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

A Presentation to the House Committee on Taxes

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by

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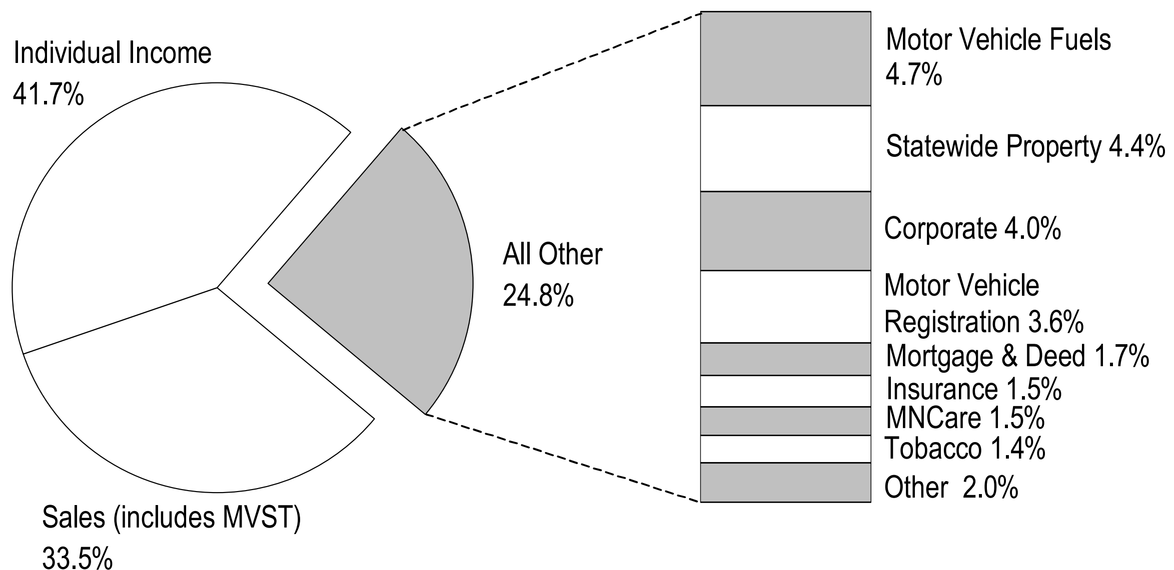
State Taxes

Minnesota State Tax Collections ($13,360 million in FY 2003)			
Individual Income	$5,619	Insurance Premiums	$199
Sales (includes motor vehicle sales)	4,511	MNCare	194
Motor Vehicle Fuels	640	Tobacco	186
State Property	588	Estate	122
Corporate Franchise	542	Alcoholic Beverages	63
Motor Vehicle Registration	488	Gambling	59
Mortgage and Deed	225	Other	24

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 2003, including those that do not go to the General Fund.

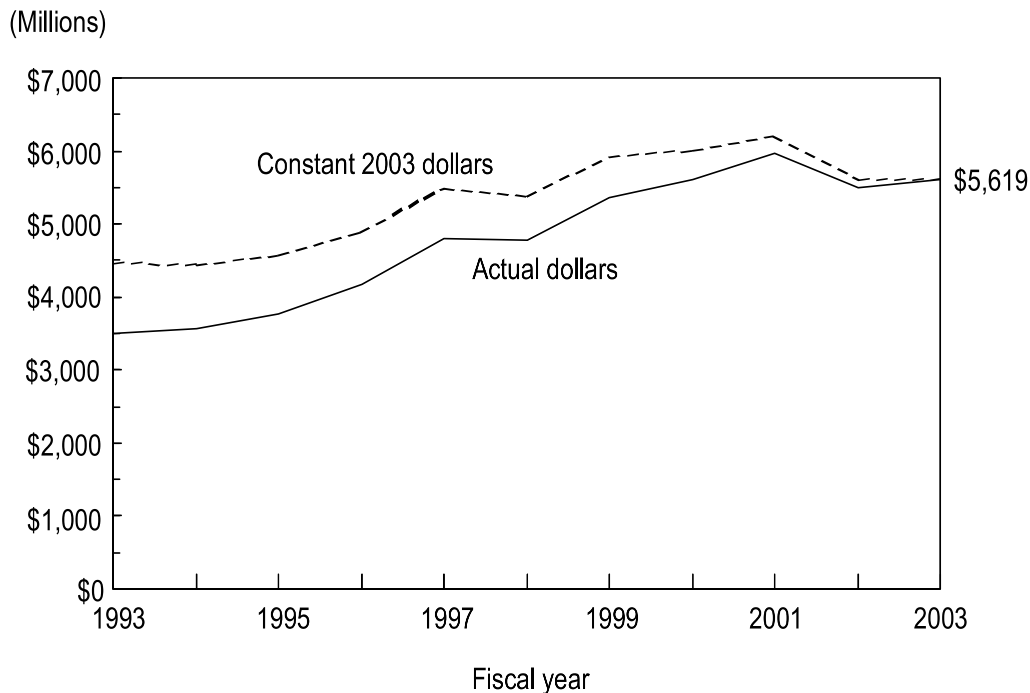


The Individual Income Tax

1. Individual Income Tax Revenues and Distribution of tax burden

   a. **Revenues.** The individual income tax is projected to raise $5.619 billion in revenue in fiscal year 2003. This includes $49 million in projected reciprocity payments from the state of Wisconsin on behalf of Wisconsin residents who work in Minnesota.

Individual Income Tax Revenues, 1993-2003



2. **Distribution of the individual income tax burden.** The Department of Revenue's *2001 Minnesota Tax Incidence Study* estimated how the income tax burden was distributed across Minnesota households in 1998. Updated estimates (based on a newer tax sample and the November 2002 economic forecast) will be released in early March 2003. (see http://www.taxes.state.mn.us/reports/incid01.html)

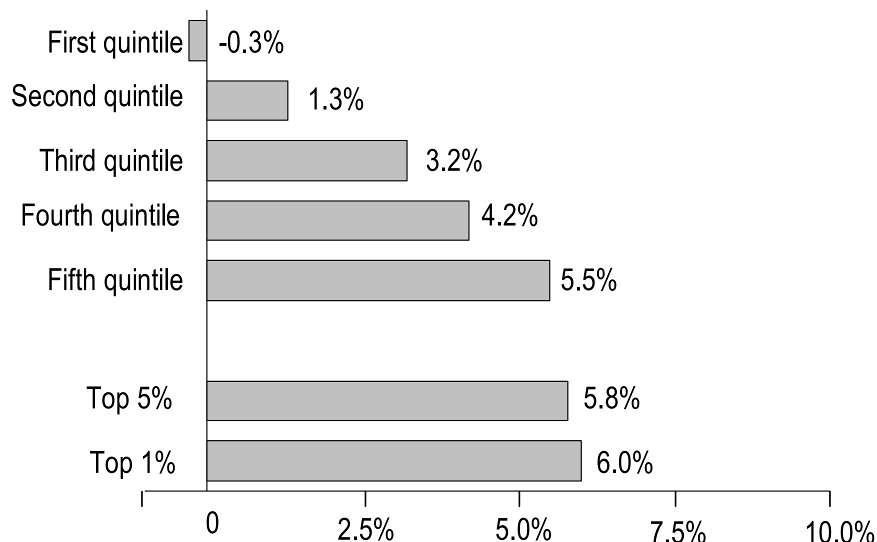
Because the income tax burden as a percent of income rises steadily from *negative* 0.3% of total income for the poorest fifth of Minnesota households to 5.5% of income for the richest fifth of Minnesota households (and 6.0% for the richest 1%), economists describe the income tax as a *progressive* tax.

The richest fifth of Minnesota households (with 58% of total income) were estimated to pay 70% of the total individual income tax in 1998.

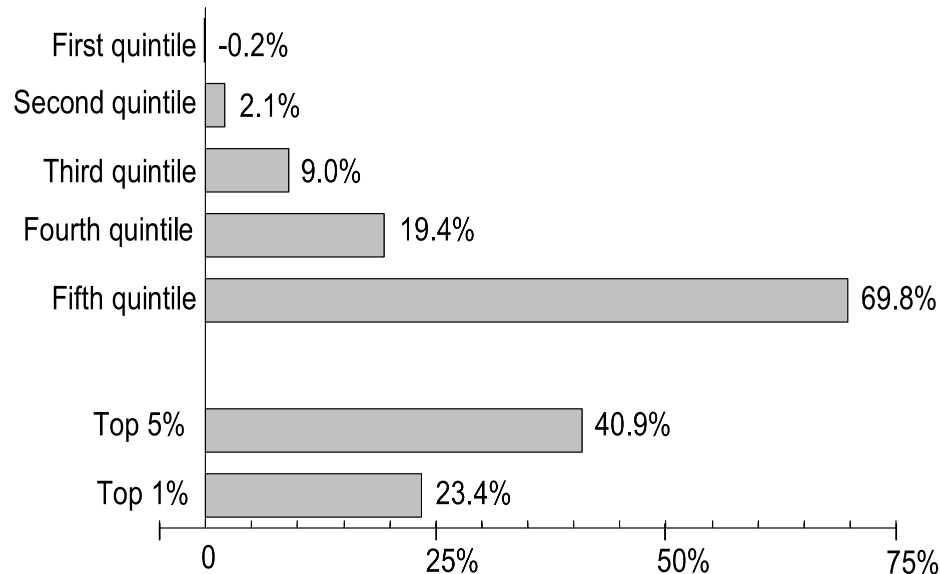
Distribution of Individual Income Tax By Population Quintiles (1998)					
Quintile	**Income Range**	**Percent of Total Income**	**Tax paid** (000s)	**Percent of Total Tax**	**Effective tax rate**
First	$13,047 or less	3.0%	-$11,149	-0.2%	-0.3%
Second	$13,047 – 24,885	7.3%	105,053	2.1%	1.3%
Third	$24,885 – 40,645	12.5%	460,437	9.0%	3.2%
Fourth	$40,645 – 66,043	20.3%	987,068	19.4%	4.2%
Fifth	Over $66,043	57.9%	3,559,061	69.8%	5.5%
Total	All Incomes	100%	$5,100,470	100%	4.5%
Top 5%	Over $127,880	31.4%	2,085,014	40.9%	5.8%
Top 1%	Over $310,000	17.3%	1,191,069	23.4%	6.0%

Source: MN Dept. of Revenue, 2001 Tax Incidence Study

Income Tax Burden
Effective Tax Rates by Population Quintiles
(1998)



Source: Department of Revenue, 2001 *Tax Incidence Study*



Source: Department of Revenue, *2001 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.

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

a. **Rates.** Minnesota's income tax rates for tax year 2003 are 5.35, 7.05, and 7.85%

Minnesota tax rates and brackets, 1998-2003

Brackets for married joint filers*	1998	1999	2000 and after
$0 to $27,780	6%	5.5%	5.35%
$27,781 to $110,150	8%	7.25%	7.05%
Over $110,150	8.5%	8%	7.85%

* Brackets shown are at 2003 levels

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.

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 non-refundable credit can be used to reduce liability to zero. A refundable credit, however, 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 non-refundable 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 Subtractions (deductions)**

i. Minnesota conforms to federal itemized deductions, including deductions for mortgage interest, property taxes, charitable contributions, investment interest, casualty and theft losses, various business expenses, and medical expenses that exceed 7.5% of the taxpayer's adjusted gross income.

ii. Minnesota allows various state deductions. These include:

(1) Subtractions required by federal law:

a. Interest on U.S. government obligations

b. Railroad retirement benefits

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

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

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

(4) Elderly subtraction

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

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

(7) Ethanol producer credit subtraction

c. **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 2003 single filers pay 5.35% on the first $19,010 of taxable income, while married joint filers pay 5.35% on the first $27,780 of taxable income. Without the marriage penalty credit, two people each with taxable income of $19,010 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 2003 the maximum credit is $290. Total marriage penalty credits for fiscal year 2003 are projected at $60.5 million with 350,000 filers qualifying for credits.[1]

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

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.

$4.9 million in long-term care credit is projected for fiscal year 2003.

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).

d. **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.

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[1] Projections of the cost of this and other credits are taken from the Minnesota Department of Revenue's *2002-2005 Tax Expenditure Budget*, available on-line at *www.taxes.state.mn.us/reports/fiscal/teb2002.html*

The maximum credit in tax year 2003 is $1,472 for claimants with two or more children; $762 for claimants with one child; and $96 for claimants with no children. The credit is subject to an income-based phaseout. Filers become ineligible for the credit when their incomes exceed: $33,651 for claimants with two or more children; $29,626 for claimants with one child; and $11,240 for claimants with no children. The phase-out is $1,000 higher for married filers. Both the maximum credit amount and the credit phaseout are indexed annually for inflation.

In tax year 2001, 212,499 recipients claimed credits with an average credit amount of $505. A total of $107.8 million in working family credits are projected to be paid in fiscal year 2003.

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 and $2,000 per family applies. The credit is subject to an income-based phaseout that starts at $33,500 of income; no credit is allowed for families with incomes over $37,500. 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 of instruments, after-school enrichment programs and academic summer camps, and up to $200 of computer hardware and educational software.

In tax year 2001, 56,414 recipients claimed the credit with an average credit amount of $343. A total of $17.4 million in K-12 education credit is projected to be paid in fiscal year 2003.

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 begins when income reaches $19,520; taxpayers with incomes over $33,170 are not eligible for the credit. The income phaseout is indexed annually for inflation, but the maximum credit is not. The dependent care

is based on 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.

6. In tax year 2001, 37,642 recipients claimed the credit with an average credit amount of $321. A total of $12.6 million in dependent care credits are projected to be paid in fiscal year 2003.

7. **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 the Department of Finance. The Departments of Finance and Revenue and the Minnesota Senate use the same model to estimate income tax changes. Types of changes that can be modeled include changes to the rates, exemption amounts, deductions, and changes to the various credits.

8. **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 their own income.

      ii. Federal income taxes were allowed to be deducted.

      iii. A broad list 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 early 1980s, during the recessions to help makeup 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 restructured the tax. The changes made were quite dramatic. They 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 it is now equivalent to about 25% of the federal earned income credit.

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.c.i)

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

9. **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.** 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 of making modest payments to large numbers of recipients. This is done by providing 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. Below are the numbers claiming these credits and their costs in FY 2003. The costs include both the offset against tax and refund amounts.

Refundable Credit	Number Claiming*	FY 2003 Cost**
Dependent Care	37,642	$12,600,000
Education	56,414	17,400,000
Working family	212,499	107,800,000
*Dept. of Revenue, 2001 income tax processing tape; ** Dept. of Revenue, *Tax Expenditure Budget FY 2002-05*		

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 non-itemizers

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. Failure to conform to the special federal depreciation rules under the federal Job Creation and Worker Assistance Act of 2002

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 $4.5 billion in fiscal year 2003. $3.9 billion is from the general sales tax, $598 million from motor vehicles sales tax and $24 million from lottery tickets. Sales taxes account for about 1/3 of total state tax revenue.

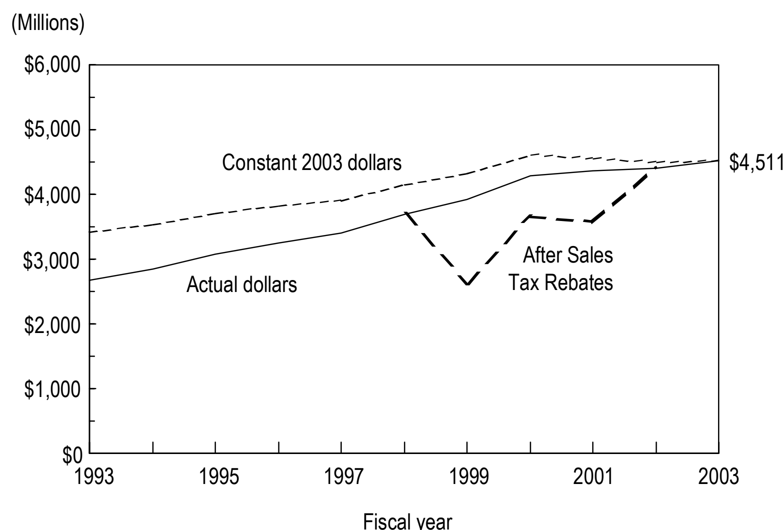
Dedication of Revenue

A substantial portion of the **motor vehicle sales tax revenues** is dedicated to transportation funds. In FY 2003 and future years the distribution of these revenues are as follows:

- 32 percent to the highway user tax distribution fund ($191 million in FY 2003);
- 20.5 percent to the metropolitan area transit fund ($123 million in FY 2003); an additional 2.0 percent is dedicated to metropolitan area transit subject to legislative appropriation beginning in FY 2004;
- 1.25 percent to the Greater Minnesota Transit fund ($7.5 million in FY 2003); and
- the remainder to the general fund ($276 million in FY 2003).

In FY 2003, 87 percent of the revenue collected from the **in-lieu tax on lottery ticket**s is deposited in various natural resources funds to fund natural resource conservation and enhancement, trails, and zoos. This percent is increased to 87.1 percent in FY 2004 and thereafter. The remainder goes to the general fund.

Sales Tax Revenues



Distribution of the Sales Tax Burden

The *Minnesota Tax Incidence Study* estimates how the sales tax burden is distributed across Minnesota households. (See www.taxes.state.mn.us/reports/incid01.html.)

Because the sales tax burden as a percent of income falls steadily from 3.6% of total income for the poorest fifth of Minnesota households to 1.6% of income for the richest fifth of Minnesota households, economists describe the sales tax as a *regressive* tax.

The richest fifth of Minnesota households (with 58% of total income) are estimated to pay 43% of the total sales tax.

Distribution of Sales Tax Burden
By Population Quintiles
(1998)

Quintile	**Income Range**	**Percent of Total Income**	**Tax paid** (000)	**Percent of Total Tax**	**Effective tax rate**
First	$13,047 or less	3.0%	$195,438	6.2%	5.7%
Second	$13,047 – 24,885	7.3%	338,783	10.8%	4.1%
Third	$24,885 – 40,645	12.5%	503,899	16.0%	3.5%
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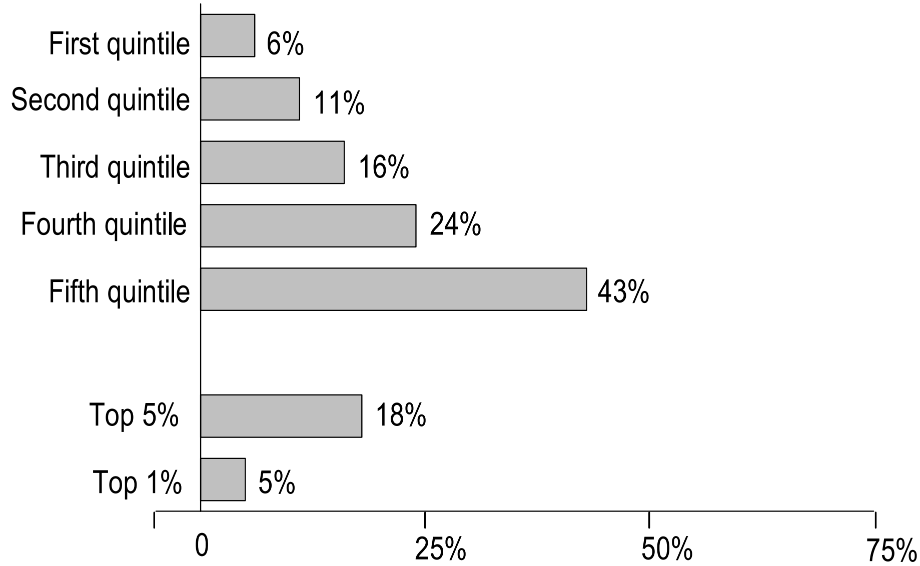
Fifth	Over $66,043	57.9%	1,363,254	43.4%	2.1%
Total	All Incomes	100%	3,140,498	100%	2.7%
Top 5%	Over $127,880	31.4%	577,661	18.4%	1.6%
Top 1%	Over $310,000	17.3%	148,303	4.7%	0.7%

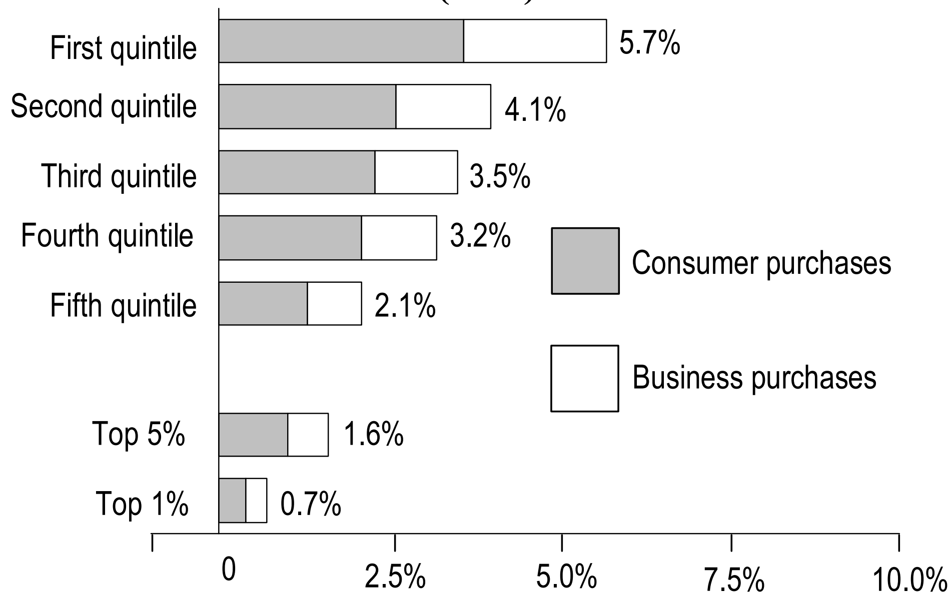
Source: MN Dept. of Revenue, 2001 Tax Incidence Study

Sales Tax Burden[2]
Distribution by Population Quintiles
(1998)



Source: Department of Revenue, *2001 Tax Incidence Study*

Sales Tax Burden
Effective Tax Rates by Population Quintiles
(1998)



Source: Department of Revenue, *2001 Tax Incidence Study*

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

Rates

- General sales tax and motor vehicle sales tax – 6.5%
- Rental motor vehicles – 12.7%
- Alcoholic beverages – 9.0%
- Manufactured housing and park trailers – 6.5% on 65% of the cost

The tax on rental motor vehicles and on alcoholic beverages will revert to 6.5 % on December 31, 2005. This is because the Streamlined Sales Tax Agreement does not allow different rates on these sales after that date.

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 if his/her purchases subject to the use tax do not exceed $770 per year.

The general rate has not changed since 1991. The sales tax rate was 3.0 percent in 1967 when it was enacted. The last change was the enactment of the "optional" local sales tax of ½ percent in 1991. This "optional" tax was officially rolled into the state tax rate in 1994.

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 - present	6.5%

Minnesota's state sales tax rate is relatively high. Only the following four states have state rates this high:

Mississippi (7.0%)
Rhode Island (7.0%)
Nevada (6.5%)
Washington (6.5%)

However, many states have a number of *local* sales taxes, and their combined state and local tax rate are in the 6 – 9 % range. The maximum state and local combined sales tax rate in Minnesota is 7.5 % (in Duluth). Fifteen states have a higher maximum combined tax rate than Minnesota.

Tax rates have 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). This will no longer be an option in the future if the state wants to comply with the Streamlined Sales Tax Agreement.

Service/good taxed	*Additional Rate*
900 telephone service July 1, 1991 – June 30, 1995	$0.50/call
Short-term motor vehicle rental - enacted July 1, 1991 as a flat fee of $7.50/rental and converted into a percent rate July1, 1994; will expire December 31, 2005	+6.2%
Residential waste fees - enacted July 1, 1993 and moved to a separate tax (CH. 297H) in 1997	+$2.00/year
Nonresidential waste fees - enacted July 1, 1993, at the rate of $0.12/cubic yard, increased January 1, 1995, and moved to a separate tax (CH. 297H) in 1997	$0.60 per cubic yard

Tax Base

In theory the sales tax is a broad based tax levied on final consumption and not on intermediate goods, but in realty 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. 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 2001 *Tax Incidence Study*, about 44 percent of the sales tax is 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.

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
- Prescription drugs and medicines, and all pain relievers
- Newspapers and subscription magazines

Business exemptions:
- Capital equipment
- Farm machinery
- Certain direct inputs to agricultural and industrial production
- Certain direct inputs for some taxable services
- Telecommunications equipment

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
- Certain sales made by nonprofit organizations.

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 Streamlined Sales Tax Agreement. 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:

Added to the sales tax base	*Effective Date*
Prepared food (e.g. restaurant meals, deli takeout)	7/1/81
Cigarettes	1/31/82
Candy and soda	5/1/82
Admissions to recreation areas, tanning parlors, health clubs, etc.	6/1/87
Nonperscription 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 had a recent 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 input	*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 capital exemption 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
Miscellaneous construction exemptions for various agricultural and other processing facilities	Various

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 2004) is taken from a more complete list in the latest *Minnesota Tax Expenditure Budget*.

Selected Examples of Potential Base Expansion	*Revenue impact at 6.5% rate FY 2004 ($ millions)*
Goods	
Food products	$480
Clothing	434
Motor fuels	287
Residential heating fuels	83
Residential water and sewer	40
Newspapers and subscription magazines*	25
Services:	
Business services	$383
Legal	209
Motor vehicle repair	147
Engineering & architectural	137
Management and professional	104
Accounting	100
General repair	82
Personal services	59
Purchases by exempt entities	
Schools	$48
Hospitals and surgical centers	61
Nonprofit organizations (excluding hospitals)	43
Local governments (excl schools & hospitals)	10

Source: Minnesota Department of Revenue, Tax Research Division, 2002 *Tax Expenditure Budget*.
*Revenue estimate 2002. $16 million if adjusted for nexus problems.

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[3]	**E**	**T**[4]	**E**
Personal Services	Mixed	Mixed[5]	**E**	**T**	**E**

Source: ABA Sales and Use Tax Deskbook, 1996-1997 edition

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 2001, that share had increased to 58.8 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 estimates that in 2000 the state lost $125 million in sales tax revenue due to remote sales—$66 million on electronic sales and $58 million on catalog sales. They estimate that the revenue loss due to Internet sales will grow to $161 million in 2004 and $269 million in 2007. The Internet also allows for the sale of digital goods (i.e., electronic greeting cards, downloaded music),

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[3] Iowa taxes a limited number of business-related services such as nonhuman laboratory testing, executive search firms, lobbying services, and copyright and license fees.

[4] South Dakota exempts a very limited number of business services, such as credit card services.

[5] 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.

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 reason that it cannot be required to collect is that 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 passed no legislation but proposed legislation has made the duty to collect contingent on sales tax simplification by the states.

Several attempts have been made at the national and federal level to reach an agreement to require Internet and other remote sellers to collect the sales tax. The National Taxpayers Association (NTA) and the Federation of Tax Administrators (FTA) sponsored an effort to develop a voluntary agreement between the states and the business community regarding collection of state and local sales taxes. The Internet Tax Freedom Act (1998) established an Advisory Commission on Electronic Commerce to make recommendations on whether Internet sales should be taxed and what type of modifications to state sales tax laws were needed to allow for their collection. The group consisted of representatives from federal, state, and local governments and the business community. Neither group reached an agreement.

Streamlined Sales Tax Project

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 is 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 a 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. There are currently 35 states that are formal members of the group developing the agreement; Minnesota is one of the states.

The final Streamlined Sales and Use Tax Agreement was adopted by the participating states on November 12, 2002. Although many states have participated in the development of the agreement, few states have taken action to amend their existing law to conform to it. Minnesota took steps during the 2001 legislative session to bring our law into compliance with the provisions that existed at that point. The state will need to adopt further changes to be

compliance with the final agreement. The other states that have amended their law to achieve compliance are North Carolina, Wyoming, and South Dakota.

Local Sales Taxes

Authority to Impose

- Cities have a general authority to impose up to a 3% lodging tax for tourism purposes.
- In 1971 the legislature prohibited local governments from imposing or increasing a local sales or income tax. This means that all new local sales taxes or changes in existing local sales taxes require enacting a special law.
- In 1997 the legislature adopted local sales tax rules (Minn. Stat. § 297A.48) 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 existing local sales taxes must conform to these rules as well.[6]

General local sales taxes that are currently imposed:

- Minneapolis 0.5%
- St. Paul 0.5%
- Rochester 0.5%
- Mankato 0.5%
- Cook County 0.5%
- Winona 0.5%
- Duluth 1.0%
- Hermantown 0.5%
- Willmar 0.5%
- Two Harbors 0.5%
- Proctor 0.5%
- New Ulm 0.5%
- St. Cloud area 0.5 % (begins in 2003 in the cities of St. Cloud, Sauk Rapids, Sartell, and St. Augusta)

Common characteristics of general local sales taxes

- Usually authorized to fund a specific "bricks and mortar" project
- Usually imposed at a 0.5% 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

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[6] Duluth's local sales and use tax is an anomaly. It was enacted in 1973 and for 10 years was the only local state tax in the state. It tends not to follow general practices. The city administrators and collects its sales tax itself, there is no requirements that proceeds be spent for a specific purpose, and there is no expiration provision.

- 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 city of Garrison has authority to impose up to a 1.0% sales tax upon approval at a local referendum. The city has never held the referendum.

Motor 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 subject to tax.

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 rate of $.20 per gallon.

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

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

Revenue

	FY2003 Revenues (millions)	% of Total State Tax Revenue
Highway Fuels	$640.4	4.7%
Aviation Fuels	4.3	< 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.

The Corporate Franchise Tax

1. 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 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 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 2 percent gross premiums tax instead.)

iv. The special federal depreciation rules under the federal Job Creation and Worker Assistance Act of 2002 are not followed

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. The weighting of the 3 factors is as follows:

(1) Property (Minnesota property/total property) – 12.5%

(2) Payroll (Minnesota payroll/total payroll) – 12.5%

(3) Sales (Minnesota sales/total sales) – 75%

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.

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.

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 tax 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 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

2. **Revenues**

a. **Overview.** The corporate franchise tax is a relatively minor source of state revenue. It is estimated to provide about 4.3% of non-dedicated general fund revenues for FY2003.

b. **Amount.** For fiscal year 2003, the Finance Department estimates that the corporate franchise tax will raise $541.7 million.

c. **Characteristics of revenues.**

i. **Elasticity.** Revenues from the tax are elastic; they grow as the economy and corporate profits grow. However, the shift to the use of pass-through entities has dampened this effect somewhat. For example, S corporations have grown from 22% of all corporations filing federal returns in tax year 1985 to over 55% in 1999. (Minnesota and federal status are the same.) "Check-the-box rules" have made it easier to operate in partnership form. Also, corporate profits have not always grown as fast the overall economy. 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, and 2001-? recessions on corporate tax revenues. As can be seen, for the 1981-82 and 2001 recessions revenues declined by about one-third. 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 period. By contrast, 2002 revenues are lower as a result of legislative changes.

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	

3. **Historical Highlights**

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

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

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

a. **Minnesota.** There have been few policy changes to the corporate franchise tax in the last decade. Major changes were made in response to federal tax reform (in 1986) and its aftermath. In the late 1980s and early 1990s, the minimum tax was restructured to eliminate the "factors tax." Proposals have been made to move toward 100% sales apportionment, but other than the baby step taken in 1999, nothing has been done on this.

b. **Other states.** The general trend in other states is to increase the sales weighting of the apportionment formulas. A large 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.

c. **Fundamental restructuring.** The tax theory underpinning the tax is shaky, at best. Public finance experts have always been very dubious about the theory of a corporate income tax. In part, as a result, proposals to replace the tax with something else periodically have been made. Usually this involves using a value added type (consumption) tax.

i. **Proposals in other states.** In recent years, a spate of these proposals have been made. Some of the states in which they have been proposed by governors or tax study commissions include

(1) Texas (then Governor Bush proposal)

(2) Montana

(3) West Virginia (tax study commission)

(4) Louisiana

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.** Michigan and New Hampshire (as a minimum tax that is added to its corporate income tax) have VAT taxes as business

taxes. However, Michigan is apparently not happy with the tax and is gradually phasing it out. Washington state 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 study of a VAT as a replacement for the corporate income tax in Minnesota is currently being conducted under a legislatively mandated study.

5. **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 the securities market.

b. **Tax incidence is unclear.** Experts differ on the incidence of the corporate tax. The popular perception is that the tax is progressive; it is apparently thought to fall on owners of corporate stock who have high incomes. This probably is 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 2001 Tax Incidence Study, prepared by the Department of Revenue, estimates that Minnesota consumers bear 39% of the tax, Minnesota labor 8%, and Minnesota capital 3%. The rest of the tax is borne by non-residents, 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, the corporate tax rarely shows 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, they 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 many studies find it to not be the case. However, economic theory would suggest it is so.

6. Sales Weighting and Apportionment

a. During the 1999, 2000, and 2001 legislative sessions, a group of businesses supported a proposal to adopt 100% sales apportionment. Because this is likely to be an issue again, it is useful to point out some basic facts about sales apportionment and to discuss some related policy issues.

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. They derived neither a benefit, nor a cost. However, the cost of the tax cut could be used to fund a general rate reduction, which would benefit all payers of the tax.

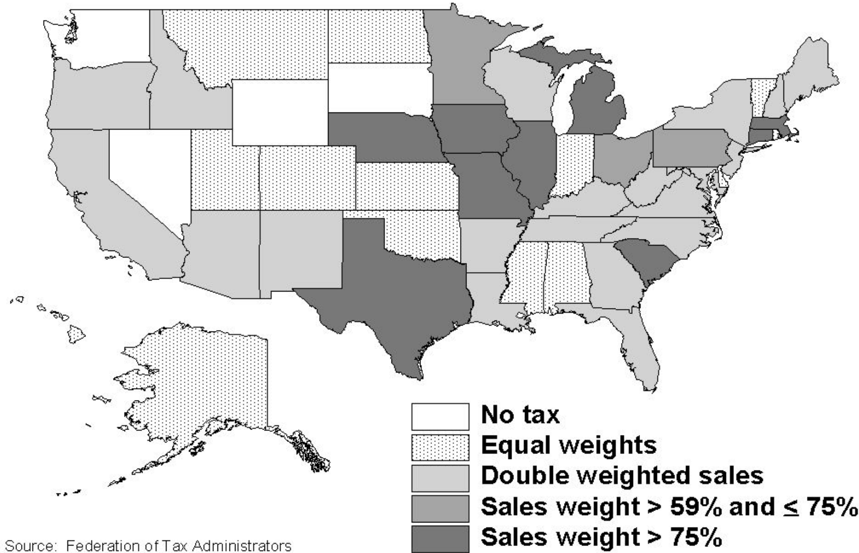
ii. Minnesota businesses whose Minnesota sales factor is lower than the average of the property and payroll factor will receive a tax cut. The larger the disparity, the bigger the benefit. A classic example would be a business with most of its operations (headquarters, plants, and so forth) in Minnesota,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

iii. Businesses who have higher Minnesota sales factors and lower average Minnesota property and payroll would have tax increases. The classic example is a national manufacturer of consumer products with few facilities in Minnesota (e.g., General Motors, Proctor & Gamble, and 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 way ahead of the curve in this regard, adopting sales weighting in 1939 as an option.) A number of states have adopted sales apportionment and it is under consideration in other states. The following map shows the apportionment formulas used in other states for manufacturers. As can be seen, a fair number of states now weight sales more heavily than Minnesota does.

Apportionment of Corporate Income
Applicable to Manufacturers



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

Motor Vehicle Registration

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

   a. Tax applies only to vehicles using the public highways.

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

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

3. **Tax Rate.** For passenger automobiles, the tax consists of $10 plus 1.25 percent of the automobile's base value. However, the tax cannot be less than $35. For vehicles in their second year of registration, the tax cannot exceed $189 and for vehicles in their third or later year, the tax cannot exceed $99. For commercial and other types of vehicles, the tax is based on weight and age.

4. **Revenue**

Fiscal Year 2003 (in millions)	$487.6
Percent of Total State Tax Revenue	3.6%

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%).

Mortgage Registry Tax

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

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

   a. Marriage dissolution decrees
   b. Mortgages given by fraternal benefit societies
   c. Mortgages to acquire or improve agricultural use real property
   d. Contracts for deed

e. Mortgages under low and moderate income housing programs operated by federal, state, and local governments
f. Mortgages to correct a legal description for the property

3. **Rate.** The rate is 0.23 percent of the principal debt.

4. **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.

5. **Revenue**

		Total Amount (in millions)
Disposition:	State General Fund (97%)	$134.8
	County Revenue Fund (3%)	4.2
Total Fiscal year 2003 (in millions)		$139.0

Percent of Total State Tax Revenue 1.0%

Deed Transfer Tax

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

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

a. Executory contracts
b. Mortgages, mortgage satisfactions, and so forth
c. Wills
d. Plats
e. Leases
f. Deeds of distributions by personal representatives
g. Deeds for cemetery lots
h. Deeds conveying permanent school lands
i. Certificates of sales or redemptions in foreclosures
j. Marriage dissolution decrees

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

4. **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).

5. **Revenue**

		Total Amount (in millions)
Disposition:	State General Fund (97%)	$82.5
	County Revenue Fund (3%)	2.6
Total Fiscal year 2003 (in millions)		$85.0
Percent of Total State Tax Revenue		0.6%

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. Towns and farmers mutual companies and mutual companies with $5 million or less in assets pay 1 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) are currently exempt from the tax, but will be subject to a 1 percent premium tax starting in calendar year 2004. The proceeds of the tax on these companies will be deposited in the health care access fund and be used to finance the MinnesotaCare program.

A separate fire marshal's tax of 0.5 percent is imposed on fire insurance premiums in the state. Farmers and township mutual companies are not subject to this tax. A surcharge of 2 percent is placed on fire insurance written on property located in first class cities.

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 non-retaliation law (two states).

Revenue

Fiscal Year 2003 (in millions)	$199.0
Percent of Total State Tax Revenue	1.5%

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 governmental programs, such as Medicare, Medical Assistance, General Assistance Medical Care, and MinnesotaCare itself. Nursing home and home health care services are generally exempt from taxation.

Tax Rates

The tax rate is 1.5 percent. The rate increases to 2 percent on January 1, 2004.

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 limited research credit for certain institutions.

Revenues

Fiscal Year 2003 (in millions)	$194
Percent of Total State Tax Revenue	1.4%

Dedication of Revenues

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

Cigarette and Tobacco Tax

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

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.

Credits

A credit or "discount" is allowed to distributors for the cigarette tax equal to (1) one percent for the first $1.5 million of stamps and (2) 0.6 percent of the stamps purchased over $1.5 million.

Revenue

Fiscal Year 2003 (in millions)	$186.3
Percent of Total State Tax Revenue	1.4%

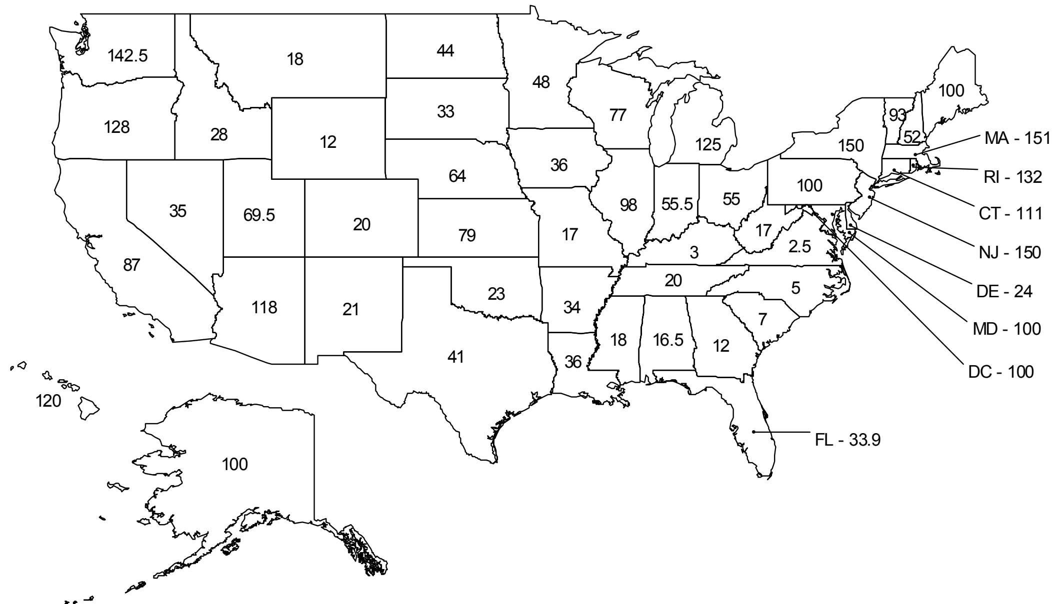
Cigarette tax revenues are deposited in the general fund, except the revenue produced by 2 cents per pack goes to the Minnesota future resources fund.

Comparison with Other States

The map below shows the tax rates in other states as of January 1, 2003.

State Cigarette Tax Rates*

as of January 1, 2003
cents per pack



* These exclude some significant local taxes.

Source: Federation of Tax Administrators and other sources

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). These amounts are as follows:

- $700,000 for individuals dying in 2003
- $850,000 for 2004
- $950,000 for 2005
- $1,000,000 for 2006 and later

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. Because of the large exemption, the estate tax applies to less than 2 percent of estates. The exemptions under the federal tax are larger than under the Minnesota tax. The federal exemption in 2003 is $1,000,000. This will rise to $1,500,000 in 2004; $2,000,000 in 2006; and $3,500,000 in 2009. The federal tax is repealed in 2010, but is scheduled to reappear in 2011 with a $1,000,000 exemption.

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 2003, these rates range from 4.8% to 16%. Because the exemption amount is determined based on a credit amount (i.e., a deduction from tax not the taxable estate), the bottom rate depends upon the exemption amount. When the exemption rises to $1,000,000, the bottom rate is 5.6%.

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 repealed this credit in 2001, so that it will be completely eliminated for decedents dying after December 31, 2004. 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 tax now is a stand-alone estate tax and imposes a real tax burden on estates and their heirs.

Revenues

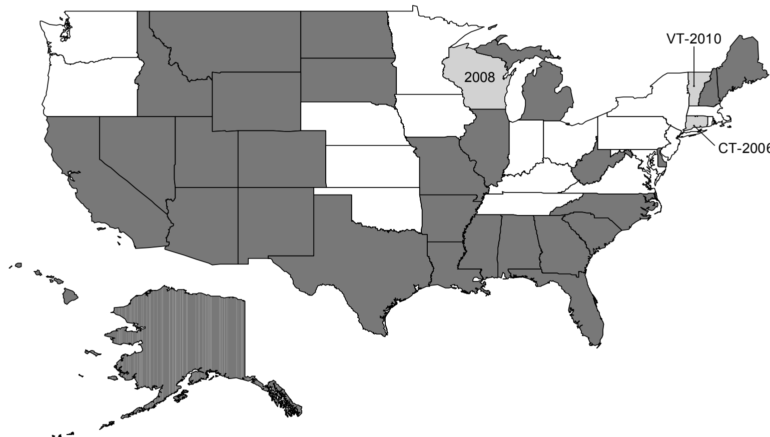
Fiscal Year 2003 (in millions)	$122.0
Percent of Total State Tax Revenue	0.9%

Revenues from the estate are deposited in the general fund. The Department of Finance (November 2002 forecast) estimates that the tax raises about $68 million per fiscal year. These revenues constitute about 0.5 percent of general fund revenues or 0.55 percent of state tax revenues. 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 July 2002, the Department of Revenue received a check from one estate for $55 million. As a result, DOF raised the forecast of FY2003 revenues to $122 million; by contrast, total collections in FY 2001 were $54.2 million.

Other States – Effect of Repeal of Federal Credit

The repeal of the federal credit will change 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. As noted above, 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) appear to be allowing their estate tax to expire with repeal of the federal credit. As of December 2002, 32 states were scheduled to have no estate tax for decedents dying 2005. (This may change as states respond to budget deficits.) The state constitutions of Alabama, Florida, and Nevada prohibit them from imposing estate taxes that exceed the federal credit. The map below shows the states scheduled to have no estate tax when the federal credit is fully repealed shaded in gray.

States Scheduled to Have No Tax
(2005 unless otherwise noted)



Alcoholic Beverage Excise Taxes

Tax Base

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

Tax Rates

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

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

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

Exemptions

Only limited exemptions apply under the tax:

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

Collection

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

Comparison with Other States

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

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

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

Revenue

Fiscal Year 2003 (in millions)	$63.2
Percent of Total State Tax Revenue	0.5%