

HOUSE RESEARCH

Bill Summary

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Overview

This bill authorizes the commissioner of the department of trade and economic development (DTED) to designate up to 10 tax-free zones in economically distressed rural areas. Residents of the zones would not pay individual income taxes or property taxes. Qualifying businesses operating in the zones would be exempt from sales, income, and property taxes. Individuals who invested in zone businesses would be exempt on their business income attributable to activity in the zone, as well as capital gain taxes on zone investments. The zones would have a maximum duration of 12 years. Designations would occur in 2003 and the tax reductions would be effective in 2004.

In addition, the bill authorizes designation of up to 5 agricultural processing facility zones. These zones would be limited to the sites of the agricultural processing facilities themselves.

Section

1 Tax-free zone property. Provides that property in a tax-free zone is exempt from property taxation. This exemption does not apply, however, to the following:

- Land
- Commercial-industrial property where the neither the owner nor the lessee is a qualified business (See the summary below for section for the definition of a

qualified business.)

- Debt service levies, if the bonds were issued before designation of the tax-free zone

The exemption applies to the first assessment year after designation of the zone by the commissioner of trade and economic development.

2 **Individual income tax exemption.** Provides that income earned by a resident of tax-free zone is exempt from individual income taxation and that income derived from investing in or operating a trade or business in a tax-free zone is exempt from individual income taxation. The qualifying rules for these exemptions are found in section 0.

3 **Corporation franchise tax exemption.** Provides income from operating in a tax-free zone is deductible in calculating taxable income for purposes of the corporate franchise tax. The details of this exemption are found in the summary of section 0 below.

4 **Individual AMT exemption.** Extends the individual income tax exemption to the alternative minimum tax or AMT.

5 **Corporate AMT exemption.** Exempts income from operating a business in a tax-free zone from the corporate AMT.

6 **Corporate minimum fee.** Excludes property and payroll located in a tax-free zone from use in calculation of the minimum fee under the corporate franchise tax. This fee applies to partnerships and S corporations, as well as traditional C corporations that are subject to the franchise tax.

7 **Sales tax exemption.** Provides a sales tax exemptions for businesses located in a tax-free zone. To qualify for this exemption, the goods or taxable services must be primarily used in the zone and purchased during the duration of the zone. The exemption extends to contractor purchases (if the final use of the property is in the zone) and to local sales taxes.

8 **Motor vehicle sales tax exemption.** Provides an exemption from the motor vehicle sales tax for vehicles used by a business in a tax-free zone. The vehicle must be both garaged in the zone and primarily used in support of zone operations of the business (e.g., delivering products produced in the zone or delivering supplies used in the zone). The exemption also applies to local sales taxes.

9 **Definitions.** Defines terms for purposes of the tax-free zone statute.

- **Agricultural processing facility** means a facility that transforms, packages, sorts, or grades agricultural, livestock, or plant products into goods for intermediate or final consumption.
- **Applicant** is a local government or governments applying for designation of a tax-free zone.
- **Commissioner** is the commissioner of trade and economic development.
- **Development plan** is a development plan adopted by the local government as part of its application for designation of a tax-free zone.
- **Local government unit** is a city (either home rule charter or statutory), county, a town, or school district.
- **Person** means individual or any type of legal entity (corporation, partnership, etc.).
- **Qualified business** means a trade or business operating within a tax-free zone. If a

business relocates operations into a zone, it must meet either of two tests to be a qualified business:

- o **it increases employment by 20% in its first full year of zone operations; or**
- o **makes a capital investment in the zone equal to 10% of its gross revenues in the prior year from the portion of the business it relocated to the zone.**

- **Tax-free zone** is a zone designated under the statute's procedure and includes an agricultural processing zone.
- **Zone percentage** is a fraction used to apportion income to zone for business operating both within and outside of the zone. The percentage is the average of the zone payrolls and property over total Minnesota payrolls and property.

10 Development plan. Requires applicants for zone designation to adopt a written development plan containing at least:

- A map of the zone with details on present uses and conditions in the area
- Evidence of community support and commitments to the zone
- Description of the plans and methods that will be used to stimulate development of the zone
- Description of the characteristics of the zone (e.g., social, economic, and demographic conditions)
- Description of the anticipated activity in the zone
- Any other information the commissioner requires.

11 Limitations. Establishes various rules governing tax-free zones:

- **Maximum size** is limited to 5,000 acres. For an agricultural processing zone, the maximum size is limited to the site of the facility, including space for ancillary facilities and expansion in the "reasonably foreseeable future."
- A zone may be divided into as many as 6 noncontiguous **subzones**. These subzones may be noncontiguous; each subzone must have a minimum size of 20 acres.
- Zones must be located **outside of the Twin Cities (7 county) metropolitan area**.
- No person or entity may own over half the property in the zone. This rule does not apply to an agricultural processing facility zone.
- A zone cannot overlap with a **border city development zone**. A border city can, however, choose to seek designation of the area of a border city development zone as a tax-free zone by providing for removal of property from the border city zone. If property owners in the existing zone are receiving incentives under it, they must consent to the removal. The removal can be contingent upon designation of the zone

as a tax-free zone. Border city development zone incentives cannot be provided to businesses for operations in a tax-free zone

- The **maximum duration** of a zone is 12 years. A shorter duration can be requested by the applicant or specified by DTED in its designation of the zone.

12 Application for designation of zones. Provides rules governing applications for zone designations.

Who may apply. One or more local governments (city or town, county, and school district) may apply for designation of a zone. The zone must be located, at least partially, in each of the applicant governmental units. A local government can apply for only one zone designation.

Contents of application. The application must include:

- A development plan for the zone
- The proposed duration of the zone
- Resolutions approving the application by all of the cities, towns, and counties that include the zone (This is essentially an agreement to provide the local tax reductions- i.e., property tax or local sales tax exemptions.)
- Consents to removals, if the proposed zone includes a border city development zone
- Supporting evidence to help the commissioner of DTED evaluate the merits of the application

13 Designation of tax-free zones. Directs the commissioner of DTED to designate no more than 10 tax-free zones. These designations are to be made based on need and likelihood of success in revitalizing economically distressed rural areas in Minnesota. The commissioner may also designate up to 5 agricultural processing facility zones.

Need indicators. The commissioner must consider the following measures of need (generally measured relative to the averages for the state as a whole):

- Percentage of the population below the poverty rate
- Unemployment rate
- Deteriorating or underutilized property
- Deteriorated housing
- Median family income
- Population loss in the last two decades

- Closing of businesses or major employers
- Physical characteristics of property that it make it difficult to develop
- Presence of existing public and private infrastructure to support expanded development

In applying these indicators, the best available data is to be used. If data that is specific to the zone is not available, the commissioner is to use data for the next smallest area that is available.

Success indicators. The commissioner may use the following as measures of likely success of a proposed zone:

- Viability of the development plan
- How creative and innovative the plan is
- Local public and private commitment to the effort
- Existing resources available in the zone
- Relationship of the designation to other projects and programs
- How regulatory burdens will be eased in the zone
- Job training efforts that will be linked to the designation

Schedule. The designations are to be made during calendar year 2003 and will take effect beginning January 1, 2004. The bill contains blank dates for (1) DTED specifying the rules for applications, (2) the application deadline, and (3) designation of zones by DTED.

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Available tax incentives. The following tax incentives are available in tax-free zones:

- Residents are exempt from the individual income tax
- Business owners are exempt from the individual income tax on income from business operations and investments in a tax-free zone
- The corporate franchise tax does not apply to corporate income generated by zone operations
- State and local sales taxes do not apply to purchases used by businesses in a tax-free zone
- Property taxes do not apply to improvements in the zone (both home and business property, if the business is a qualified business)

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Individual income tax exemption. Provides income tax exemptions for residents of tax-free zones, individuals operating businesses in zones, and investors in zones. These exemptions

only apply if the income would otherwise be taxable.

Exemption for residents. A resident is defined as an individual who is domiciled in and lives in the zone for at least 184 consecutive days. This 184-day period is measured from the earlier of the zone designation or when the individual moved into the zone. The individual must be a resident on the last day of the taxable year to qualify. A resident of a zone is not taxable on the following income (if it is received while a resident of the zone):

- Wages
- Trade or business income
- Interest and dividends
- Income from a trust or estate (that otherwise would be taxable to the individual)
- Capital gain (not exempt as gain on zone property described below) - prorated for the period of time that the property was held which the individual was a zone resident

Rents. Rents received for both real and tangible personal property located in the zone are exempt. Rents from personal property that is used both within and outside of the zone must be apportioned based on the number of days the property was used in the zone.

Business income of nonresidents. Income from operating a business in a tax-free zone is exempt. If the business operates both within and outside of the zone, the income must be apportioned using the share of property and payroll located in the zone to the total property and payroll of the taxpayer.

Capital gains. Capital gains on real and tangible personal property located in a tax-free zone or sale of a business operated in the zone are exempt from taxation. Different rules apply to determine the amount of the exemption:

- **Real property.** Capital gains on real property located in a tax-free zone are exempt from taxation based on the share of the holding period that took place while the area was designated a tax-free zone. To illustrate, assume A purchased a piece of real property for \$1,000 and held the property for 10 years. A, then, sold the property for \$5,000. For 6 years of the 10-year holding period, the property was located in a tax-free zone. Of A's \$4,000 capital gain (\$5,000 sale price - \$1,000 purchase price = \$4,000), 60 percent or \$2,400 would be exempt from taxation ($\$4,000 * 60\% = \$2,400$), since 6 years out of the 10-year holding period occurred while the zone was designated a tax-free zone.
- **Tangible personal property.** Capital gains on tangible personal property located in a tax-free zone are exempt from taxation based on the share of the holding period that took place while the zone was designated a tax-free zone and the usage of the property in the zone. This calculation is essentially the same as that for real property. However, if the personal property was used both within and without the zone, the exemption amount must also be multiplied by a fraction. The numerator of the fraction is the number of days the property was used in the zone while it was designated as a tax-free zone and the denominator is the total number of days the

taxpayer held the property.

- **Ownership in qualified business.** Capital gain on an ownership interest (e.g., stock or a partnership interest) in a qualified business is exempt from taxation. This exemption equals the tax-free zone percentage for the business multiplied by the capital gain. The zone percentage is calculated using as its denominator the total property and payroll (not just the Minnesota payroll and property). This exemption does not apply if the zone percentage is less than 25 percent. The business entity is responsible for notifying the owner of its qualification for the capital gain exemption.

16 Corporate franchise tax exemption. Provides that a corporation operating in the zone is exempt from the corporate franchise tax, if it is a qualified business. If the entire business operates in the zone, the corporation is fully exempt taxation under the corporate franchise tax and would not be required to file a return. If the corporation does business both within and outside of the zone, the following rules apply:

- **Regular tax.** The corporation's taxable net income is multiplied by its zone percentage (average property and payroll in the zone divided by total Minnesota property and payroll) and subtracted from its taxable income.
- **AMT.** The corporation's alternative minimum taxable income is multiplied by the zone percentage and this amount is subtracted from the taxable income.
- **Minimum fee.** Its zone property and payroll are excluded from calculating the minimum fee.

17 Repayment of tax benefits. Requires a business to repay tax benefits or any non-tax amounts provided by the local governments, if the business:

- Relocated into the zone after its designation and
- Ceased to operate its business in the zone.

The provision requires repayment of the last two years of benefits received before the business ceased its zone operations.

Disposition or repayments. Repayments of state tax reductions are paid to the state and deposited in the general fund. Repayments of property taxes are distributed to local governments in the same manner as delinquent property taxes. Repayments of local sales taxes are made to the unit imposing the tax.

Authority to collect. The commissioner of revenue is given authority to collect repayments in the same manner as unpaid taxes.

18 Tax-free zone aid. Provides for the payment of state aid to partially reimburse cities and counties with tax-free zones for a proportionately large loss of tax base as a result of the zones. To qualify for this aid, a city or county must experience at least a 3% drop in tax capacity (as compared with a base year of 2001) as a result of the property tax exemption provided through the tax-free zone. The amount of aid is calculated using the following formula:

$0.5 * \text{local unit's rate in 2003} * [\text{tax-free zone exempt tax capacity} - (0.03 * 2003 \text{ tax capacity})]$

Certification by assessor. The county assessor is to certify entitlements to this aid to the commissioner of revenue. The commissioner notifies the each city and county of its entitlement to aid by August 20 of the assessment year. The aid is paid by July 20 of the payable year. An appropriation is made to the commissioner of revenue for the aid.

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Appropriations. Appropriates an unspecified amount to the commissioners of DTED and revenue to cover the cost of administering the act.