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

Background Information for Members of the House Committee on Taxes

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State Taxes

Minnesota State Tax Collections

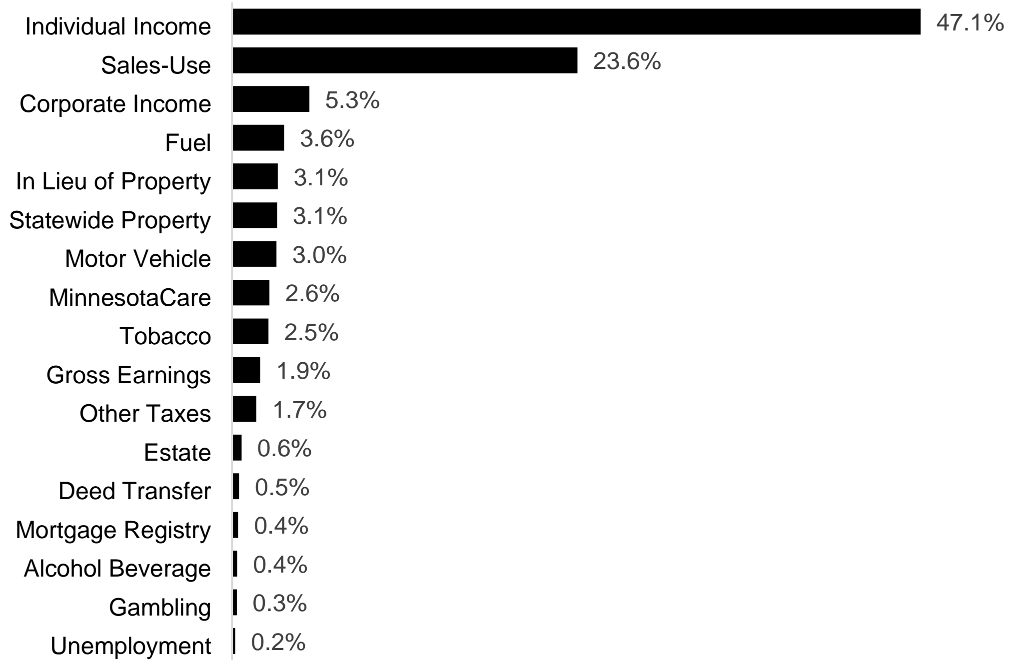
$26.2 Billion in Fiscal Year 2019

	FY 19 Projected Revenue (Million $)
Individual Income	12,350
Sales-Use	6,195
Corporate Income	1,389
Fuel	936
In Lieu of Property	821
Statewide Property	808
Motor Vehicle	798
MinnesotaCare	671
Tobacco	651
Gross Earnings	506
Other Taxes	463
Estate	168
Deed Transfer	127
Mortgage Registry	109
Alcohol Beverage	92
Gambling	85
Unemployment	58

Source: Minnesota Management and Budget, November 2018 Consolidated Fund Statement.

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 2019, including those that do not go to the General Fund.

Individual Income and Sales are by far the Largest State Taxes



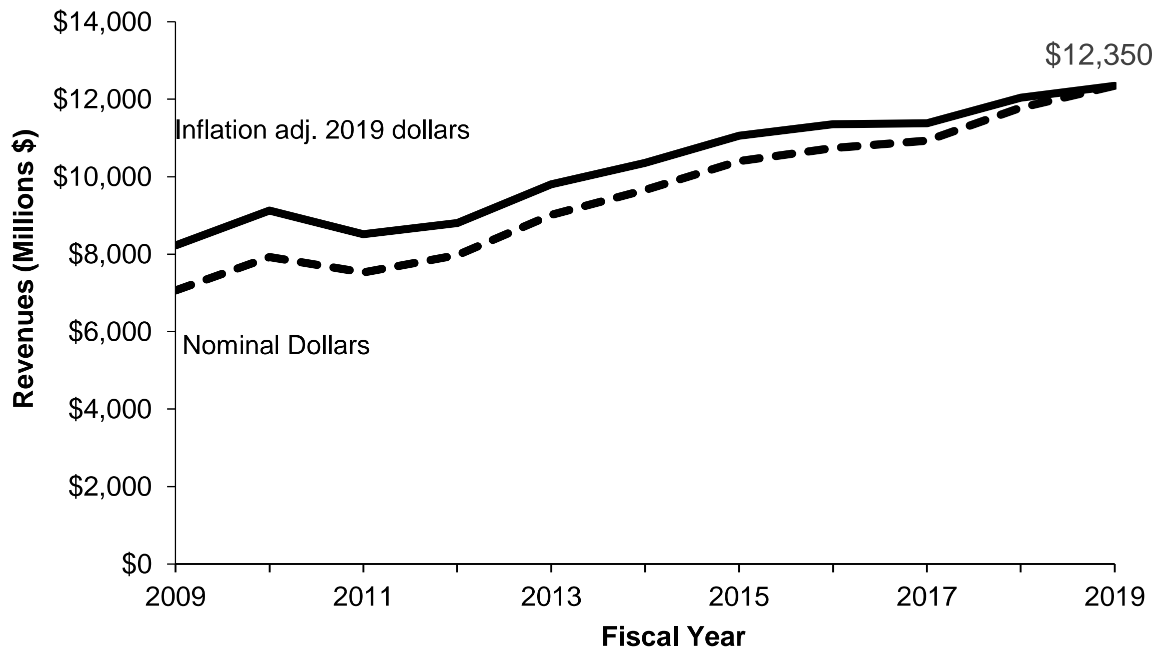
Share of FY 19 Projected Tax Revenues

The Individual Income Tax

1. Individual Income Tax Revenues and Distribution of Tax Burden

   a. **Revenues.** The individual income tax is projected to raise $12.2 billion in revenue in fiscal year 2019 (MMB February 2018 forecast).

Individual Income Tax Revenues, 2009-2019



Inflation adjusted using the Consumer Price Index for All Urban Consumers (CPI-U).
Source: MMB. February 2012 through November 2018 consolidated fund statements.

2. **Distribution of the individual income tax burden.** The Department of Revenue's *2017 Minnesota Tax Incidence Study* estimated how the income tax burden was distributed across Minnesota households in 2014. Updated estimates (based on a newer tax sample and the November 2018 economic forecast) will be released in early March 2019. (See https://www.revenue.state.mn.us/research_stats/research_reports/2017/2017_tax_incidence_study_links.pdf). Because the income tax burden as a percent of income rises steadily from *negative* 1.1% of total income for the poorest fifth of Minnesota households to 5.9% of income for the richest fifth of Minnesota households (and 7.7% for the richest 1%), economists describe the income tax as a *progressive* tax.

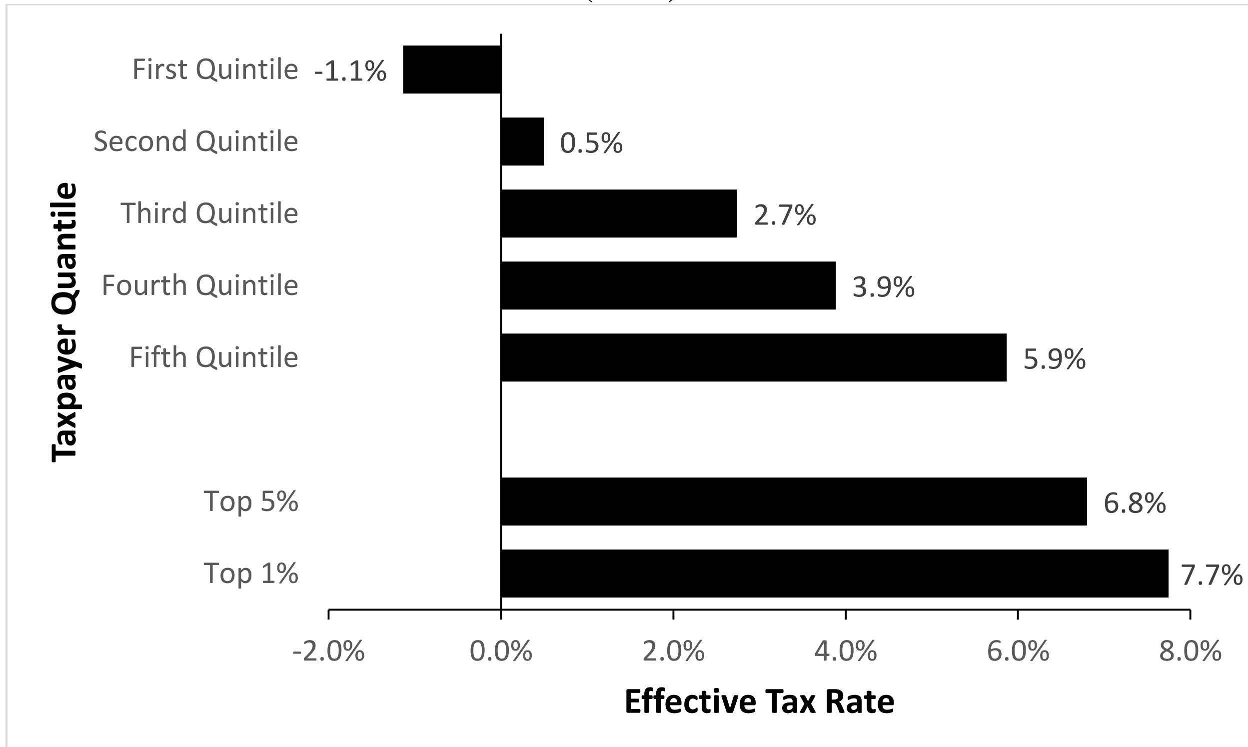
The top fifth of Minnesota households (with 58.5% of total income) were estimated to pay 75.5% of the total individual income tax in 2014.

Distribution of Individual Income Tax by Population Quintiles (2014)

Quintile	Income Range	Percent of Total Income	Tax Paid (000s)	Percent of Total Tax	Effective Tax Rate
First	$18,218 or less	2.8%	-$65,101	-0.7%	-1.1%
Second	$18,219 – 35,360	6.7%	69,542	0.7%	0.5%
Third	$35,361 – 59,617	11.9%	679,303	7.2%	2.7%
Fourth	$59,618 – 102,785	20.1%	1,629,777	17.2%	3.9%
Fifth	Over $102,785	58.5%	7,145,125	75.5%	5.9%
Total	All incomes	100.0%	9,458,646	100.0%	4.5%
Top 5%	Over $213,506	31.7%	4,491,789	47.5%	6.8%
Top 1%	Over $512,192	16.2%	2,613,912	27.6%	7.7%

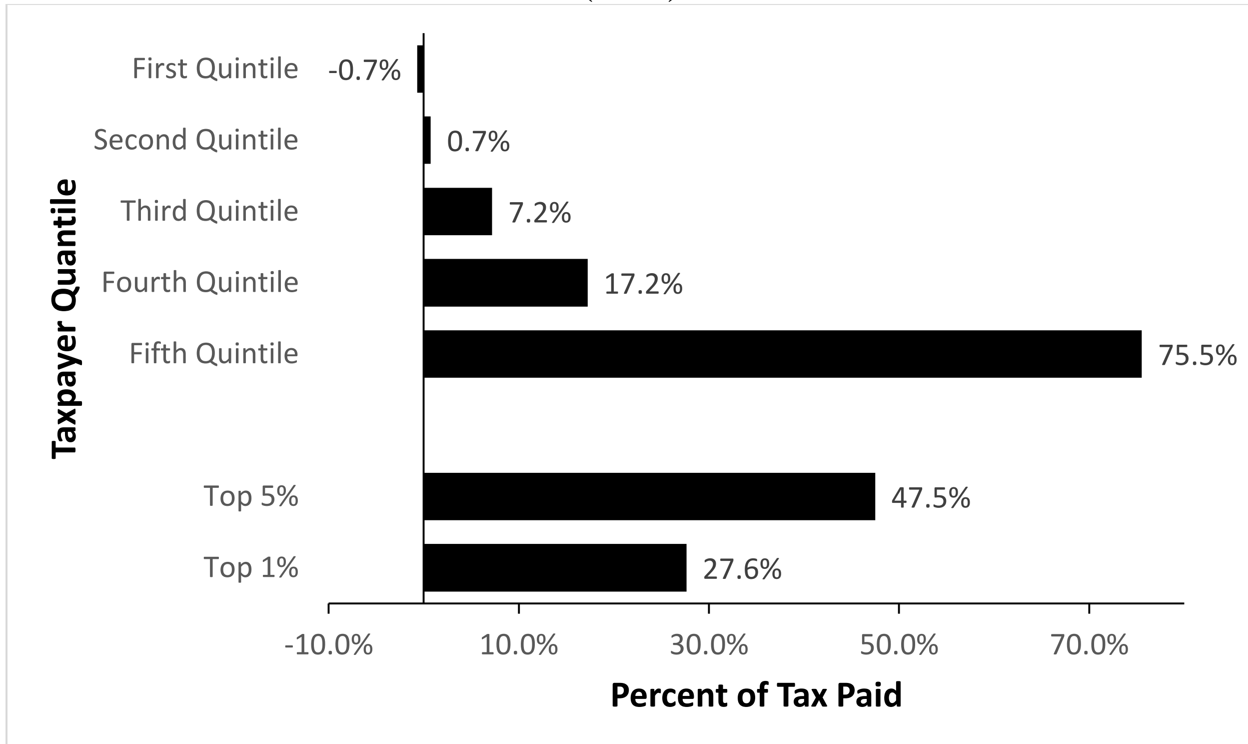
Source: MN Dept. of Revenue, 2017 Tax Incidence Study, page 29.

Income Tax Burden
Effective Tax Rates by Population Quintiles
(2014)



Source: Department of Revenue, 2017 *Tax Incidence Study*

Income Tax Burden
Distribution by Population Quintiles
(2014)



Source: Department of Revenue, 2017 *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. A 1971 Minnesota

Supreme Court held that Minnesota could not automatically incorporate future federal tax changes in defining Minnesota taxable income. *Wallace v. Commissioner of Taxation*, 184 N.W.2d 588 (Minn. 1971). The court concluded that this would unconstitutionally delegate legislative power to tax to congress. The constitutions in some other states explicitly or by court decision allow automatically link state tax bases to change in federal law.

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. The 2018 legislature failed to pass legislation that conform to federal tax legislation enacted in 2017 and 2018. This means that Minnesota's tax code is out of conformity with many federal provisions, which complicates the filing process for tax year 2018 returns filed in 2019.

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

a. **Rates.** Minnesota's income tax rates for tax year 2017 are 5.35%, 7.05%, 7.85%, and 9.85%

Minnesota Tax Rates and Brackets, 1998-2019

Brackets for married joint filers*	1998	1999	2000-12	2013-Present
$0 to $38,770	6%	5.5%	5.35%	5.35%
$38,771 to $154,020	8%	7.25%	7.05%	7.05%
$154,021 to $273,150	8.5%	8%	7.85%	7.85%
Over $273,150	8.5%	8%	7.85%	9.85%

* Brackets shown are at 2019 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 (6.75%). 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. House Research estimates that about 14,400 taxpayers are projected to pay about $27.8 million in AMT for tax year 2015.

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 9.85% bracket who qualifies for a $1,000 deduction receives a tax benefit of $98.50 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. State limitation on itemized deductions (adjusted for different federal limitation)

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

c. Bonus depreciation deduction

d. Section 179 expensing deduction

e. Net operating loss carryover (NOL) adjustments for years when Minnesota did not conform to more generous federal NOL carryback rules

f. Numerous changes included in the 2017 Tax Cuts and Jobs Act (TCJA) to which Minnesota has not yet conformed.

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. Minnesota requires taxpayers to add back the federal itemized deduction for state income or 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) A portion of taxable Social Security benefits.

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

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

(6) Military pay

a. for active duty performed by Minnesota residents

b. for National Guard and reserve active service, training, and administrative functions (AGR)

(7) Military retirement pay, including survivor benefit payments

(8) Elderly subtraction

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

(10) Gain on sale of farm property if taxpayer is insolvent

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

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

(13) Interest earned in first-time homebuyer savings accounts.

(14) Reciprocity subtraction (residents of Michigan and North Dakota)

(15) Railroad expenses for which the federal railroad track maintenance credit is claimed (Because the federal credit is in lieu of the business expense deduction, taxpayers would otherwise not be allowed to deduct these expenses in computing Minnesota tax – that is, these expenses are not reflected in reflected in federal taxable income.)

(16) Up to $3,000 in contributions by a married joint taxpayer to a section 529 college savings account ($1,500 for other taxpayers). The subtraction is limited to individuals who do not claim the 529 credit.

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 2019 single filers pay 5.35% on the first $26,520 of taxable income, while married joint filers pay 5.35% on the first $38,770 of taxable income. Without the marriage penalty credit, two people each with taxable income of $26,520 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 2019 the maximum credit is $1,462. Total marriage penalty credits for fiscal year 2019 are projected at $92.6 million with approximately 433,000 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 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. A recent U.S. Supreme Court decision held that state taxes (if they tax all of the income of their residents, not just in-state income) must allow a credit like this (or a similar mechanism) to prevent income for out-of-state sources being taxed more heavily than that from in-state sources. *Comptroller v. Wynne*, 135 S. Ct. 1787 (2015).

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.

Taxpayers are projected to claim $9.4 million in long-term care credit in fiscal year 2019, with approximately 64,000 filers claiming the credit annually.

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 that the employer incurs versus what it charges the employee). This credit is estimated to reduce revenues by less than $50,000 for FY 2019 for 300 filers.

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

[1] Projections of the cost of this and other credits are taken from the Minnesota Department of Revenue's *2016-2019 Tax Expenditure Budget*, available on-line at *http://www.revenue.state.mn.us/research_stats/research_reports/2016_tax_expenditure_links.pdf*.

income (including military retirement income) in excess of $30,000. About 1,600 filers are projected to claim about $400,000 in credits in fiscal year 2019. Individuals claiming the subtraction for military retirement pay are not allowed to claim this credit.

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 credit does not apply to sole proprietors, though.) The 2010 legislation also made the credit refundable. The 2013 legislature eliminated the refundability of the credit, making it once again a nonrefundable credit. 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 2019 is $27.1 million.

vii. **Credit for sales of agricultural assets to a beginning farmer.** The 2017 legislature enacted a nonrefundable credit for taxpayers who sell or rent agricultural assets to a beginning farmer. The credit is calculated based on the value of the asset or the amount of rental income. The credit is capped at $5,000,000 in tax year 2018 and $6,000,000 in future years. The credit sunsets in TY 2023. The Department of Revenue estimates that the credit will reduce revenues by $5 million in FY 2019.

viii. **Beginning farmer credit.** The 2017 legislature enacted a nonrefundable credit of up to $1,500 for beginning farmers who participate in a financial management program. A taxpayer may claim the credit for up to three years while participating in the program. The credit is effective in tax year 2019 and sunsets in TY 2023. The Department of Revenue estimates that the credit will reduce revenues by $300,000 in FY 2019.

ix. **Student loan credit.** The Minnesota Student Loan Tax Credit is a nonrefundable credit for payments of principal and interest on eligible higher education loans. Individuals with one or more qualified education loans may claim the credit to reduce their Minnesota income tax liability by up to $500. The credit was enacted by the 2017 Legislature, effective beginning in tax year 2017.

The Department of Revenue estimates that the credit will reduce revenues by $27.8 million in fiscal year 2019.

x. **College Savings (529) Credit.** Minnesota's Section 529 Plan Credit is a nonrefundable credit for contributions to a college savings account established by any state under section 529 of the Internal Revenue Code. The credit equals 50 percent of contributions, up to a maximum of $500. The maximum credit is phased out as income increases with varying thresholds for individuals and married joint filers. The credit is fully phased out for individuals with AGI in excess of $100,000 and married couples filing joint returns with income in excess of $160,000.

The Department of Revenue estimates that the credit will reduce revenues by $7.8 million in fiscal year 2019.

xi. **Credit for a teacher completing a master's degree.** The 2017 legislature enacted a credit for teachers who complete a master's degree in a "core content area" other than teaching or pedagogy. The credit is allowed for teachers who begin a degree program in fall 2018 or later, and is earned upon completion of the program. The maximum credit is $2,500, and is allowed once. The Department of Revenue estimates the credit will cost less than $50,000 in fiscal year 2019.

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. In 2014, Minnesota restructured its credit to be more like the federal credit. 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 2019 is $2,156 for claimants with two or more children; $1,117 for claimants with one child; and $139 for claimants with no children. The credit is subject to an income-based phaseout. Filers become ineligible for the credit when their incomes exceed: $52,776 for married joint claimants with two or more children ($50,162 for other filing statuses); $47,170 for married joint claimant with one child ($41,330 for other filing statuses); and $15,667 for married claimants with no children. Both the maximum credit amount and the credit phaseout are indexed annually for inflation.

In tax year 2016, about 324,390 recipients claimed credits with an average credit amount of $768. A total of $266 million in working family credits are projected to be paid in fiscal year 2019.

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.

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 (9.85%) would derive a $246 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.

In tax year 2016, 45,526 recipients claimed the credit. A total of $11.6 million in K-12 education credit is projected to be paid in fiscal year 2019.

iii. **Dependent care credit.** The Minnesota and federal dependent care credits partially offset the cost of child care for certain workers. The maximum Minnesota and federal credit is $1,050 for one child and $2,100 for two or more children. 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.

The *state credit* equals the federal credit for which the claimant is eligible, subject to an income-based phaseout. While all filers with tax liability and qualifying expenses may claim the federal credit, the state credit is fully phased out for filers with higher incomes. In tax year 2019, the phaseout begins when adjusted gross income exceeds $52,160 and the credit is fully phased out when income reaches $64,160 for claimants with one dependent, and $76,160 for claimants with two or more dependents. The income threshold for the phaseout is adjusted each year for inflation.

In tax year 2016, 30,921 recipients claimed the credit. A total of $32.9

million in dependent care credits are projected to be paid in fiscal year 2019.

iv. **Combat zone 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. About 1,700 claimed the credit in 2016. An estimated $700,000 in credits will be paid in fiscal year 2019.

v. **Historic structure rehabilitation credit.** The 2010 Legislature enacted a historic rehabilitation credit equal to the similar federal credit. Investors may claim the credit as a grant instead. The credit equals 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 2017 federal tax bill, the Tax Cuts and Jobs Act (TCJA), required that the federal credit be taken over five years. The 2018 legislature did not conform to this change.

The estimated cost of the credit for FY 2019 is $32.9 million; virtually all credit claims have been under the corporate franchise or insurance premiums tax. The credit sunsets after FY 2021.

vi. **Stillbirth credit**. The 2016 legislature enacted a refundable credit of $2,000 for the parents of a stillborn child. DOR estimates the credit will reduce revenues by $800,000 in FY 2019.

vii. **Credit for taxes paid to Wisconsin.** Minnesota's credit for taxes paid to another state is not refundable. The 2017 legislature enacted a refundable credit for taxes paid to Wisconsin. The credit applies to personal service income (such as wages) only. The credit only applies if no tax reciprocity agreement is in place with Wisconsin; the credit effectively mimics the tax treatment under reciprocity. DOR estimates the credit will reduce revenues by $5.8 million in FY 2019.

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. 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, although a few states enacted income taxes (and repealed them) in the 19th century. Some features of the original Minnesota tax:

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 allowed.

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 during the recessions in the early 1980s, to help make up for downturns in state revenues. These surtaxes were repealed when the economy recovered from the recession.

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 for 2010 was about 31% 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. This credit was repealed by 2011 legislature.

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.

t. **2013: Fourth (higher top rate) bracket adopted; no conformity.** The 2013 legislature adopted a fourth tier bracket with a rate of 9.85% that applied to married joint filers with taxable incomes above $250,000 and chose not to conform to changes in federal taxable income that Congress enacted in 2012.

u. **2014: Retroactive conformity.** The 2014 legislature reversed the decision of the 2013 legislature to not conform on numerous of the federal provisions, retroactive to tax year 2014, and prospectively for other provisions (e.g., the higher standard deduction for married joint filers).

v. **2015: One year of conformity.** The 2015 legislature adopted conformity for federal changes through 2014, the only tax bill that was enacted into law during the 2015 session.

w. **2016: Subtraction for military retirement pay**. The 2016 legislature did not enact a tax bill (as a result of the governor's pocket veto of the omnibus tax bill), but did enact in a supplemental spending bill the subtraction for military retirement pay, the stillbirth credit, and a one-year extension of the angel investment credit with a $10 million annual limit for tax year 2017.

x. **2017: Conformity and new tax expenditures.** The 2017 legislature enacted an early conformity bill on January 12, as well as an omnibus tax bill during the May special session. The omnibus tax bill significantly expanded a number of individual income tax expenditures. The bill included four new subtractions, including a partial subtraction for taxable Social Security Benefits. It also included five new nonrefundable credits for college savings account contributions, student loans, beginning farmers, and teachers who complete master's degrees. The bill enacted a new refundable credit for taxes paid to Wisconsin, and expanded the refundable working family credit, dependent care credit, and the research and development credit.

y. **2018: Nonconformity to significant federal tax changes.** Congress enacted the Tax Cuts and Jobs Act (TCJA) in December 2017. TCJA made a number of significant changes that affected the calculation of federal taxable income (FTI), which is the starting point for Minnesota's individual income tax. The bill limited and repealed certain itemized deductions, repealed the personal and dependent exemptions, increased the standard deduction, and made numerous changes to the tax treatment of pass-through businesses. The 2018 legislature passed two bills conforming to these changes and significantly restructuring the state tax system, but the bills were vetoed by the Governor. As a result, the state is out of conformity with the TCJA's changes for tax year 2018.

8. Recent Trends in Policy Changes to Tax

Surveying the last 25 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, beginning during the 1990s and continuing since, 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 to 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. The 2013 legislature eliminated the refundability for the research credit.

In 2013, the legislature enacted the Greater Minnesota internship credit and in 2014, the legislature enacted a 75-percent refundable credit (maximum of $2,000) for expenses incurred by parents or guardians to treat reading disorders. This credit was limited to tax year 2014 and was estimated to reduce revenues by $2.6 million. It has now expired.

In 2016, the legislature enacted the credit for parents of stillborn children.

The 2017 legislature repealed the Greater Minnesota internship credit, but enacted six new tax credits and expanded the working family, dependent care, and research credit. The new credits were the student loan credit, two credits for beginning farmers, a credit for college savings account contributions, a credit for teachers who complete master's degrees, and a credit for taxes paid to Wisconsin.

Below are the numbers claiming refundable credits in tax year 2016 (except as otherwise noted) and their projected costs in FY 2019. The costs include both the offset against tax and refund amounts.

Refundable Credit	Number Claiming*	FY 2019 Cost**
Dependent Care	30,921	$32,900,000
K-12 Education	45,526	11,600,000
Working family	324,390	266,100,000
Military service (combat zone)	1,700	800,000
Historic rehabilitation (including corporate and insurance taxes)	NA	44,800,000
Stillbirth credit	Effective TY 17	800,000
Taxes paid to Wisconsin	Effective TY 17	5,800,000

* Dept. of Revenue, 2016 income tax processing data; revenue estimate angel investor report (universal of all angel investors claiming the credit at the time of the study).
** Dept. of Revenue, *Tax Expenditure Budget FY 2018-121*.

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. Student loan credit

viii. Two credits for beginning farmers

ix. A credit for teachers who complete master's degrees.

x. Stillbirth credit

xi. Credit for taxes paid to Wisconsin.

xii. Subtraction for disposition of farm property

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

xiv. Subtraction for organ donation expenses

xv. Subtractions for various categories of military pay

xvi. Subtraction for railroad track maintenance expenses not allowed as federal deductions (but used to claim a federal credit)

xvii. Subtraction for a portion of taxable Social Security benefits.

xviii. Subtraction and credit for 529 contributions.

xix. Subtractions for interest earned in first-time homebuyer accounts.

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

xxi. 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.

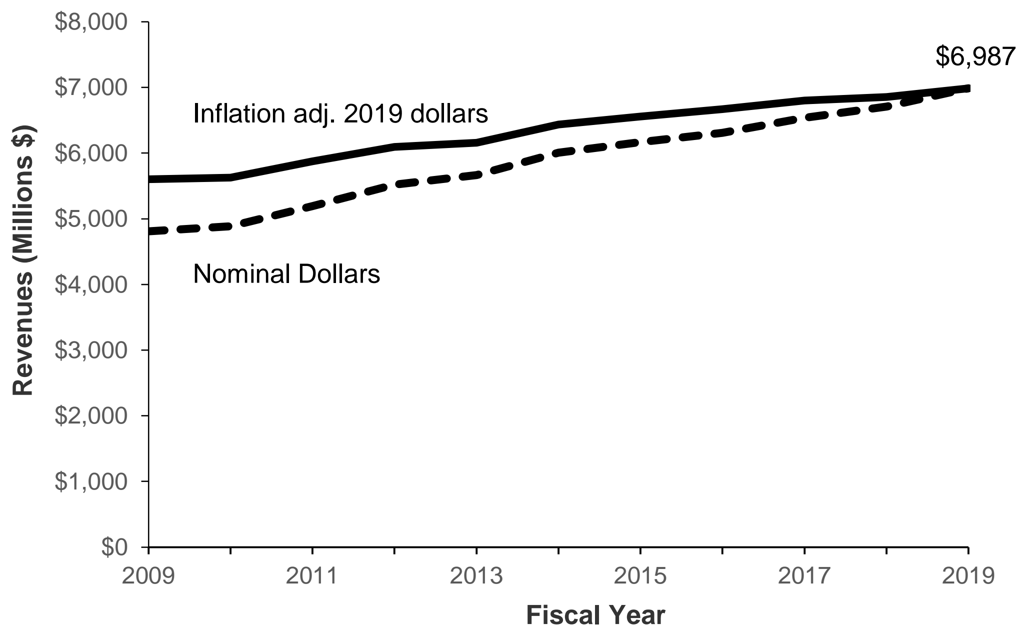
Sales Taxes

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 $7 billion in fiscal year 2019. $5.7 billion is from the general sales tax, $335 million from the rate under the Legacy Amendment (0.375% rate), $795 million from motor vehicles sales tax and $109 million from lottery tickets. Sales taxes account for slightly less than 30% of total state tax revenues.

Sales Tax Revenues, 2009-2019



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/Pages/Tax_Incidence_Studies.aspx.)

Because the sales tax burden as a percent of income falls steadily from 7.5% of total income for the poorest fifth of Minnesota households to 1.8% of income for the richest fifth of Minnesota households, economists describe the sales tax as a *regressive* tax.

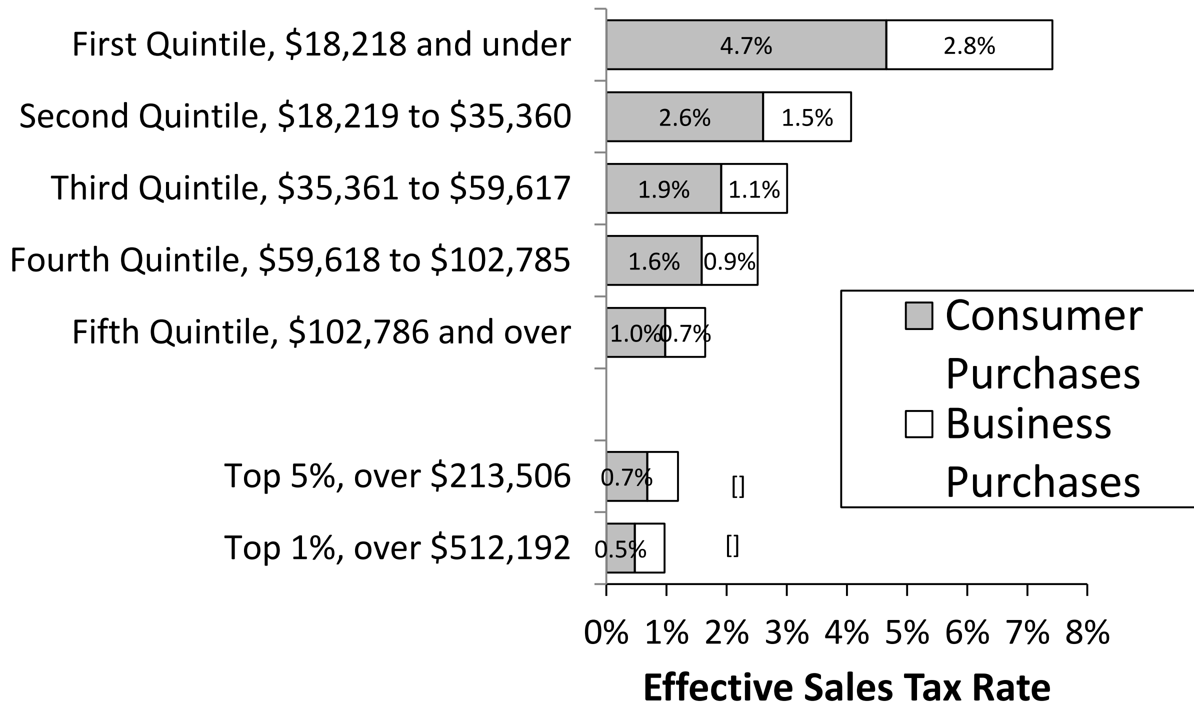
The richest fifth of Minnesota households (with 57.6% of total income) are estimated to pay 41.8% of the total sales tax.

Distribution of Sales Tax Burden
by Population Quintiles
(2010)

Quintile	Income Range	Percent of Total Income	Tax Paid (000s)	Percent of Total Tax	Effective Tax Rate
First	$18,218 or less	2.8%	$424,714	8.9%	7.4%
Second	$18,219 – 35,360	6.7%	570,734	11.9%	4.0%
Third	$35,361 – 59,617	11.9%	744,649	15.5%	3.0%
Fourth	$59,618 – 102,785	20.1%	1,055,252	22.0%	2.5%
Fifth	Over $102,786	58.5%	2,001,501	41.7%	1.6%
Total	All incomes	100%	$796,850	100.0%	2.3%
Top 5%	Over $213,506	31.7%	786,883	16.4%	1.2%
Top 1%	Over $512,192	16.2%	351,222	6.8%	1.0%

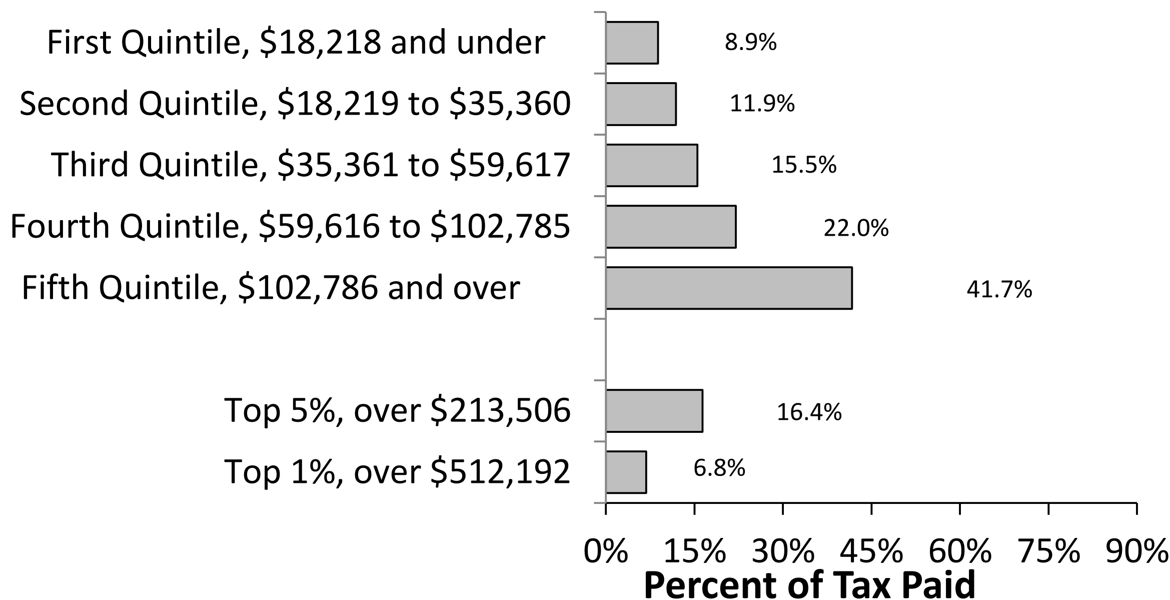
Source: MN Dept. of Revenue, 2017 Tax Incidence Study, page 29

Sales Tax Burden
Effective Tax Rates by Population Quintiles (2014)



Source: Department of Revenue, *2017 Tax Incidence Study*

Sales Tax Burden[2]
Distribution by Population Quintiles (2014)



Source: Department of Revenue, *2017 Tax Incidence Study*

Dedication of Revenue

Motor Vehicle Sales Tax (MVST). A constitutional amendment providing for the complete dedication of MVST revenues to transportation and transit funding passed at the 2006 general election. The phased-in dedication was completed in FY 2012 and 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 $795 million in FY 2017.

Other general sales tax revenues dedicated to transportation funding. The state has also dedicated some of the general sales tax revenue related to motor vehicles to transportation funding as well. This started with the dedication of most of the sales tax revenues from long-term motor vehicle leases in 2008. In 2017 all sales taxes from long-term motor vehicle leases

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

were dedicated to transportation along with revenues generated by both the general and special sales taxes from short-term motor vehicle leases[3]; and also the sales tax revenues estimated to be derived from the sale of motor vehicle repair parts.

- **Revenues from long-term motor vehicle leases.** Unlike motor vehicle sales, long-term motor vehicle leases are subject to the general sales tax of 6.875% and are not subject to the constitutional dedication. Currently 100 percent of these revenues are statutorily dedicated to transportation purposes with the money distributed as follows:
    - 38 % to the county state-aid highway fund;
    - 38 % to the Greater Minnesota transit account;
    - 13 % to the Minnesota transportation fund; and
    - 11 % to the highway user tax distribution fund.

  The portion going to the county 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.

- **Revenue from short-term motor vehicle leases.** Beginning July 1, 2017, the revenue from both the regular and extra sales taxes imposed on short-term motor leases is dedicated to the highway user tax distribution fund. The special taxes on these leases are reported separately and the general sales tax revenues from these leased are estimated based on the special tax revenue.

- **Revenue from motor vehicle repair parts.** Repair parts for motor vehicles are sold by car dealers, auto repair stores and general merchandise retail stores. Remittance of sales taxes collected on these items are not reported by retailers separately therefore the statute includes a set amount of general sales tax revenue to be moved to the highway use tax distribution fund. The amounts dedicated are:
    - $2.628 million/month from July 1, 2017 through June 30, 2019; and
    - $12.137 million/month beginning July 1, 2019.

In-lieu tax on lottery tickets. 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 $295 million in FY 2015. The revenue is dedicated as follows:

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[3] Short-term motor vehicle leases are leases of passenger automobiles, vans, and pickup trucks for 28 or fewer days. An additional 9.2 % special sales tax is imposed on these leases in addition to the 6.875% general sales tax,

Forecasted Legacy Amendment Fund Receipts (in millions)						
Fund	**FY 2020**	**FY 2021**	**FY 2020-21**	**FY 2022**	**FY 2023**	**FY 2022-23**
Outdoor Heritage (33%)	114.6	119.6	234.2	124.4	127.9	252.3
Clean Water (33%)	114.6	119.6	234.2	124.4	127.9	252.3
Parks & Trails (14.25%)	49.5	51.7	101.2	53.7	55.2	108.9
Arts & Cultural Heritage (19.75%)	68.6	71.6	140.2	74.5	76.5	151.0
Total All Funds (100%)	$347.3	$362.5	$709.8	$377.0	$387.5	$764.5

Source: Minnesota Management and Budget Department, 2018 February 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 – 21.075%[4]
- 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.

[4] This rate consists of the 6.875% general tax, a 9.2% short-term lease tax, and a 5% fee to reimburse dealer for the registration tax.

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%[5]
July 1, 2029 – future years	6.5%

Minnesota's state sales tax rate is relatively high. Only the following states have state rates as high as Minnesota (6.875%), as of January 1, 2019:[6]

California (7.25%)[7] Indiana (7.0%) Mississippi (7.0%)
Rhode Island (7.0%) Tennessee (7.0%)

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 27 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). The ability to impose a different tax rate on other specific goods is limited under the Streamlined Sales and Use 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 July 1, 1994	+6.2%
Residential waste fees enacted July 1, 1993, and moved to a separate tax (Ch. 297H) in 1997	+$2.00/year

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

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

[7] California's rate includes a mandatory county rate of 1.25 percent.

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 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 2017 *Tax Incidence Study*, about 43 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 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[8]

[8] 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%.

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 most local governments[9], 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

Most base expansions have been as a result of a state fiscal crisis. One of the more recent expansions, 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:

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[10]	6/1/92
Most installation and delivery charges	1/1/02
Digital products and downloads	6/1/2013
Business repair services and warehousing[11] (repealed before effective date)	--

[9] This exemption for school districts was expanded to include counties, cities, and townships in 2013. The exemption is expanded to include special taxing districts, except the Metropolitan Council, and all joint powers boards beginning January 1, 2016, and to the Metropolitan Council beginning January 1, 2017.

[10] Most of this expansion was repealed July 1, 2013.

[11] This tax base expansion was enacted during the 2013 legislative session with an effective date of March 1, 2014 but was repealed in the 2014 session before it took effect.

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 capital 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
Miscellaneous construction exemptions for various agricultural and other processing facilities**	Various
* These exemptions are administered as refunds. ** 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 2019 ($ millions)*
Goods	
Food products	$909
Clothing	408
Motor fuels	593
Residential heating fuels	126
Residential water and sewer	90
Newspapers and subscription magazines	46
Services	
Business services	$3,061
Legal (consumer)	96
Motor vehicle repair (consumer)	160
Accounting (consumer)	18
Funeral services	39
Repair and maintenance of personal property	21
Personal care services	118
Other personal services	18
Purchases by exempt entities	
Local governments	$336
Hospitals and surgical centers	114
Nonprofit organizations (excluding hospitals)	88

Source: Minnesota Department of Revenue, Tax Research Division, 2018-2021 *Tax Expenditure Budget*

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. Prior to 2018 the state could not require remote sellers to collect the state tax (see sales tax and remote sales below). Internet sales increased the amount of total remote sales and therefore the lost tax revenue. The Department of Revenue's estimated the loss, for CY 2011, as $204 million with $149 million due to e-

commerce and $55 million to catalog sales.[12] The Internet also allows for the sale of digital goods (i.e., electronic greeting cards, downloaded music) as a substitute for taxable tangible goods. However, most digital products were made taxable in 2013.

Sales tax and remote sales

Beginning October 1, 2018 most remote sellers with more than a de minimus amount of sales must collect and remit Minnesota sales tax. A remote seller is a retailer that does not have a physical presence in a state. The June 2018 Supreme Court case *South Dakota v. Wayfair*allows states to require remote sellers to collect sales taxes if certain conditions are met.

This case essentially overturned two previous Supreme Court cases – *Bellas Hess* in 1967 and *Quill* in 1992. These older cases involved mail order companies who were the major remote sellers at that time. In *Quill*, which affirmed *Bellas Hess*, the court ruled that remote sellers did not have to collect the sales tax because the sellers had no physical nexus to the taxing state and therefore the imposition of the tax placed an undue burden on interstate commerce. The Court noted that the complexity of the different tax systems was too much of an administrative cost to business. The Court also stated that Congress could take action to overturn the ruling legislatively but congress never acted.

Between 1992 and 2018 Minnesota took a number of actions to try to impose sales tax collection duties on remote sellers despite the Supreme Court ruling. Some of the legislative actions included:

- Not repealing our economic presence test similar to the North Dakota economic presence test that was ruled unconstitutional under *Quill (* instead adding language to the effect that *this was effective to the extent allowed under the U.S. constitution or federal law);*
- Passing a number of statutory provisions that attempt to establish that a company had a physical presence including "affiliate nexus," "click through nexus," and nexus based on use of an online "market place provider" with a physical presence in this state; and
- Joining the Streamlined Sales Tax Project (SSTP) and adopting the sales tax simplification provisions included in the Streamlined Sales and Use Tax Agreement (SSUTA) which is discussed in the box on the next page.

In *Wayfair,* the Supreme Court overturned the *Quill* physical presence rule and replaced it with an economic presence standard. The Court then held that South Dakota's economic presence nexus standard did not violate the U.S. dormant commerce clause because the significant economic and virtual contacts the respondent had with the state were sufficient to establish nexus with the state, thus allowing the state to impose the requirement to collect. (South Dakota had an exclusion from the collection requirement for remote sellers with minimal sales in the state (less than 100 transactions or $100,000 in sales in a year) which now essentially functions as a de facto threshold for economic nexus as states contemplate legislation in this area.) While the Court remanded the case to determine whether other constitutional issues

[12] 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.

related to undue burden or discrimination could invalidate the law, they suggested that because South Dakota had taken a number of steps to reduce the burden of sales tax collection on remote sellers, the law would withstand further constitutional scrutiny. Some of the most important provisions cited by the court in this regard included:

- access for remote sellers to use of a free certified service provider (paid by the state) to facilitate the collection and remittance of the tax; and
- simplification and standardization of the administration practices, and definitions of items subject to the state sales tax.

These two items are requirements of all states that are members of SSUTA. As a member state we meet a number of the criteria for simplification cited in the court case. In addition, we already had in our statutes an exclusion for remote sellers with minimal sales into the state (although it differs slightly form the South Dakota exclusion). And our economic presence nexus provision was no longer unconstitutional. For those reasons the Minnesota Department of Revenue administratively started to require collection and remittance of sales tax from remote sellers beginning with sales made after September 30, 2018. Our statue requiring Internet marketplace providers with a physical presence in the state to collect tax on sales made on their platforms also had a contingent date based on congressional action or the overturning of the *Quill* case so this provision also went into effect on October 1.

Although the state is now collecting sales tax on remote sales, the revenues gained may be lower than expected. This is for a number of reasons, including a number of Internet sellers (such as Amazon and Apple) already had a physical presence in the state and were already collecting the tax on many sales. Also Revenue is trying to accommodate new remote sellers registering with the state by providing them with some flexibility as they set up their system to collect. Additionally some "remote sales" continue to be exempt from Minnesota sales tax because of other exemptions in our system or because the sellers are exempt from collecting because they make minimal sales into the state.

As the state ramps up sales tax collection by remote sellers it is likely that there will need to be changes to the sales tax statutes to clarify how the law should be administered and to remove language that may be redundant.

History of the Streamlined Sales and Use Tax Agreement and Minnesota

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.

The final Streamlined Sales and Use Tax Agreement (SSUTA) was adopted by the project on November 12, 2002. It is constantly being amended to reflect input from businesses and

other interested parties. Currently 24 states, including Minnesota, have adopted the required legislation and are full members of the SSUTA. 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 act 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. Prior to *Wayfair* a number of businesses came 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. The state was collecting more than $20 million annually from these voluntary registrants.

Advantages to remaining a member of SSUTA. South Dakota is also a member of SSUTA and the Supreme Court cited a number of SSUTA provisions in effect in that state as reasons why the imposition of the duty to collect sales tax on remote sellers in that state may not be an "undue burden on interstate commerce". If the state withdrew from the agreement it would likely still need to comply with many of its provisions. In addition SSUTA provides the state with access to service providers that are paid under contract arrangement with the SSUTA governing board to collect and remit sales tax to member states on behalf of remote sellers.

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 or statute that supersedes the prohibition.
- 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.[13]
- 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 statutory authority in the metropolitan area and in greater Minnesota for counties to impose taxes for transit and transportation projects was also granted. These are discussed separately.
- The 2008 tax bill also enacted a provision prohibiting local governments from spending money advocating or promoting additional local sales tax bills. That provision was to expire June 1, 2010, but was amended in 2010 to extend it permanently but to allow limited expenditures to host public forums on the issue and to provide information on the use and impact of the proposed tax.
- 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.
- In 2013 and 2014, existing taxes were expanded and several new county taxes were authorized to help fund the Destination Medical Center in Rochester and the Lewis and Clark Water Project in southwestern Minnesota. Only the Rochester sales tax expansion is in effect.
- In 2017 nine new local sales taxes were authorized, including one for a county and one for a sanitary district.
- Local sales tax has expired six times–most recently in the city of Worthington September 30, 2018.
- Currently, there are 34 general local sales taxes and 15 various food, beverage, lodging, and entertainment taxes imposed under special law.

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[13] 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.

General local sales taxes that are currently imposed and year they were first authorized:

- Duluth (1973) 1.0%
- Rochester (1983) 0.5%
- Minneapolis (1986) 0.5%
- Mankato (1991) 0.5%
- St. Paul (1993) 0.5%
- Hermantown (1996) 1.0%[14]
- 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)
- Albert Lea (2005) 0.5%
- Bemidji (2005) 0.5%
- Austin (2006) 0.5%
- Baxter (2006) 0.5%
- Brainerd (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 %
- Fergus Falls (2011) 0.5%
- Hutchinson (2011) 0.5%
- Lanesboro (2011) 0.5%
- Marshall (2011) 0.5%
- Medford (2011) 0.5%
- East Grand Forks – 2017 1.0%
- Fairmont – 2017 0.5%
- Fergus Falls – 2017 0.5%
- Moose Lake – 2017 0.5%
- New London – 2017 0.5%
- Spicer – 2017 0.5%
- Walker – 2017 1.5%
- Clay County -2017 0.5%
- Garrison, Kathio, West Mille Lacs Lake Sanitary District – 2017 1.0%

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

[14] In 2012 Hermantown received authority to increase its local sales tax rate from 0.5% to 1.0%. The rate increase was effective March 1, 2013.

- 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 previous or next general election

Statutorily authorized county transit and transportation taxes:

In 2008, the legislature enacted two new statutes to allow counties to impose local sales taxes to help fund transportation. The Metropolitan Transportation Area sales tax provision allowed any county in the Twin Cities seven-county metropolitan area to join the Metropolitan Transportation Area, which imposed a tax in the area to fund transit projects. This provision is currently not used. The Greater Minnesota transportation sales and use tax provision allowed the remaining 80 counties in the state, plus any metropolitan area county not joining the metropolitan transit area to impose a tax singly or as part of a joint powers agreement to fund a specified transportation or transit project, or transit operations.

Anoka, Dakota, Hennepin, Ramsey, and Washington counties, by resolution of their county boards, joined the now defunct Metropolitan Transportation Area joint powers agreement. Carver and Scott counties, although eligible, did not join the agreement. Scott County chose to impose its own separate tax under the Greater Minnesota transportation sales and use tax authority. The five counties making up the joint powers agreement which imposed this tax voluntarily terminated the agreement on September 30, 2017. All of these counties now impose a local transportation tax under the Greater Minnesota transportation sales and use tax authority instead.

Counties Currently Imposing a Transportation Sales and Use Tax

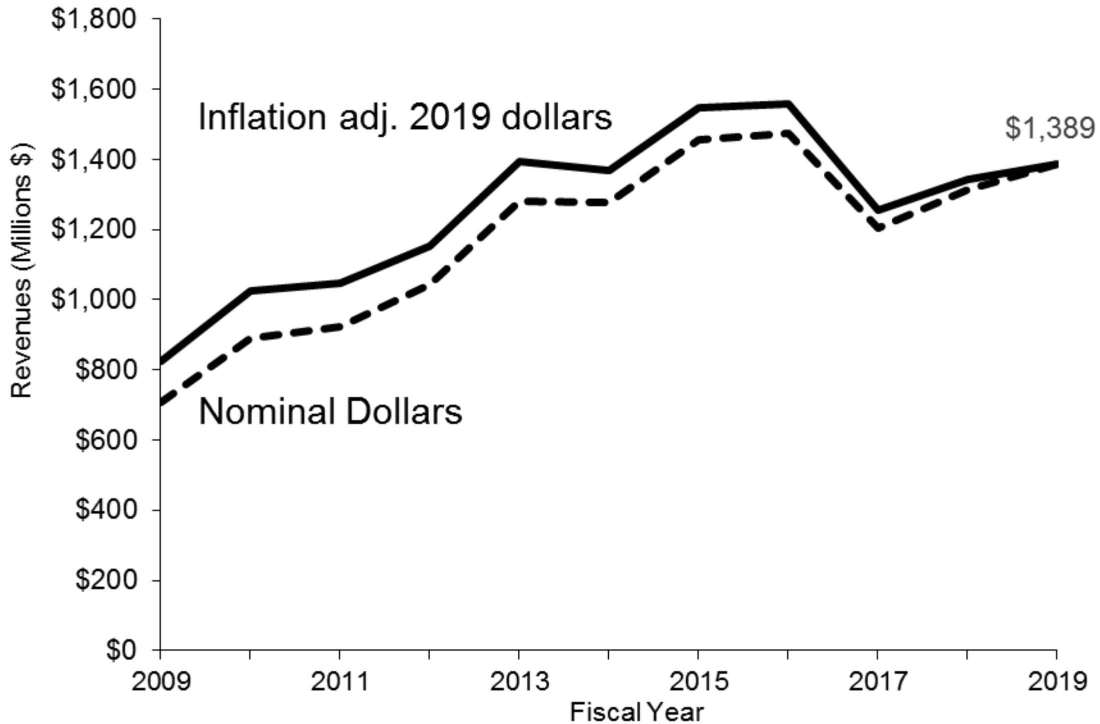
County	Date Tax Imposed	Tax Rate	Also Imposes a $20 per Vehicle Excise Tax
Anoka*	10/1/2017	0.25%	Yes
Becker	7/1/2014	0.50%	No
Beltrami	4/1/2014	0.50%	Yes
Blue Earth	4/1/2016	0.50%	No
Brown	4/1/2016	0.50%	No
Carlton	4/1/2015	0.50%	Yes
Carver	10/1/2017	0.50%	Yes
Cass	4/1/2016	0.50%	No
Chisago	4/1/2016	0.50%	No
Cook	1/1/2017	0.50%	No
Crow Wing	4/1/2016	0.50%	No

Dakota*	10/1/2017	0.25%	Yes
Dodge	1/1/2019	0.5%	No
Douglas	10/1/2014	0.50%	No
Fillmore	1/1/2015	0.50%	No
Freeborn	1/1/2016	0.50%	No
Goodhue	1/1/2019	1.0%	Yes
Hennepin*	10/1/2017	0.50%	Yes
Hubbard	7/1/2015	0.50%	No
Kandiyohi	4/1/2018	0.50%	Yes
Lake	4/1/2017	0.50%	No
Lyon	10/1/2015	0.50%	No
Mille Lacs	1/1/2017	0.50%	No
Morrison	1/1/2018	0.50%	No
Mower	1/1/2018	0.50%	No
Nicollet	1/1/2018	0.50%	No
Olmsted**	7/1/2017	0.50%	No
Ottertail	1/1/2016	0.50%	Yes
Pine	1/1/2017	0.50%	No
Polk	1/1/2018	0.25%	No
Ramsey*	10/1/2017	0.50%	Yes
Rice	1/1/2014	0.50%	No
St. Louis	4/1/2015	0.50%	Yes
Scott	10/1/2015	0.50%	Yes
Sherburne	1/1/2019	0.5%	No
Stearns	1/1/2018	0.25%	No
Steele	4/1/2015	0.50%	No
Todd	1/1/2015	0.50%	No
Wabasha	4/1/2016	0.50%	No
Wadena	4/1/2014	0.50%	No
Washington*	10/1/2017	0.25%	Yes
Winona	1/1/2017	0.50%	Noh
Wright	10/1/2017	0.50%	No

Notes:
* One of the counties that was part of the now defunct Metropolitan Transportation Area.
** Olmstead County originally imposed a tax of 0.25% on 1/1/2014 under Minnesota Statutes, section 469.46 to fund improvements related to the Destination Medical Center. The tax was increased to 0.50% in 2017 under the general law.

The Corporate Franchise Tax

Corporate Franchise Tax Revenues, FY 2009-2019



Graphic by House Research.
Inflation adjusted using the Consumer Price Index for All Urban Consumers (CPI-U).
Source: MMB. February 2012 through November 2018 consolidated fund statements.

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

iii. The special temporary federal depreciation rules ("bonus depreciation") enacted in 2002, 2003, and 2008 through 2017 do not apply.

iv. The section 179 expensing rules do not apply. Instead, 80 percent of the allowance is added to federal taxable income in the year claimed federally, and that amount is subtracted in equal amounts in the following 5 taxable years.

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; traditionally a 3-factor formula (based on the in-state percentage of property, payroll, and sales) was used. Minnesota has used a heavily sales weighted formula for decades and starting in tax year 2014, uses only sales (i.e., the percentage of the corporation's sales that are shipped or picked up by buyers in Minnesota). As noted below, most states now use sales only weighting, at least for manufacturers.

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 sales as the numerator and the total group's sales 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 income (rather than apportioning it) 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. **Historic rehabilitation credit.** A refundable credit applies equal to the comparable (nonrefundable) federal credit, effective beginning for tax year 2010.

v. **Employer transit pass credit.** This nonrefundable 30-precent credit applies to the employer-provided discount (reduced price) on transit passes for the taxpayer's employees. Estimated credits are approximately $700,000 per year.

vi. **Credit for sales of agricultural assets to a beginning farmer.** The 2017 legislature enacted a nonrefundable credit for taxpayers who sell or rent agricultural assets to a beginning farmer. The credit is calculated based on the value of the asset or the amount of rental income. The credit is capped at $5,000,000 in tax year 2018 and $6,000,000. The credit sunsets in TY 2023. The Department of Revenue estimates that the credit will reduce revenues by $5 million in FY 2019.

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 2013 legislature increased the dollar amount of the fee and indexed it for inflation. The tax ranges from $200 to $9,960, depending upon the size of the business measured by Minnesota property, payroll, and sales. The fee schedule for tax year 2018 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.

Tax Year 2016
Corporate Franchise Tax
Minimum Fee Schedule

Property, Payroll and Sales	Fee
less than $990,000	0
$990,000 to 1,989,999	$200
$1,990,000 to 9,959,999	$600
$9,960,000 to 19,929,999	$1,990
$19,930,000 to 39,859,999	$3,990
$39,860,000 or more	$9,960

2. Revenues

a. **Overview.** The corporate franchise tax is a relatively minor source of state revenue. It is estimated to provide about 5.4% of nondedicated general fund revenues for FY2019 (February 2018 forecast).

b. **Amount.** For fiscal year 2019, Minnesota Management and Budget estimates that the corporate franchise tax will raise $1.295 billion (February 2018 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. 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 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 2007-09 recessions, revenues declined by one-third or more, and typically rebounded within two to four years to equal or exceed their prior levels. 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, 2006-2008, and 2013. 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). If anything, volatility appears to have increased in the last two decades.

Corporate Franchise Tax Revenues
Peak to Trough Change During Recessions

Fiscal Year	Revenues (millions)	Percent change
1980	$381.2	-33.3%
1983	254.3	
1985	380.4	+49.6%
1990	478.9	-12.2%
1992	420.3	
1996	701.7	+67.0%
2000	800.1	-33.8%
2002	529.5	
2006	1,061.6	+100.5%
2007	1,171.1	-43.3%
2010	663.5	
2014	1,341.4	+102.2%
Source: MN Management & Budget		

3. **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.

m. In 2013, the legislature completely repealed the preference for foreign source income.

n. In 2017, the legislature changed the financial institution apportionment rules to include noncorporate entities and eliminated the corporate franchise tax exceptions for insurance companies that do not meet the federal definition of an insurance company or that are domiciled outside Minnesota.

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, other than 2013 repeal of the preferences for certain forms of foreign income and operations. 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 allowed certain qualifying domestic corporations ("Foreign Operating Corporations" or FOCs) to exclude 80 percent of their income from taxation. This was 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. In 2013, the legislature ended the explicit preference for foreign source income altogether. The *de facto* preference for foreign source income (i.e., the ability of multinational corporations to use transfer pricing to shift income to tax haven countries to reduce their tax burdens) has become a federal and international issue for OECD (Organisation for Economic Co-operation and Development) countries. These techniques flow through to state corporate taxes that use waters-edge type combined reporting, as Minnesota and nearly all states do.

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.

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. Nevada voters in 2014 rejected a proposal to adopt a gross receipts style tax, but in 2015 the Nevada legislature (following a governor's recommendation) enacted a gross receipts style business. This end a long period in which Nevada had no business entity tax.

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, Nevada, 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 (now the State Economist) completed a study of replacing the Minnesota corporate franchise tax with a VAT style tax for the Legislative Coordinating Commission in 2005.

iv. **The Federal Tax Cut and Jobs Act (TCJA).** Congress passed the TCJA in December 2017 which included a number of significant reforms to business taxes, including a reduction in the corporate rate from 35% to 21%, the repeal of the corporate AMT, a new deduction for pass-through business income, and provisions relating to the taxation of income in foreign tax havens. The TCJA also limited or eliminated some deductions, while providing for more generous treatment of depreciated property, as well as modifying NOL rules. Minnesota did not conform to any of these federal changes in 2018.

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 public securities markets. However, because so many publicly held companies are held by otherwise tax exempt investors (e.g., by foundations, pension funds, and foreigners or by other

retirement accounts such as IRAs and 401k accounts), recent estimates suggest less than one-third of C corporate profits are actually subject to double taxation.

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 2017 Tax Incidence Study (p. 108), prepared by the Department of Revenue, estimates that Minnesota consumers bear 42% of the tax, Minnesota labor 18%, and Minnesota capital 5%. The rest of the tax (45%) 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.

6. **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 is now completed.

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 using 100% sales 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 received 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).

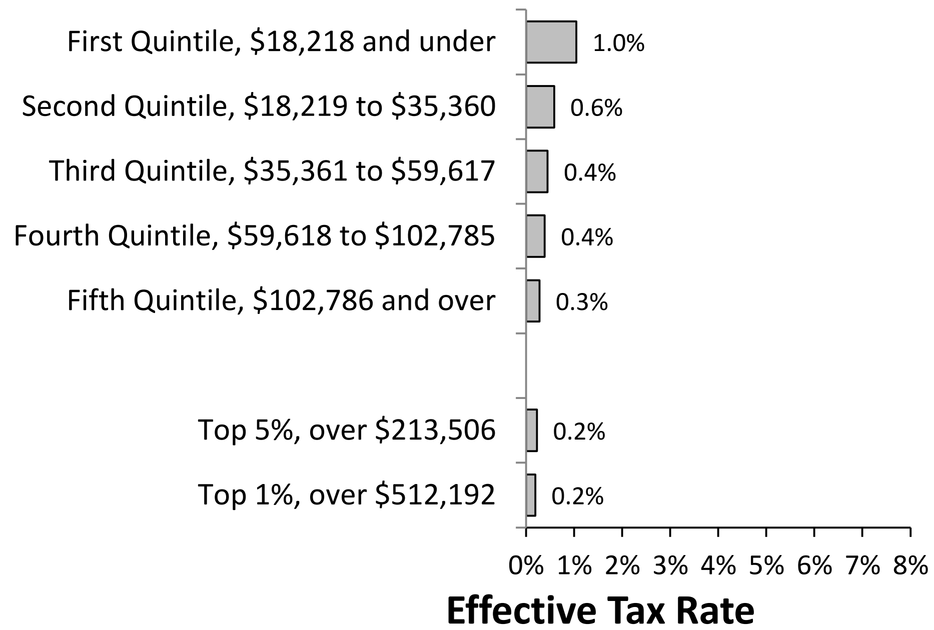
Businesses who have higher Minnesota sales factors and lower average Minnesota property and payroll have tax increases. The classic example is a national manufacturer of consumer products with few facilities in Minnesota (e.g., Proctor & Gamble or Microsoft).

c. **Competitiveness effects.** The principal argument for sales weighting is that it increases the state's competitiveness, i.e., it will help to attract investment or economic activity to the state, because it reduces the effective tax rate on new investment in plant and equipment. Put simply, because tax liability is unaffected by the presence of property or payroll, investing in a new or expanded plant or hiring additional employees has no effect on tax liability. Conversely, closing a plant or moving an office will not reduce tax liability, unless doing so totally severs ties with the state so that the business has no nexus (unclear whether just eliminating all property and payroll is sufficient to achieve that result). Some empirical studies support the conclusion that sales weighting increases investment in a state. 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.

d. **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

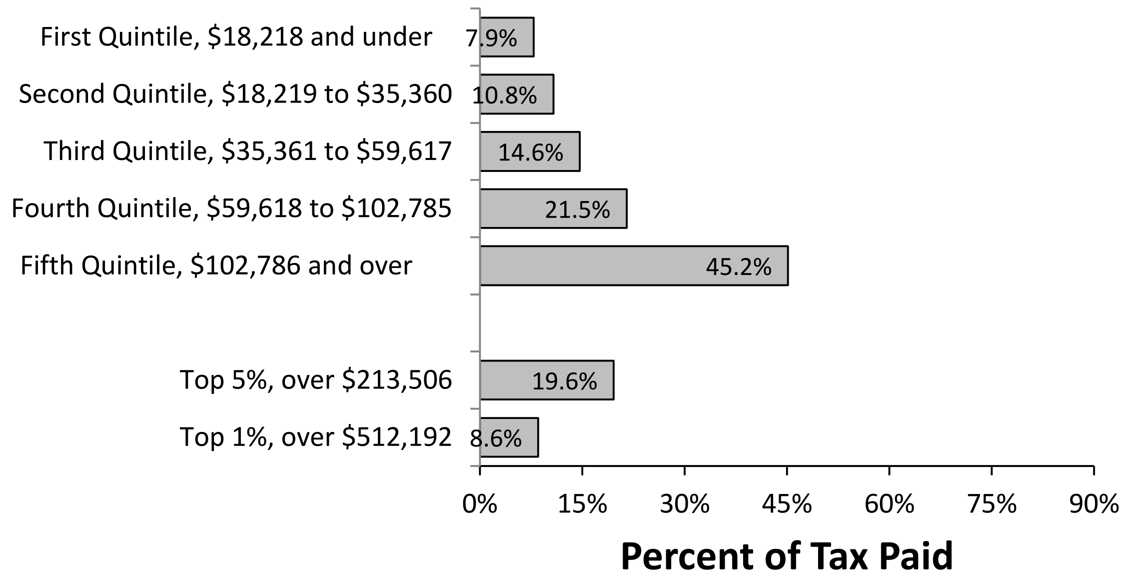
sales, regardless of where their capital is located. This makes it much more likely that the tax will be passed along to consumers.

Corporate Tax Burden
Effective Tax Rates by Population Quintiles (2014)



Source: Department of Revenue, 2017 *Tax Incidence Study*

Corporate Tax Burden
Distribution by Population Quintiles (2014)



Source: Department of Revenue, 2017 *Tax Incidence Study*

Motor Vehicle Fuels Tax

Tax Base

There are three main motor vehicle fuels taxes: the gasoline tax, the special fuels tax, and the aviation tax. The gasoline tax is imposed on all motor fuels used by vehicles on the public highways and on marine gasoline. The special fuels tax is imposed on propane and liquefied or compressed natural gas used by licensed motor vehicles. The aviation tax applies to aviation gasoline and jet fuel.

Exemptions

Motor fuels used by public transit systems receiving state financial assistance are exempt, as are fuels used by providers of transportation services for certain recipients of medical assistance, ambulance services, and certain providers of medical and dental services.

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 $.035 per gallon (the maximum amount under a variable rate which has applied since 7/1/2012). Thus, the total rate is 28.5 cents per gallon.

Special fuels are subject to an excise tax. Propane is taxed at the rate of 18.75 cents per gallon. Liquified natural gas is taxed at the rate of 15 cents per gallon while compressed natural gas is taxed at the rate of $1.974 per thousand cubic feet (or 25 cents per gasoline equivalent).

Aviation fuels are subject to an excise tax. Aviation gas is subject to a rate of 5 cents per gallon. Jet fuel is subject to a rate of 15 cents per gallon. However, airlines are subject to tax at lower graduated rates on their purchases. 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

	FY2018 Revenues (millions)	% of Total State Tax Revenue
Highway Fuels	$912.9	3.5%
Aviation Fuels	5.8	< 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). Until 2017, this rate was adjusted annually for inflation in the average retail price of cigarette under a 2013 change in the law. The 2013 legislation also repealed the $.75-cent/pack health impact fee and increased the combined basic rate and old health impact fee rate by $1.60 per pack to $2.83/pack. When the annual inflation adjustment was repealed in 2017, the tax was set at $3.04/pack, which was then the rate in effect under the inflator. The tobacco products tax is a percentage of the wholesale price.

Tax Rates

Cigarettes	$3.04/pack of 20
Tobacco Products	95% of wholesale price

Two exceptions apply to the 95-percent tax rate that applies to tobacco products:

- A minimum tax applies to each container of moist snuff equal to the tax rate on a pack of 20 cigarettes.
- Premium cigars (hand-rolled with a wholesale price of $2/cigar or more) are subject to a maximum tax of $.50/cigar, which effectively imposes a tax of $.50 on all premium cigars.

Nonsettlement cigarette fee. A special cigarette fee of 50 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 at a 35-cent per pack rate and increased by the 2013 legislature to 50-cents per pack rate. By its terms, the fee was intended to compensate the state for costs 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.

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

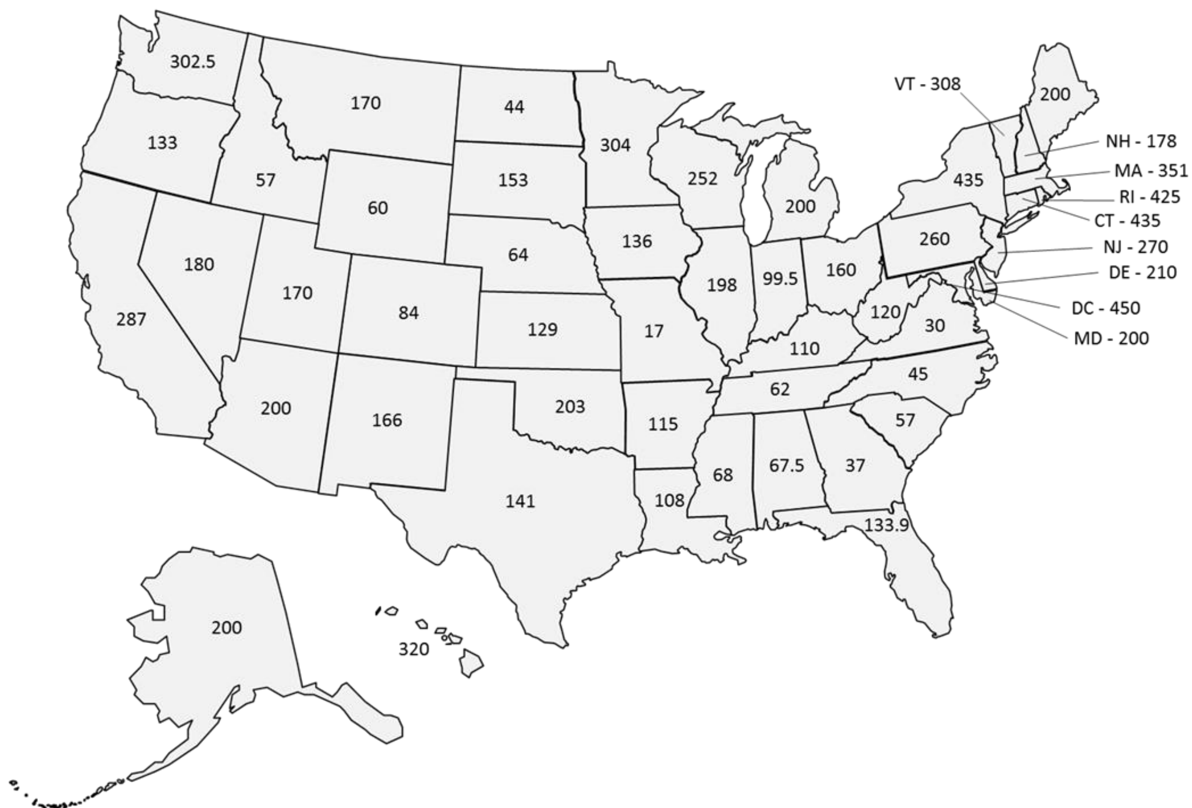
Fiscal Year 2019 (in millions)	$624
Percent of Total State Tax Revenue	2.3%

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.

Comparison with Other States

The map below shows the tax rates in other states as of January 1, 2017. 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.

Cigarette Excise Tax Rates



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 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.

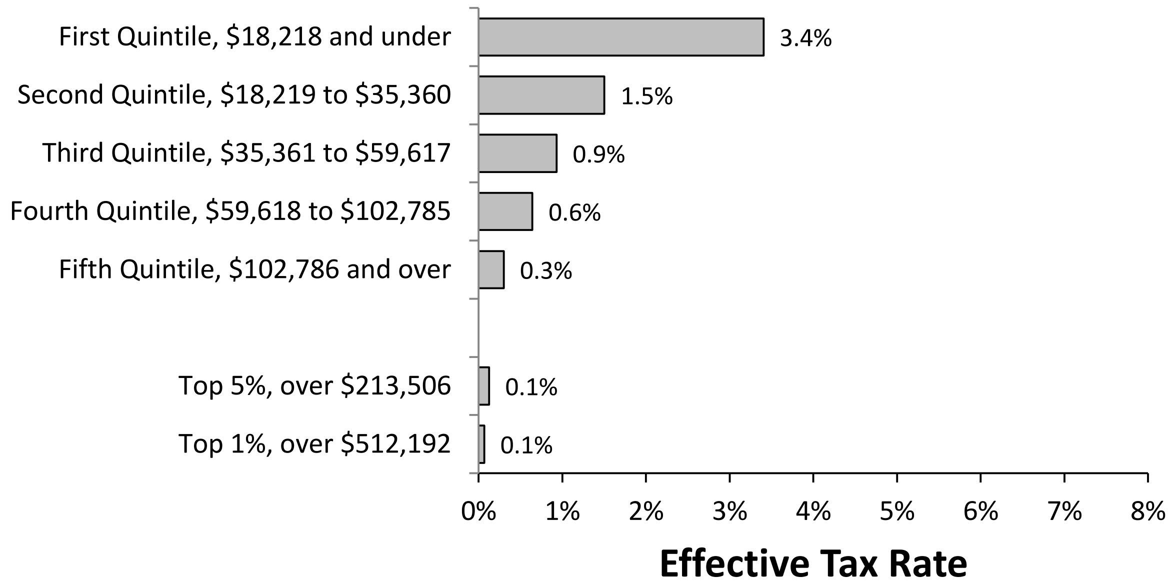
Revenue

Fiscal Year 2019 (in millions)	$93.1
Percent of Total State Tax Revenue	0.3%

The actual FY2018 revenues by beverage type and for the gross receipts tax are shown in the table below.

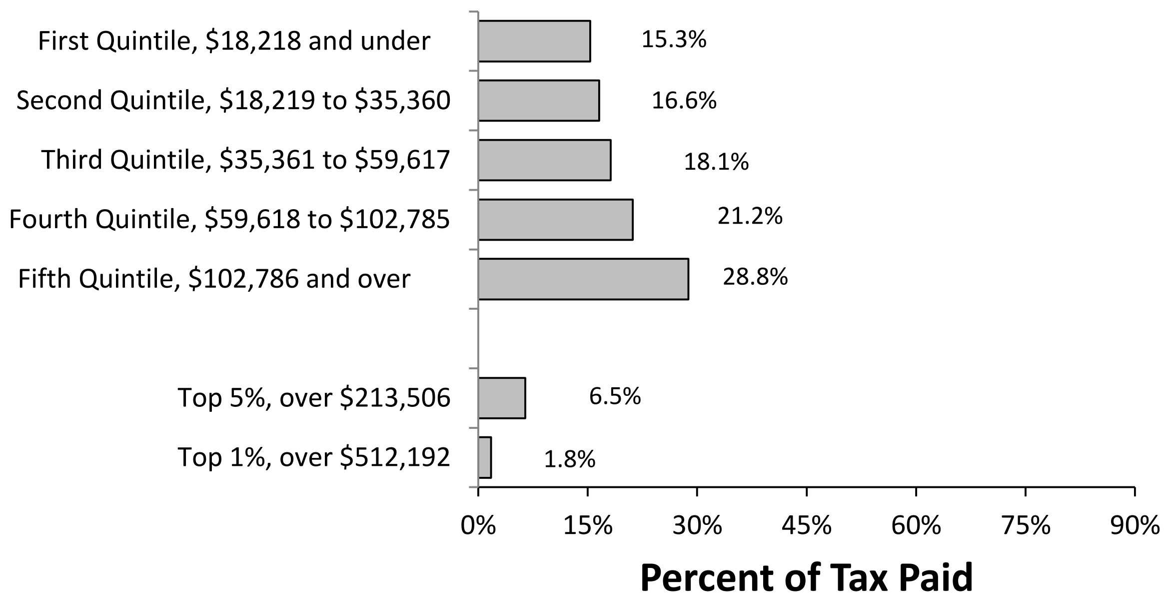
Beverage Type	**FY2018 Revenues (000)**	**% of Total**
Beer	$15,260	8.15%
Wine	7,764	4.14%
Distilled Spirits	69,451	37.08%
Excise tax total	92,437	49.35%
2.5% gross receipts tax	94,840	50.63%
Total	**$187,315**	
Source: MN Department of Revenue		

Excise Tax Burden (Fuels, Cigarette, and Alcohol)
Effective Tax Rates by Population Quintiles (2014)



Source: Department of Revenue, 2017 *Tax Incidence Study*

Excise Tax Burden (Fuels, Cigarette, and Alcohol)
Distribution by Population Quintiles (2014)



Source: Department of Revenue, 2017 *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 2019 (in millions)	$795
Percent of Total State Tax Revenue	3.1%

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. The law provides for contingent reduction in the tax rates, if certain conditions are met (ratio of revenue to expenditures from the fund and cash balances).

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 2019 (in millions)	$692
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 scheduled 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 2019 (in millions)	$507
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 2019		Total Amount (in millions)
Disposition:	State General Fund (97%)	$114.9
	County Revenue Fund (3%)	3.5
Total Fiscal Year 2019 (in millions)		$118.4
Percent of Total State Tax Revenue		0.5

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 2019		Total Amount (in millions)
Disposition:	State General Fund (97%)	$142.9
	County Revenue Fund (3%)	4.4
Total Fiscal Year 2017 (in millions)		$147.3
Percent of Total State Tax Revenue		0.5%

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 after deducting debts, funeral costs, and the cost of administering the estate. 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.

The value of taxable gifts (i.e., the amount of gifts made to a recipient in a calendar year over the annual federal exemption amount, currently $14,000) made within three years of the decedent's death are also added to the value of the taxable estate. Federal law includes, which Minnesota law follows, the amount of any federal gift tax paid on those gifts in the estate. (The gifts themselves are not included in the federal estate because federal gift tax applied or the gift reduced the joint exclusion amount available under the federal estate and gift taxes.)

Exemption

Prior to 2014, Minnesota had a *de facto* exemption of $1 million, based on a reference to the state death tax credit under prior federal law. Because of the manner in which the reference to old federal law was calculated, the $1 million amount did not function as a true exemption. Under 2014 legislation, a Minnesota-specific exemption (or true exemption) was provided, starting at $1.2 million for 2014 deaths and increasing in annual steps of $200,000 until it reached to $2 million by 2018. Yet in 2017, the legislature modified the exemption, increasing the amount that is exempt from the estate tax to $3 million in steps by 2020. By comparison, the federal estate tax provides an exemption amount of $11.4 million for deaths in 2019. The federal exemption amount is indexed for inflation and is "portable," that is, the surviving spouse inherits or can use the amount of federal exemption (exclusion) that was not used on the death of the first spouse. Congress doubled the amount of the exemption in the TCJA, but this provision will sunset in 2026.

The 2011 legislature enacted exemptions for qualified small business property and qualified farmland. These additional exemptions were effective for decedents dying after June 30, 2011, and are capped, in combination, at an amount that when added to the basic exemption equals $5 million for an estate. (Because the basic exemption is phasing up, the maximum amount of these combined special exemptions are reduced by an equal amount.) 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 2017 legislation also enacted new Minnesota rate schedules due to the conversion of the exemption from a zero bracket amount (in the rate structure) to an exclusion or exemption that is deducted in computing the Minnesota taxable estate. For estates of decedents dying in 2018 and thereafter, the rates range from 13.6 percent to 16 percent; the top rate applies to estates with values of $10.1 million or more.

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. However, as noted above, many of the federal estate's definitions and rules apply by reference to the Minnesota estate tax.

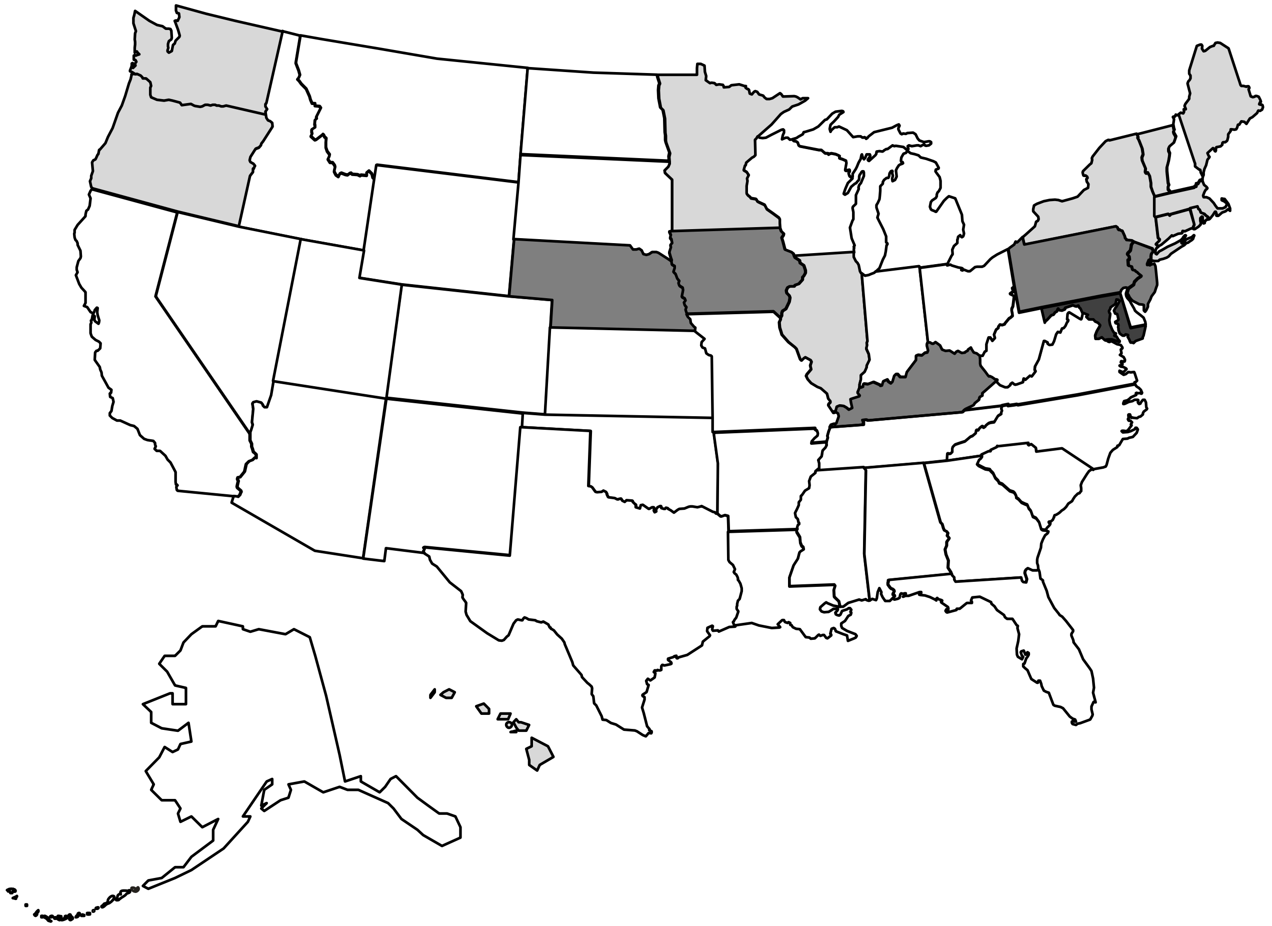
Revenues

Fiscal Year 2019 (in millions)	$129.3
Percent of Total State Tax Revenue	0.5

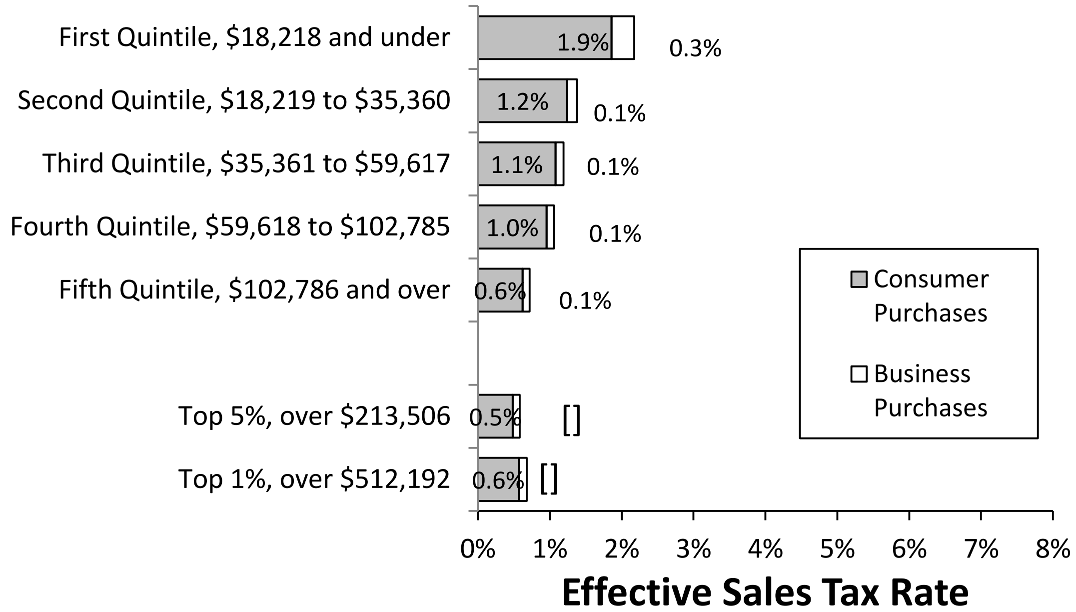
Revenues from the estate tax are deposited in the general fund. Revenues from the tax are very volatile, since they depend on the deaths of a few individuals. If one very wealthy individual dies, collections can soar. For example, in August 2005, the Department of Revenue received a tax payment for one estate of $112 million (total collections for FY 2006 were $216 million compared with total collections for FY 2005 of $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 January 2019, 33 states no longer have estate or inheritance taxes. The map on the next page shows the status of states' estate and inheritance taxes for 2019 deaths. Light shaded states have estate taxes, darker shaded states have inheritance taxes, and the darkest shaded states have both taxes. New Jersey estate tax was repealed starting for 2018 deaths, leaving the state with only an inheritance tax.

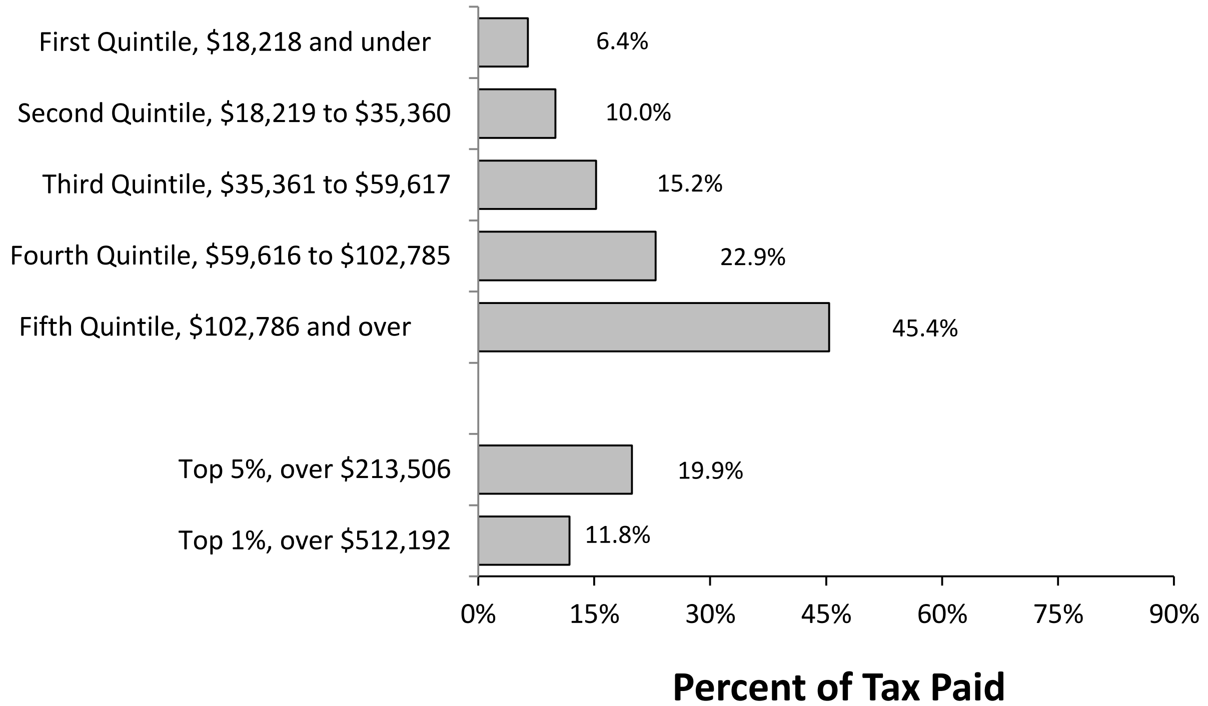


Other State Taxes Burden
Effective Tax Rates by Population Quintiles (2014)



Source: Department of Revenue, 2017 *Tax Incidence Study*

Other State Tax Burden
Distribution by Population Quintiles (2014)



Source: Department of Revenue, 2017 *Tax Incidence Study*