food products | $705 |
| Clothing | 323 |
| Motor fuels | 786 |
| Residential heating fuels | 136 |
| Residential water and sewer | 70 |
| Newspapers and subscription magazines | 58 |
| Services | |
| Business services | $2,756 |
| Legal (consumer) | 103 |
| Motor vehicle repair (consumer) | 135 |
| Accounting (consumer) | 29 |
| Funeral services | 30 |
| Repair and maintenance of personal property | 19 |
| Personal care services | 102 |
| Other personal services | 16 |
| Purchases by exempt entities | |
| Schools | $115 |
| Hospitals and surgical centers | 75 |

| *Selected Examples of Potential Base Expansion* | *Revenue impact at 6.875% rate FY 2013 ($ millions)* |
|---|---|
| Nonprofit organizations (excluding hospitals) | 109 |
| Local governments (excl schools & hospitals) | 30 |

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

## Current Taxability of Selected Base Expansions in Neighboring States

**T = Taxes E = Exempt**

| *Potential Base Expansion* | *State* | | | | |
|---|---|---|---|---|---|
| | *Minnesota* | *Iowa* | *North Dakota* | *South Dakota* | *Wisconsin* |
| General Groceries | **E** | **E** | **E** | **T** | **E** |
| Clothing | **E** | **T** | **T** | **T** | **T** |
| Services: | | | | | |
| Motor vehicle repair | **E** | **T** | **E** | **T** | **T** |
| General repair | **E** | **T** | **E** | **T** | **T** |
| Legal | **E** | **E** | **E** | **T** | **E** |
| Accounting | **E** | **E** | **E** | **T** | **E** |
| Business | **E** | Mixed[7] | **E** | **T**[8] | **E** |
| Personal Services | Mixed | Mixed[9] | **E** | **T** | **Mixed**[10] |

Source: FTA Report – State Sales Taxation of Services, 2007 survey, revised March 2010.

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

[8] South Dakota taxes all services except those specifically exempted.

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

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

## External factors affecting the sales tax base

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

**The Internet impacts the sales tax in multiple ways.** The state cannot require remote sellers to collect the state tax (see sales tax and remote sales below). Internet sales have increased the amount of total remote sales and therefore the lost tax revenue. The Department of Revenue's most recent estimate for the loss, for CY 2011, is $204 million with $149 million due to e-commerce and $55 million to catalog sales.[11] The Internet also allows for the sale of digital goods (i.e., electronic greeting cards, downloaded music), which are not currently taxable. The substitution of digital goods for taxable tangible goods also erodes the sales tax base.

## Sales tax and remote sales

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

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

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

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

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

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

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

**Revenues associated with being a SSUTA member state.** One benefit of participating in the SSUTA is that a number of businesses have come forward and voluntarily registered to collect the Minnesota sales tax, either directly with the state under its SSUTA amnesty provision, or through the SSUTA central registration system. For the period between 10/1/2005, when the agreement went into effect, until the end of FY 2012 the state has collected $149.3 million in sales tax revenues from these businesses.

**Current compliance with SSUTA.** In 2012 the Compliance Review and Interpretations Committee of the SSUTA, a committee created by the governing board to hear appeals and propose recommendations to the governing board, recommended that Minnesota was substantially out of compliance with the SSUTA. This relates to Minnesota's definition of prepared food, because Minnesota exempts ready-to-eat meat and seafood. This provision has been law since 2002 and this was the first time the state was found to be out of compliance. Following a vote, Minnesota was found to be compliant with the Agreement. The president of the board has called for a definition of what it means to be substantially compliant as a result.

# Local Sales Taxes

**Authority to impose:**

- Cities have a general authority to impose up to a 3 percent lodging tax for tourism purposes.
- In 1971, the legislature prohibited local governments from imposing or increasing a local sales or income tax. This means that all new local sales taxes or changes in existing local sales taxes require enacting a special law.
- In 1997, the legislature adopted local sales tax rules (Minn. Stat. § 297A.99) to be followed when authorizing any new local sales tax. The rules require that local sales taxes use the same base as the state tax, that it be a sales and use tax, and that the tax be administered by the Department of Revenue. All older local sales taxes had to conform to these rules as well.[12]
- The 2005 and 2006 sessions saw a resurgence of interest and authorization of local sales taxes. A number of new taxes were authorized and the authorities for existing taxes were extended.
- Several additional sales taxes were authorized or extended during the 2008 legislative session. General authority in the metropolitan area and in greater Minnesota for counties to impose taxes for transit and transportation projects was also granted. The 2008 tax bill also enacted a provision prohibiting local governments from spending money advocating or promoting additional local sales tax bills. That provision expired June 1, 2010.
- No new general local sales taxes were authorized in 2009 or 2010 although several new food and beverage and lodging taxes were allowed.
- Six new general local sales taxes were authorized in 2011 and three have been imposed.
- Local sales tax has expired five times–most recently in the city of Willmar, where the tax expired for the second time on December 31, 2012.
- Currently, there are 23 general local sales taxes imposed and 15 various food, beverage, lodging, and entertainment taxes imposed under special law.

**General local sales taxes hat are currently imposed and year authorized:**

- Duluth (1973) 1.0%
- Rochester (1983) 0.5%
- Minneapolis (1986) 0.5%
- Mankato (1991) 0.5%
- St. Paul (1993) 0.5%
- Hermantown (1996) 0.5%
- Two Harbors (1998) 0.5%
- Proctor (1999) 0.5%
- New Ulm (1999) 0.5%
- Central Minn. cities (2002) 0.5 %
  (includes St. Cloud, Sauk Rapids, Sartell, St. Augusta, St. Joseph, and Waite Park)

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

- Albert Lea (2005) 0.5%
- Bemidji (2005) 0.5%
- Austin (2006) 0.5 %
- Baxter (2006) 0.5 %
- Owatonna (2006) 0.5 %
- Hennepin Co. (2006) 0.15%
- Clearwater (2008) 0.5%
- North Mankato (2008) 0.5%
- Cook County (2008) 1.0 %
- Metro Transit tax (2008) 0.25 %
  (imposed by Anoka, Dakota, Hennepin, Ramsey, and Washington Counties)
- Fergus Falls (2011) 0.5%
- Hutchinson (2011) 0.5%
- Lanesboro (2011) 0.5%

**Common characteristics of general local sales taxes:**

- Usually authorized to fund a specific "bricks and mortar" project
- Usually imposed at a 0.5 percent rate
- The tax does not usually extend to motor vehicles although many have an alternative flat $20 tax on motor vehicles sold by local dealers
- Normally has an expiration provision – the tax either expires when a certain amount has been raised or on a certain date
- In recent years all have required a local referendum at the next general election

**Local governments with authority to impose a tax:**

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

# The Corporate Franchise Tax

## 2. The Basics

a. **Tax base** is net income of "C" corporations. The tax applies only to C corporations. S corporations, partnerships, and other "pass-through entities" (such as RICs, REMICs, and REITs) are generally not subject to the corporate tax. Most base concepts roughly follow the federal income tax – federal depreciation rules are used and so forth. However, the state deviates on a number of items of modest importance, including (ranked based on revenue importance):

i. Dividend received deduction (This deduction is intended to avoid taxing income to corporate entities more than once; federal law has a similar, but not identical, deduction.)

ii. Foreign source income and foreign operating corporation provisions

iii. Exemption for insurance companies (They pay a gross premiums tax instead.)

iv. The special temporary federal depreciation rules ("bonus depreciation") enacted in 2002, 2003, and 2008 through 2012 do not apply.

v. The section 179 expensing rules do not apply.

vi. Income attributable to operating in a Job Opportunity Building Zone (JOBZ) is exempt from taxation.

b. **Apportionment formula.** For multi-state corporations, a state can constitutionally tax only income fairly attributable to the state. Thus, a method must be used to determine the income attributable to in-state activity. All states do this with an apportionment formula; most use a 3-factor formula.

i. **3-factor formula.** Minnesota uses a 3-factor formula based on the Minnesota shares of property, payroll, and sales. The formula is used to derive a fraction that is multiplied by total income to determine the Minnesota proportion of each factor. The 2005 Legislature provided for phasing-in apportionment based only on the sales factor, over a period of eight years (2007 – 2014). The phase-in schedule is listed below in section 6a. The weighting of the factors for tax year 2031 is:

(1) Property (Minnesota property/total property) – 2%

(2) Payroll (Minnesota payroll/total payroll) – 2%

(3) Sales (Minnesota sales/total sales) – 96%

ii. **Combined reporting.** For complex corporations (i.e., those with multiple corporations, such parent-subsidiary or brother-sister corporations), Minnesota uses a system of combined reporting for unitary businesses. This method requires each corporation in a unitary group to calculate its tax based on the total income of the unitary group, using its own factors as the numerator and the total group's apportionment factors as the denominator. This method prevents most transactions among related corporations in the unitary group from affecting the total tax liability of the group. State corporate taxes that do not use this method allow corporations to artificially shift income (e.g., through "transfer pricing" among the related corporations) to states in which income is lightly taxed or is not taxed at all. Minnesota has used combined reporting since 1982.

c. A **tax rate** of 9.8% applies to Minnesota taxable income.

d. **Tax credits.** Corporations are allowed various credits. These include:

i. **Research credit.** This credit applies to increases in research and development expenditures over a base amount. This credit roughly follows the federal credit, except it is limited to research conducted in Minnesota and is refundable (starting tax year 2010).

ii. **Credit for taxes paid to another state.** This credit is intended to prevent the same corporate income from being taxed by Minnesota and another state. It applies in very few circumstances, since apportionment prevents most double taxation. The credit applies when another state assigns (rather than apportions) income and Minnesota taxes the same income (either by assignment or apportionment).

iii. **Enterprise zone credits.** These credits apply to certain activities in border city enterprise zones, if the credits are granted by the cities with the enterprise zones.

iv. **JOBZ job credit.** A refundable credit applies to corporations operating in Job Opportunity Building Zone (JOBZ) areas who hire additional higher paid employees. The credit effectively applies, at a 7% rate, to wages paid over $30,000 and below $100,000 (amounts are indexed for inflation since 2003).

v. **Historic rehabilitation credit.** A refundable credit applies equal to the comparable (nonrefundable) federal credit, effective beginning for tax year 2010.

e. **Alternative minimum tax.** An AMT applies under which corporations are required to compute their tax using a broader tax base (less generous depreciation allowances and so forth) and lower rate (5.8%). If the AMT is higher than the regular tax, the corporation must pay the AMT amount.

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

**Corporate Franchise Tax**
**Minimum Fee Schedule**

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

3. **Revenues**

a. **Overview.** The corporate franchise tax is a relatively minor source of state revenue. It is estimated to provide about 3% of nondedicated general fund revenues for FY2013.

b. **Amount.** For fiscal year 2013, Minnesota Management and Budget estimates that the corporate franchise tax will raise $1.1 billion (November 2012 forecast).

c. **Characteristics of revenues.**

i. **Elasticity.** Revenues from the tax are elastic; they grow as the economy and corporate profits grow. However, increased use of pass-through entities and other factors have dampened this effect somewhat. For example, S corporations have grown from 22% of all corporations filing federal returns in tax year 1985 to over 68% in 2007. (Minnesota and federal status are the same.) "Check-the-box" rules have made it easier to operate in partnership form. Until recently, corporate profits have not always grown as fast the overall economy. Use of various tax shelters mechanisms (including the foreign income provisions under Minnesota law) likely also reduced corporate tax revenues somewhat. The net result is that corporate tax receipts have lagged somewhat.

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

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

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

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

4. **Historical Highlights**

a. The tax was enacted in 1933 (at same time as the individual income tax) with graduated rates from 1% to 5%. These were the same as the individual income tax rates. As with the individual tax, federal tax was deductible. In 1937, the rates were converted to a flat rate of 7%.

b. In 1939, the legislature allowed manufacturing corporations to use sales weighted (70%) apportionment.

c. In 1953, the weighted apportionment option was extended to all corporations (not just manufacturers).

d. Over the years the legislature has changed the rate of the tax several times, imposed surtaxes, and adopted various minimum tax mechanisms.

e. In 1971, the federal income tax deduction was repealed and rates were raised to 12%. This was done to raise money to finance the "Minnesota Miracle."

f. In 1982, the research credit was enacted and combined reporting apportionment was adopted.

g. In 1987, the tax was significantly restructured in response to federal tax reform. This involved adopting the tax base expansions that were part of federal tax reform, requiring all taxpayers to use weighted apportionment, reducing the tax rate (9.5%), and adopting the "factors" minimum tax.

h. In 1988, the legislature enacted provisions granting preferential treatment to various types of foreign source income.

i. In 1990, the rate was increased from 9.5% to 9.8%.

j. In 1999, the legislature increased the sales weighting of the apportionment formula to 75%-12.5%-12.5% (effective tax year 2001).

k. In 2005, the legislature adopted an 8-year phase-in of 100% sales apportionment.

l. In 2008, the legislature rewrote the preferences for income received from foreign sources or by certain corporations with foreign operations, so these preferences were limited to income derived from foreign sources as provided under federal law.

5. **Recent Trends in Policy Changes to the Tax.**

a. **Minnesota.** There have been few policy changes to the corporate franchise tax in the last decade. Major changes were made in response to federal tax reform (in 1986) and its aftermath. In the late 1980s and early 1990s, the minimum tax was restructured to eliminate the "factors tax."

b. **Foreign source income provisions.** In 1988, Minnesota adopted a series of interrelated provisions governing the taxing of foreign source income. These provisions were enacted in response to the adoption of combined (or unitary) reporting in 1982. These provisions essentially allow certain qualifying domestic corporations ("Foreign Operating Corporations" or FOCs) to exclude 80 percent of their income from taxation. This is done on the theory that these corporations – which were intended to be primarily (defined at 80%) conducting foreign operations – would be afforded similar treatment to true foreign corporations. The law also allows exclusion of 80 percent of the foreign royalty and similar

income paid by foreign corporations or FOCs. In 2005, the legislature modified the law to require FOCs to have substantial property (at least $2 million) and payroll ($1 million) in foreign countries to qualify. This was done to reduce the ease of shifting domestic source income into "shell" type corporations and qualifying for the reduced tax rates that apply to this income. A 2005 Minnesota Supreme Court decision made it clear that corporations that follow the required form under the law will qualify for the preferential tax treatment. In 2008, the legislature limited the preferential treatment for FOCs and for foreign royalty and similar to income meeting the rules defining foreign income for federal income tax purposes. For more detail on FOCs and these provisions, see the House Research Department website.

c. **Other states.** The general trend in other states is to increase the sales weighting of the apportionment formulas. A fair number of states have gone from equal weighting to double sales weighting and a few states have gone to 100% sales apportionment for some or all types of businesses. Many separate reporting states have adopted provisions designed to minimize the effect of tax avoidance structures used by multi-state corporations (in particular holding companies for intangibles that are based in Delaware or Nevada). These provisions typically disallow the deduction of expenses (e.g., payments to holding companies for intangibles that are intended to shift income to states where such income as not taxed – typically Delaware or Nevada). Several states have adopted combined reporting rules – e.g., Massachusetts, West Virginia, and Wisconsin – and combined reporting is under consideration in more states (e.g., it is being proposed by various policy makers in Pennsylvania and Maryland).

d. **Fundamental restructuring.** The tax theory underpinning the tax is shaky, at best. Public finance experts have always been dubious about the theory underlying a corporate income tax. They typically favor the use of value added taxes or VATs. Three states, Michigan, Ohio and Texas, have recently restructured their corporate taxes by shifting to gross receipts taxes or a combination of gross receipts and profits taxes (Michigan). Proposals have been made in other states to restructure or repeal corporate taxes. Michigan in 2011 reversed course and repealed its gross receipts tax, reverting to a corporate profits style tax.

i. **Proposals in other states.** Some of the states in which they have been proposed by governors or tax study commissions include

(1) Utah

(2) Montana

(3) West Virginia (tax study commission)

(4) Louisiana

(5) Nevada

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

ii. **Laws in other states.** New Hampshire (as a minimum tax that is added to its corporate income tax) has a VAT tax as a business tax. Ohio, Texas, Washington, and West Virginia have gross receipts based business entity taxes. These taxes are not as volatile as profits based taxes, but are not favored by experts because they can result in pyramiding or multiple tax burdens. Like a sales tax on business inputs, they favor vertically integrated businesses.

iii. **Minnesota.** In Minnesota, the Senate passed a VAT twice (in 1997 and 1998), not as a replacement for the franchise tax, but as a source of revenue to pay for property tax reform. A University of Minnesota economics professor completed a study of replacing the Minnesota corporate franchise tax with a VAT style tax for the Legislative Coordinating Commission in 2005.

6. **Policy Issues and Perspectives on the Tax**

a. **Tax falls unevenly on businesses.** The tax applies only to C corporations. Businesses doing business in other forms (partnerships, S corporations, and so forth) are not taxable. C corporations tend to be larger businesses. Most publicly held corporations are C corporations. As a result, the tax becomes, in effect, a toll charge on being a public company with access to public securities markets.

b. **Tax incidence is unclear.** Experts differ on the incidence of the corporate tax. The popular perception is that the tax is progressive; these (non-expert) observers apparently think the tax falls on owners of corporate stock who have high incomes. This may be true for the federal tax. For a state tax, the ability of capital to flow across state borders to seek its highest return limits the ability of a state to tax capital. Thus, for a high tax state like Minnesota, a portion of the tax probably shifts forward to consumers or backward to labor. The 2011 Tax Incidence Study (p. 94), prepared by the Department of Revenue, estimates that Minnesota consumers bear 38% of the tax, Minnesota labor 3%, and Minnesota capital 9%. The rest of the tax (50%) is borne by nonresidents, much of which is likely borne by capital.

c. **The tax is a hidden tax.** Despite repeated surpluses and calls for tax cuts of many types during the 1990s, the corporate tax rarely showed up on the lists of popular candidates for cutting. This reflects an obvious fact: few people are even vaguely familiar with or care about the tax. The tax is imbedded in prices. Real people only pay it in the prices they pay for goods or services or in reduced wages

(or returns on capital). In short, most don't know they're paying it. The hidden nature of the tax raises accountability concerns, but makes the corporate tax politically popular.

d. **The tax may cause competitive problems.** There is some empirical evidence that a high corporate tax can cause states problems in competing for new investment. This conclusion is controversial and other studies find it to not be the case. However, economic theory would suggest it is so.

7. **Sales Weighting and Apportionment**

a. In the 2005, the legislature enacted a governor's recommendation to adopt an 8-year phase-in of 100% sales apportionment. The table shows the phase-in schedule, which will be completely phased-in next year (tax year 2014).

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

b. **Effects on different types of businesses**

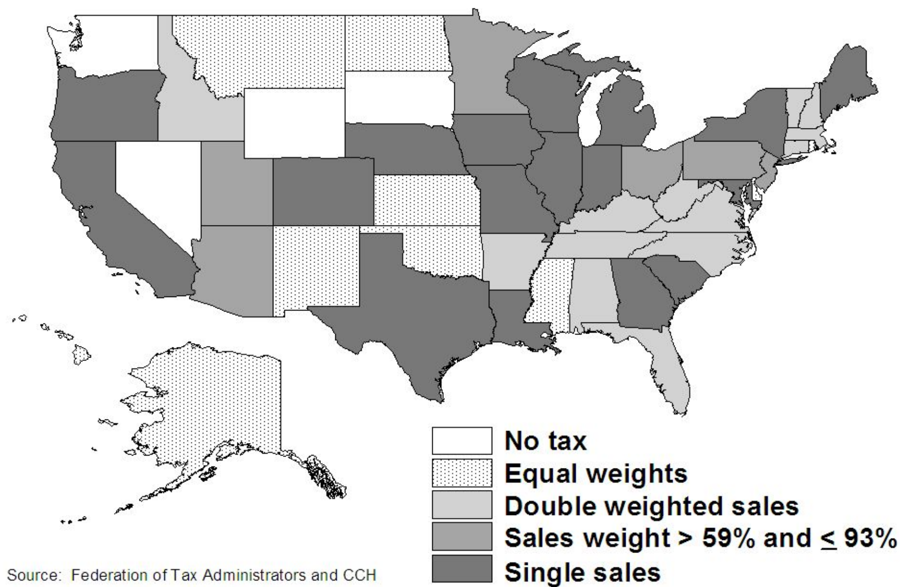
i. 100% Minnesota businesses (those with 100% of their property, payroll, and sales located in Minnesota) are unaffected by the shift to sales based apportionment. They derive neither a benefit, nor experience higher taxes. However, the cost of the tax cut could be used to fund a general rate reduction, which would benefit all payers of the tax.

ii. Minnesota businesses whose Minnesota sales factor is lower than the average of the property and payroll factor receive a tax cut. The larger the disparity, the bigger the benefit. A classic example would be a business with most of its operations (headquarters, plants, and so forth) in Minnesota, but which makes its sales nationwide (e.g., 3M or General Mills).

iii. Businesses who have higher Minnesota sales factors and lower average Minnesota property and payroll have tax increases. The classic example is a national manufacturer of consumer products with few facilities in Minnesota (e.g., Proctor & Gamble or Microsoft).

c. **Trend in other states**

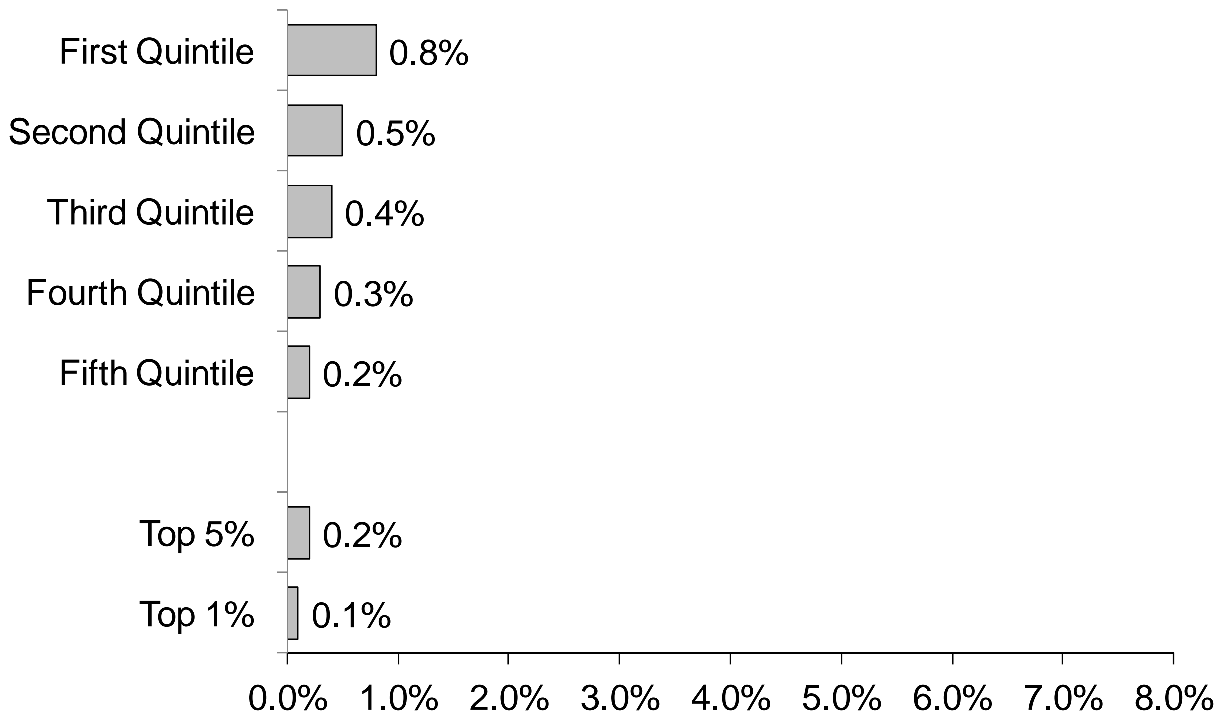
As noted above, the trend in other states has been to increase the weight of the sales factor. (Minnesota was ahead of the curve in this regard, adopting 70% sales weighting in 1939 as an option.) New Jersey and Utah are scheduled to use single sales in 2013, Virginia (in addition to Minnesota) in 2014, and Arizona in 2017. The map below shows the apportionment formulas for manufacturers as of tax year 2012. Some states allow elections between two formulas. The map shows these with the highest permitted sales weighting.



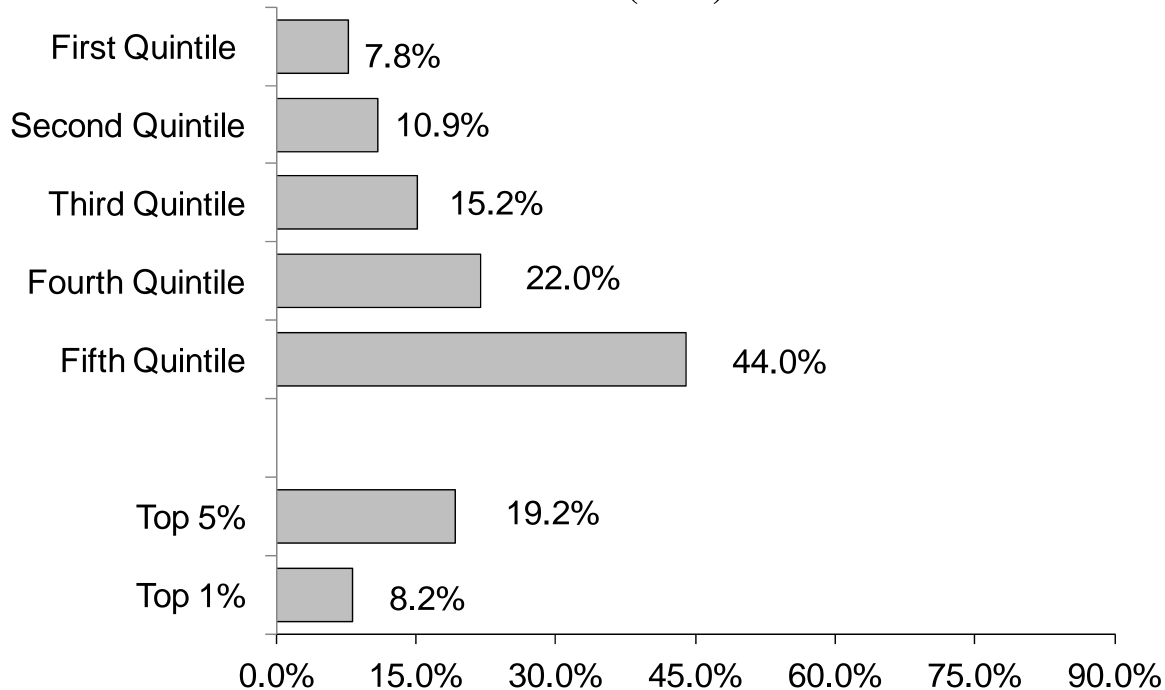

d. **Competitiveness effects.** The principal argument for sales weighting is that it increases the state's competitiveness, i.e., it will attract investment or economic activity to the state, because it reduces the effective tax rate on new investment in plant and equipment. Some empirical studies support this conclusion. It should be noted, however, that sales apportionment increases the "nexus penalty" associated with the corporate tax. It may discourage an out-of-state profitable business that sells in Minnesota, but otherwise has no facilities in Minnesota, from locating facilities in Minnesota. Doing so would subject it to Minnesota tax (nexus) and substantially increase its tax. Thus, sales apportionment may discourage national companies (without nexus) from locating branch plants or distribution facilities in Minnesota. For companies with nexus, it has a positive effect on the incentive to locate more facilities in Minnesota, regardless of their factors.

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

**Corporate Tax Burden**
**Effective Tax Rates by Population Quintiles**
**(2008)**




Source: Department of Revenue, 2011 *Tax Incidence Study*




Source: Department of Revenue, 2011 *Tax Incidence Study*

# Motor Vehicle Fuels Tax

**Tax Base**

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

**Exemptions**

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

**Tax Rates**

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

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

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

Thus, the combination of the regular tax rate and the surcharge yields a maximum rate of 28.5 cents per gallon, which has applied since July 1, 2012.

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

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

**Revenue**

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

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

# Cigarette and Tobacco Tax and Fees

## Tax Base

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

## Tax Rates

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

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

**Nonsettlement cigarette fee.** A special cigarette fee of 35 cents/pack applies to "nonsettlement cigarettes." These are cigarettes produced by manufacturers other than the major companies that settled the liability lawsuits filed by the state or companies that voluntarily elect to participate and make annual payments (as approved by the Attorney General). This fee was enacted by the 2003 Legislature. By its terms, it was intended to compensate the state for cost attributable to the use of these cigarettes (similar to what settling companies are paying) and to deter youth smoking. The Minnesota Supreme Court upheld the constitutionality of the fee in a 2006 decision; the U.S. Supreme Court declined to review the case. *Council of Independent Tobacco Mfr. v. State,* 713 N.W.2d 300 (Minn. 2006) *cert. denied* 549 U.S. 1052 (2006). Collections under this fee are not included in the collection numbers listed below. This fee yielded about $2.7 million in FY 2011; the estimated amount for FY 2013 is not yet available.

## Enforcement and Collection

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

## Revenue

| | |
|---|---|
| Fiscal Year 2013 (in millions) | $421 |
| Percent of Total State Tax Revenue | 2.1% |

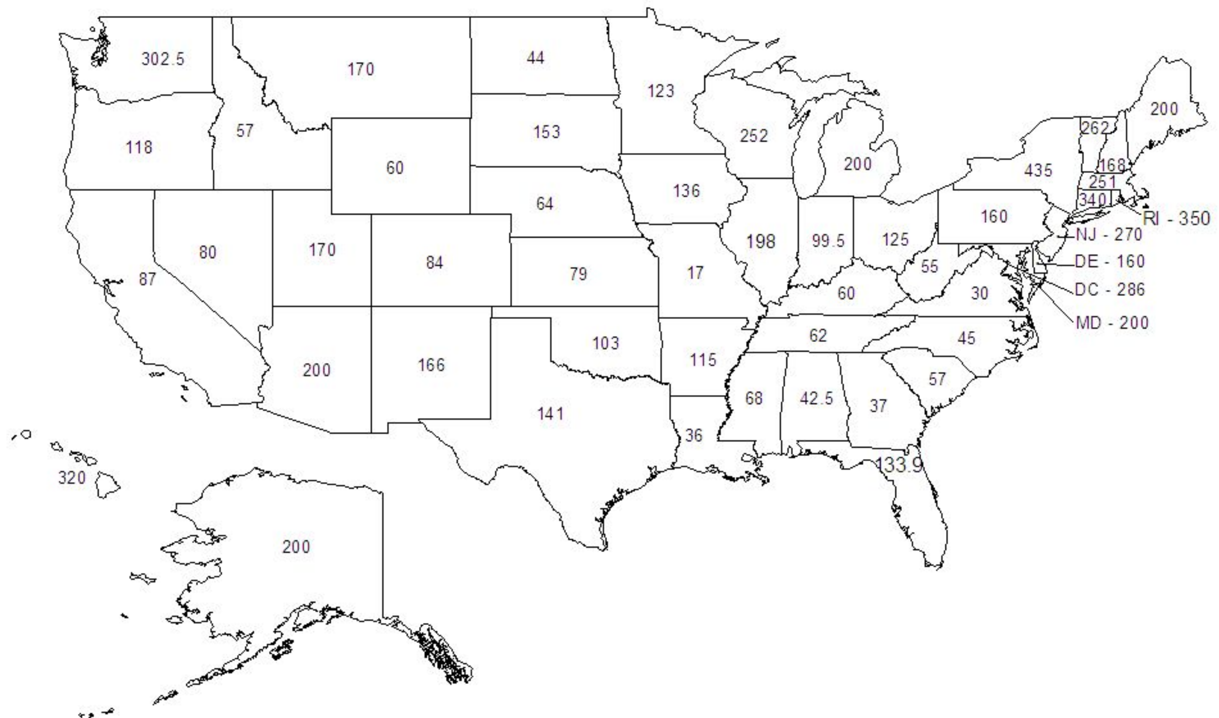
Revenues from the tobacco products tax are deposited in the general fund. Cigarette tax revenues of $22.25 million/year go to fund the Academic Health Center, $3,937,000/year to the medical education and research account, and the rest to the state general fund. The health impact fee revenues (estimated to be $201.6 million for FY2013) are deposited in a health impact fund

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

## Comparison with Other States

The map below shows the tax rates in other states as of July 1, 2012. The map does not reflect the effect of general sales taxes (including Minnesota's per pack tax in lieu of the sales tax). Some states have no sales tax or exempt cigarettes from sales taxation, lowering the overall tax burden.

**State Cigarette Tax Rates***
as of 7/1/2012
cents per pack




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

# Alcoholic Beverage Excise Taxes

## Tax Base

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

## Tax Rates

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

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

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

## Exemptions

Only limited exemptions apply under the tax:

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

## Collection

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

## Comparison with Other States

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

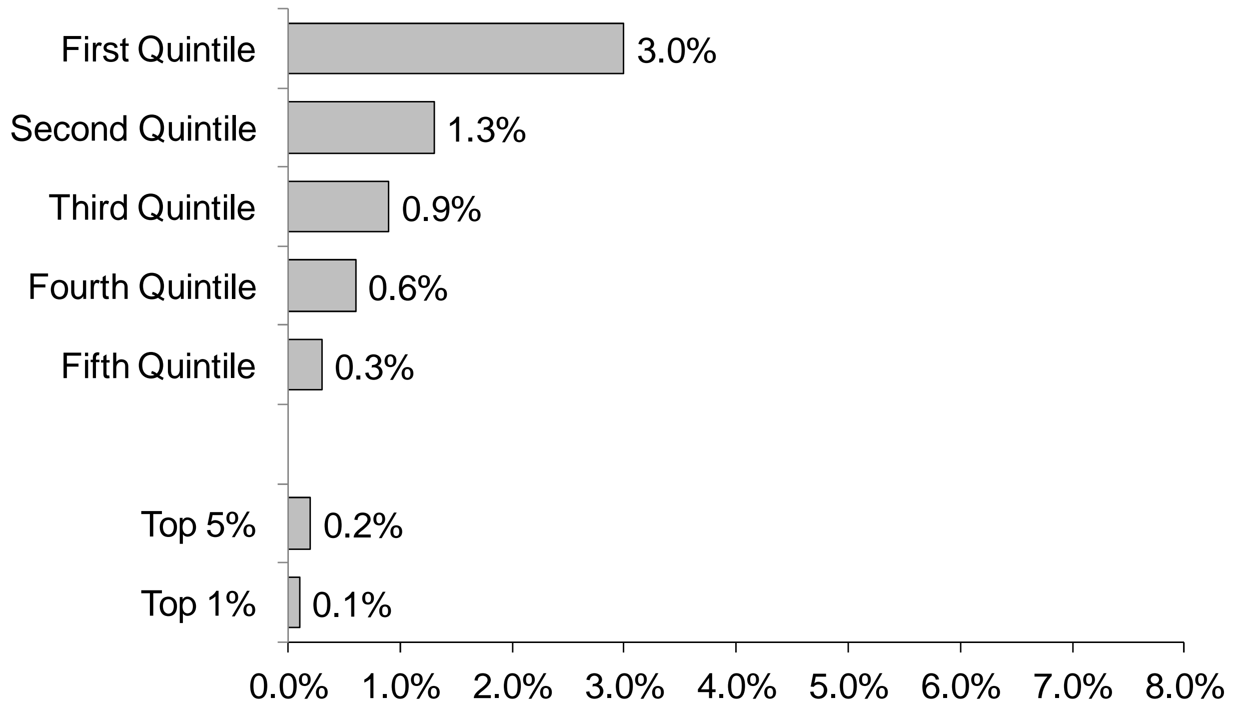
Minnesota's wine and beer excise taxes are average or below average compared with most other states. The table to the right compares Minnesota's tax with taxes in surrounding states. Minnesota's tax on distilled spirits (liquor) is among the higher taxes for states with excise taxes. A number of states (including Iowa) have liquor monopolies and a portion of the price markup is a *de facto* tax; it is difficult to compare the tax burden with these states. Minnesota also imposes a 2.5% gross receipts tax on sales of alcoholic beverages, in addition to the regular 6.5% state sales tax. This additional tax replaced a higher sales tax rate and is discussed briefly in the sales tax section. Only North Dakota (of the surrounding states) imposes a similar gross receipts tax (2%) in addition to an excise tax. Thus, the total Minnesota alcohol tax burden is higher than suggested by simply comparing excise tax burdens.

## Revenue

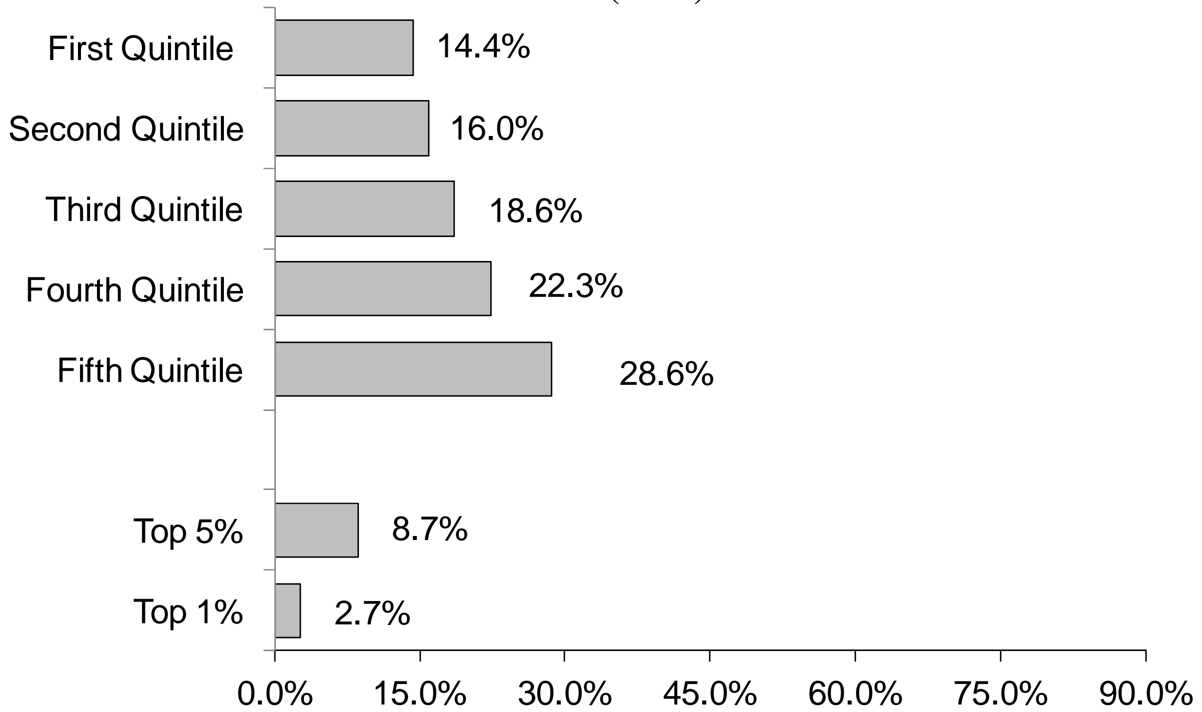
| | |
|---|---|
| Fiscal Year 2013 (in millions) | $78.9 |
| Percent of Total State Tax Revenue | 0.4% |

The actual FY2011 revenues by beverage type and for the gross receipts tax are shown in the table below.

| **Beverage Type** | **FY2011 Revenues (000)** | **% of Total** |
|---|---|---|
| Beer < 3.2% | $302 | 0.2% |
| Beer > 3.2% | 15,407 | 10.5% |
| Cider | 50 | 0.0% |
| Wine < 14% | 3,712 | 2.5% |
| Wine > 14% | 535 | 0.4% |
| Sparkling Wine | 828 | 0.6% |
| Distilled Spirits | 56,271 | 38.2% |
| Excise tax total | 77,105 | 52.3% |
| 2.5% gross receipts tax | 70,253 | 47.7% |
| **Total** | **$147,358** | |
| Source: MN Department of Revenue | | |




Source: Department of Revenue, 2011 *Tax Incidence Study*




Source: Department of Revenue, 2011 *Tax Incidence Study*

# Motor Vehicle License Tax

### Tax Base

Tax base consists of the base value of the passenger vehicles (plus a minimum amount) and minimums or weight based fees for commercial vehicles.

Tax applies only to vehicles using the public highways.

Base value is determined from the manufacturer's suggested retail price, using a statutory depreciation schedule. Accessories and optional equipment are generally not included in the base value.

### Exemptions

Exemptions include vehicles owned by governmental units, school buses, ambulances, fire vehicles, and so forth. Exempt vehicles are required to have exempt registration plates.

### Tax Rate

For passenger automobiles, the tax consists of $10 plus 1.25 percent of the automobile's base value. However, the tax cannot be less than $35. For commercial and other types of vehicles, the tax is based on weight and age.

### Revenue

| | |
|---|---|
| Fiscal Year 2013 (in millions) | $593 |
| Percent of Total State Tax Revenue | 3.0% |

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

# MinnesotaCare Taxes

## Tax Base

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

## Exemptions

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

## Tax Rates

The tax rate is 2 percent.

## Special Features

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

## Revenues

| | |
|---|---|
| Fiscal Year 2013 (in millions) | $509 |
| Percent of Total State Tax Revenue | 2.6% |

## Dedication of Revenues

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

## Sunset

Under actions adopted by the 2011 legislature, the MinnesotaCare taxes are schedule to expire on January 1, 2020.

# Insurance Premiums Tax

## Tax Base

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

## Exemptions

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

## Tax Rate

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

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

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

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

## Retaliatory Tax

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

## Revenue

| | |
|---|---|
| Fiscal Year 2013 (in millions) | $377 |
| Percent of Total State Tax Revenue | 1.9% |

# Mortgage Registry Tax

## Tax Base

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

**Exemptions.** The various exemptions apply. These include:

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

## Rate

The rate is 0.23 percent of the principal debt.

## Collection

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

## Revenue

| Fiscal Year 2013 | | Total Amount (in millions) |
|---|---|---|
| Disposition: | State General Fund (97%) | $124.8 |
| | County Revenue Fund (3%) | 3.7 |
| Total Fiscal Year 2013 (in millions) | | $128.5 |
| Percent of Total State Tax Revenue | | 0.6% |

# Deed Transfer Tax

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

**Exemptions**. Various exemptions apply, including:

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

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

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

**Revenue**

| Fiscal Year 2013 | | Total Amount (in millions) |
|---|---|---|
| Disposition: | State General Fund (97%) | $68.8 |
| | County Revenue Fund (3%) | 2.1 |
| Total Fiscal Year 2013 (in millions) | | $70.9 |
| Percent of Total State Tax Revenue | | 0.4% |

# Estate Tax

## Tax Base

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

## Exemption

The exemption amount is set by reference to federal law as it was in effect before enactment of the 2001 federal tax act (Economic Growth and Tax Relief and Reconciliation Act or EGTRRA). Starting with decedents dying in 2006 and later, the amount is $1,000,000. Because transfers to surviving spouses are exempt, a $1 million exemption allows a married couple with a joint net worth of less than $2 million to avoid the tax by putting $1 million into a family trust or similar arrangement on the death of the first spouse. (By comparison, the marital deduction or exemption under the federal estate tax is "portable" and a transfer to a family trust or similar arrangement on the death of the first spouse is not necessary to preserve the exemption for the couple. The new portability rule is a result of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that was enacted in December 2010. The American Taxpayer Relief Act of 2012 made portability and the higher exemption amount a permanent feature of the federal estate tax.) Because of the exemption, the estate tax applies to less than 2 percent of estates. The exemption under the federal tax is larger than under the Minnesota tax. The federal exemption is $5,120,000 for deaths in 2012. This amount is annually indexed for inflation.

The 2011 legislature enacted exemptions for qualified small business property and qualified farmland. These additional exemptions are effective for decedents dying after June 30, 2011, and are capped, in combination, at $4,000,000 for an estate. A variety of special qualifying rules apply to the decedent's use of the property and its nature. In addition, the property must pass to a qualified heir (family member) who continuously uses the property in a businesses or holds it as homestead agricultural property for three years. A recapture tax applies if the heir does not meet these requirements.

## Tax Rates

The tax rates are determined by reference to federal law (i.e., under the rates for the expiring credit for state death taxes). For decedents dying in 2013, the statutory rates range from 6.4% to 16%. However, because the Minnesota tax equals the amount of the old federal credit and because the value of the credit is a function of the old federal tax liability (including the old federal exemption amount), the effective marginal rates on estates just over $1 million can be up

to 41% (i.e., the rates under the old federal estate tax, not the credit rates). These "bubble" rates return to the normal marginal rates for estates of about $1.1 million.

**Relationship to federal tax**

For the 16 years ending December 31, 2001, the Minnesota estate tax was directly linked to the federal tax as a "pick-up" or "soak-up" tax equal to the credit allowed under federal estate tax for state death taxes. As a pick-up tax, the Minnesota tax imposed no additional tax burden on estates. For each dollar of state tax paid, federal tax was reduced by an equal amount. However, Congress phased out this credit in 2001. For decedents dying after December 31, 2004, the credit no longer applies. In 2001, the legislature chose to continue imposing the estate tax under the rules in effect before Congress repealed the credit. As a result, the Minnesota tax now is a stand-alone estate tax and imposes a real tax burden on estates and their heirs.

**Revenues**

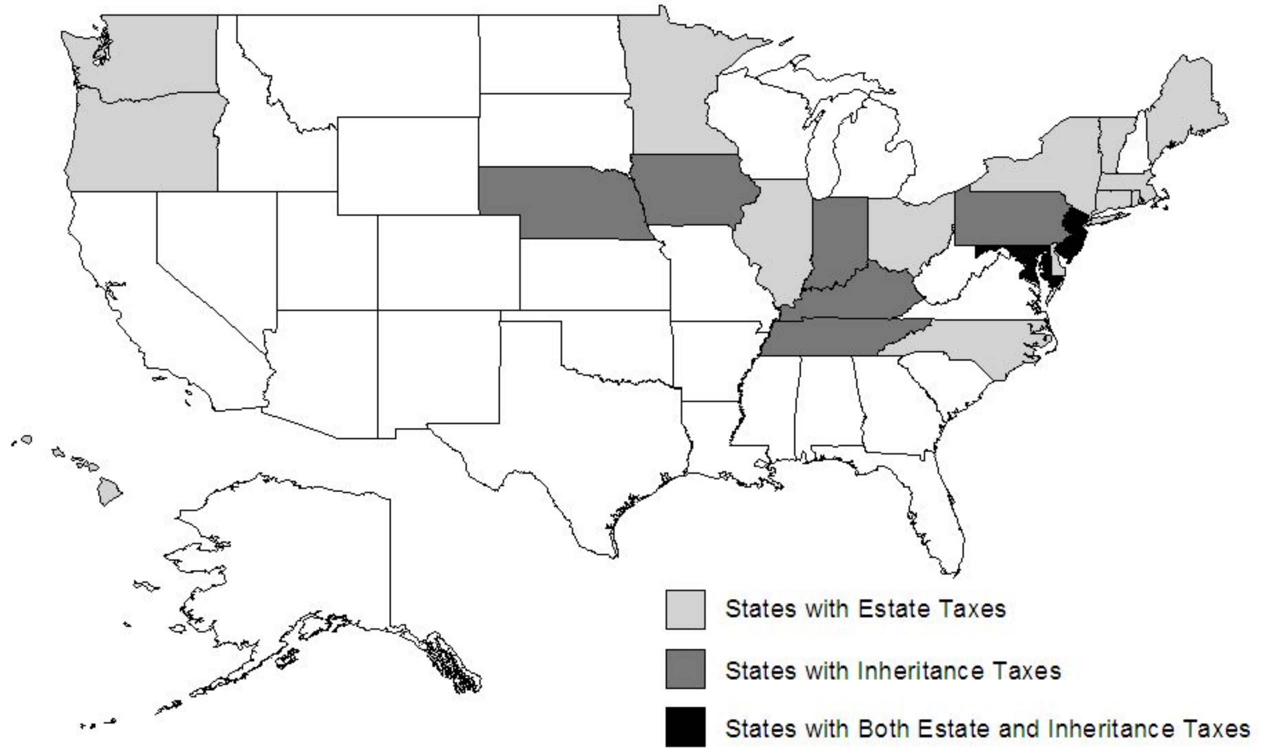
| | |
|---|---|
| Fiscal Year 2013 (in millions) | $140.2 |
| Percent of Total State Tax Revenue | 0.7% |

Revenues from the estate tax are deposited in the general fund. Revenues from the tax are very volatile, since they depend on the deaths of a few individuals. If one very wealthy individual dies, collections can soar. For example, in August 2005, the Department of Revenue received a tax payment for one estate of $112 million (total collections for FY 2006 were $216 million compared while total collections for FY 2005 were $72.7 million). In other years, revenues may fall below estimates.

**Other States – Effect of Repeal of Federal Credit**

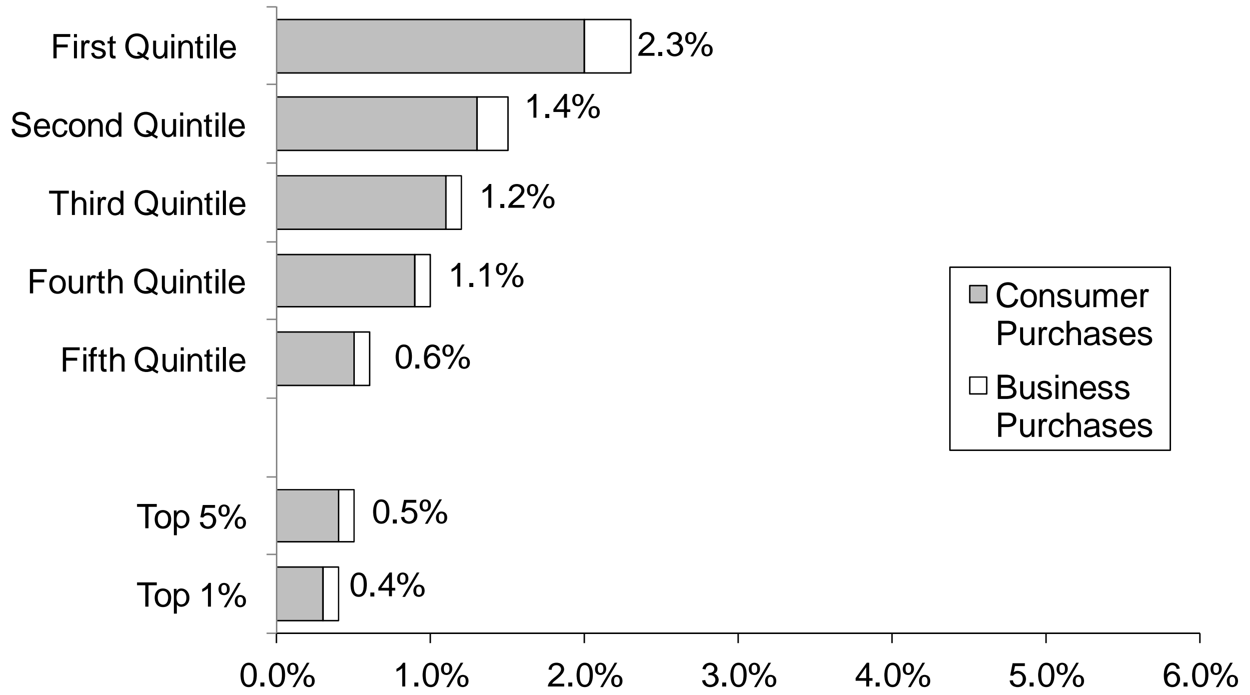
The repeal of the federal credit for state death taxes has changed the dynamics of state estate taxes considerably. When Minnesota imposed only a pick-up tax, the federal treasury paid the effective burden of the tax. As a result, Minnesota residents had no reason to change their domiciles to another state to avoid the Minnesota tax. Repeal of the federal credit makes the state tax a "real" tax that reduces the amount of money and other property that can be left to heirs. Affluent individuals may be willing to change their domiciles to avoid paying potentially multi-million state estate tax liabilities. At this point, most other states (unlike Minnesota) have allowed their estate or inheritance taxes to expire or have repealed them. As of December 2012, 30 states no longer have estate or inheritance taxes. The map on the next page shows the status of states' estate and inheritance taxes for 2012 deaths. Two additional states are phasing-out their taxes: Tennessee starting for deaths in 2016 and Indiana for deaths in 2022.

## State Estate and Inheritance Taxes

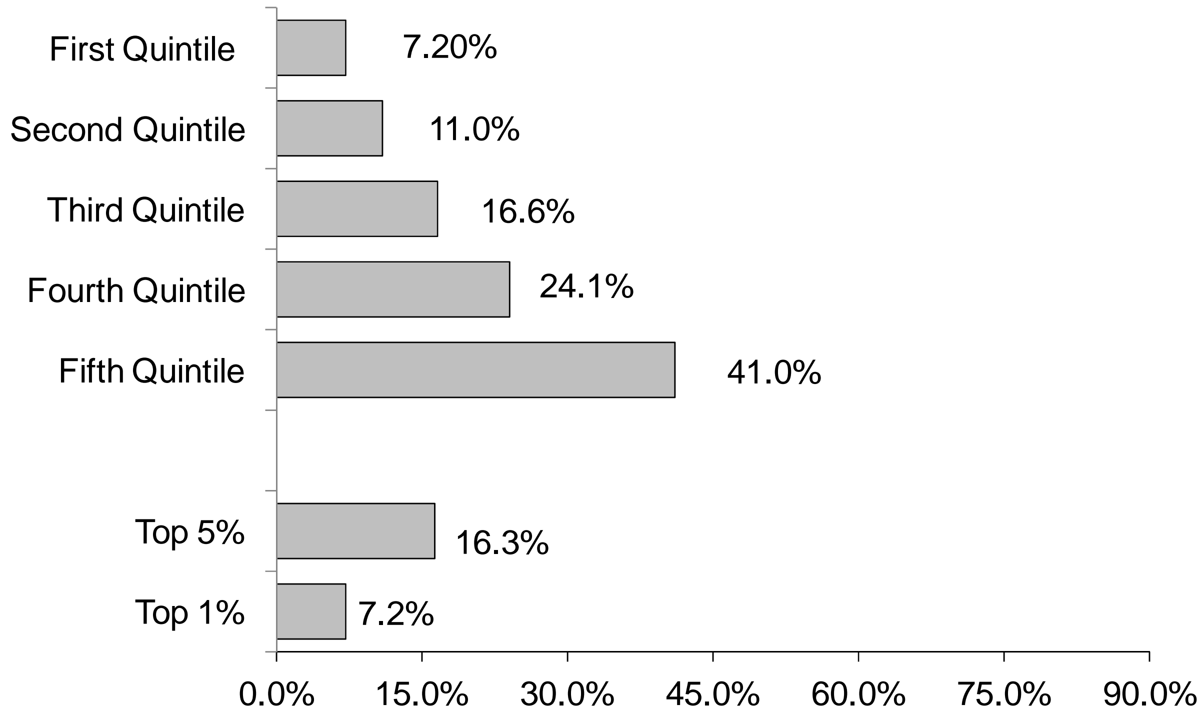



Note: Applicable for decedents dying in 2012

## Other State Tax Burden
## Effective Tax Rates by Population Quintiles
## (2008)




Source: Department of Revenue, 2011 *Tax Incidence Study*




Source: Department of Revenue, 2011 *Tax Incidence Study*

# Job Opportunity Building Zone (JOBZ) Program

In 2003, the legislature enacted the Job Opportunity Building Zone or JOBZ program. This program essentially is an enterprise zone program for rural Minnesota (it does not apply to areas within the 7-county Twin Cities metropolitan area). In December 2003, the Commissioner of the Department of Employment and Economic Development (DEED) designated 10 JOB zones. As originally designated, the 10 zones contained about 29,000 acres in 325 subzones. (The acreage now designated varies because of modifications made to the zones.) Subzones are noncontiguous parts of a zone, which may be located in different cities and counties from the rest of the zone. Nearly all of the counties outside of the seven-county metropolitan area contain designated JOBZ acreage. As of November 1, 2012, DEED reported 269 completed business subsidy agreements with committed capital investment exceeding $642 million. (DEED updates these statistics on its website regularly.)

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

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

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

**Tax Reductions Under JOBZ Program**
($ amounts in thousands)

| | **FY2014** | **% of total** | **FY2015** | **% of total** |
|---|---|---|---|---|
| Individual income tax | | | | |
| Income exclusion | $3,000 | 8.4% | $3,300 | 9.0% |
| Jobs credit | 700 | 1.9% | 700 | 1.9% |
| Corporate franchise tax | | | | |
| Income exclusion | 7,000 | 19.5% | 7,800 | 21.2% |
| Jobs credit | 1,100 | 3.1% | 1,100 | 3.0% |
| Sales tax | 8,000 | 22.3% | 7,100 | 19.3% |
| Motor vehicle sales tax | 200 | 0.6% | 200 | 0.5% |
| Property tax | 15,900 | 44.3% | 16,600 | 45.1% |
| **TOTAL** | **$35,900** | 100.0% | **$36,800** | 100.0% |

Source: MN Dept. of Revenue, *Tax Expenditure Budget Fiscal Years 2012 – 2015* (February 2012).

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

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

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

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