

# Overview of Department of Revenue Tax Reform Options

Over the past year, the Minnesota Department of Revenue has engaged in a tax reform process that has included a Citizen's Jury, Citizens Dialogues around the state, stakeholder meetings, and internal study teams. The Department of Revenue is now designing a tax reform package for the Governor's consideration. The Governor will determine which of these options will be part of the administration's tax legislation for the 2001 session.

Below is an overview of the options under consideration by the Department of Revenue. Items that are more technical or administrative in nature, or that would affect a narrow range of taxpayers, are listed very briefly. Readers desiring more detail should see the Department of Revenue's briefing papers at [www.taxes.state.mn.us/reform/brpap2000.html](http://www.taxes.state.mn.us/reform/brpap2000.html).

## INDIVIDUAL INCOME TAX

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### ***Broaden the base and lower the rates***

Options under consideration include:

- Change the starting point in determining Minnesota income tax from Federal Taxable Income (FTI) to Federal Adjusted Gross Income (FAGI). FTI is the measure of income after subtracting either itemized or standard deductions, FAGI is a broader measure of income before taking deductions. This change would eliminate the effect of federal itemized deductions (such as charitable giving and the mortgage interest deduction) on the Minnesota income tax.
- Eliminate most additions to and subtractions from taxable income on the Minnesota tax form. There are currently 5 additions and 11 subtractions, including the non-itemizer charitable deduction, health insurance subtraction for the self-employed, and K-12 education deduction.
- Eliminate many credits, such as the long-term care insurance credit and employer transit pass credit.
- As a result of these changes, the income tax rates could be lowered to 5%, 6.5%, and 7.5% while still collecting the same total amount of tax. The current income tax rates are 5.35%, 7.05%, and 7.85%.
- Streamline refundable credits (see below).
- Remove check-offs from the income tax form (state elections campaign and non-game wildlife fund). Revenue is not necessarily proposing eliminating these programs or their funding, but rather suggests that they be administered outside the income tax system.
- 70% of taxpayers would receive a tax cut, 30% would see a tax increase. Approximately 100,000 persons would no longer owe any Minnesota income tax. The progressivity of the income tax would remain about the same.

### ***Streamline Refundable Income Tax Credits***

Revenue is considering combining the existing Working Family Credit (WFC) and the K-12 education credit. The Working Family Credit is a refundable credit for low-income taxpayers with earnings from work. For tax year 2000, a small WFC is available to taxpayers with no children up to an income of \$10,380. Larger WFCs are available to families with children; one-

child families are eligible with incomes up to \$27,413 and families with two or more children up to \$31,152.

This proposal would use the existing WFC as the base and add an additional \$100 for one child and \$200 for two children as a replacement for the K-12 education credit. Although the simplification of the K-12 credit may increase the number who receive it, some families on the upper limits of income eligibility for the K-12 credit would no longer receive any credit, as they are not eligible for the WFC.

It is not clear at this point whether the streamlined credit would also incorporate the current Minnesota child care credit – there is some discussion of eliminating the credit and transferring the cost to direct child care appropriations.

In addition to streamlining, Revenue may propose additional expansion of the WFC as needed to offset tax increases to low-income taxpayers that may occur from other changes in the tax system.

### ***Additional Options Under Consideration***

- Re-engineering the current individual income tax system – this involves modifications to the implementation and processing of individual income taxes.
- Tax Compliance – Revenue is focusing on non-filers (those who legally should file but do not) and bringing them into compliance.

## **PROPERTY TAX**

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### ***Direct state payment of the general education levy***

The primary focus of the Ventura administration's tax reform process is the property tax. The Governor has already begun to discuss his proposal for the state to pay directly for the state-determined general education levy.

Currently, Minnesota spends a total of \$7.3 billion on K-12 education. Only 25% of this spending — \$1.8 billion — comes from the property tax, direct state aids make up 66%, and the remaining 9% comes from other sources. Of the \$1.8 billion in education spending that is raised through property taxes, 48%, or \$900 million, is the state-determined general education levy. This is the portion of school funding that the state requires local governments to raise through the property tax.

Under Governor Ventura's proposal, the \$900 million general education levy would be taken off local property tax collections, but the state would need to replace those property taxes with other revenue sources. Some of the ways the state is looking to fill the gap are through a statewide property tax on business properties, expansion of the sales tax base, and/or cuts in intergovernmental aid to towns and cities called HACA.

### ***Classification Reform***

Minnesota is one of about 30 states that impose different property classification rates (class rates) based on a property's use. The class rate describes what percentage of the property's market value will be used to determine its property tax.

Differences in class rates mean that properties of equal value but different uses will pay different amounts of tax. The major classifications are: Residential Homestead (owner-occupied homes), Residential Non-homestead, Market-rate Apartments, Low-Income Apartments, Commercial/Industrial/Public Utility, Seasonal Recreational Commercial (resorts), Seasonal Recreational Residential (cabins), and Agricultural.

Within some of these class rates, there are different tiers based on value. For example, the first \$76,000 of value (called the first tier) of a homestead has a class rate of 1%, but any value over \$76,000 (the second tier) has a class rate of 1.65%.

Revenue is considering combining some of these classes, so that all similar-use properties (such as homes, apartments, and cabins) are subject to the same class rate, and to eliminate or reduce tiers within classes.

Overall, Revenue suggests that the state rely more on the Property Tax Refund program (known more commonly as the Circuit Breaker and Renters Credit) to provide targeted tax relief, rather than providing general tax relief to whole categories of property through the classification system.

### ***Reforms in property tax administration***

Options include:

- Eliminate This Old House/This Old Business, repeal Blind/Disabled/Veterans class rate, and exemption for Congressional Medal of Honor winners, and determine how the goals of these programs could be better met through non-class rate mechanisms. Grandfather current beneficiaries.
- Let Limited Market Value sunset in 2002. Limited Market Value is a provision in current law that caps the amount that a property's assessed value can grow in one year. Revenue suggests that the state's Special Property Tax Refund be used to cushion the effect of large market value increases. This Refund is for homeowners of any income level who experience large increases in their property tax bills.
- Evaluate changes to incentives for non-development of land, alternative payment dates (such as going to monthly payment options), changes to the Senior Deferral Program, taxation of manufactured homes, and homestead definitions.

### ***Additional Options Under Consideration***

- Changes to assessment practices/state oversight
- Changes to forms/process to make property tax more understandable

## **EXEMPT ENTITIES**

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### ***Modifications to the definition of "purely public charities" for exemption from property tax***

Under current law, Minnesota provides an exemption from the property tax for institutions of "purely public charity." However, the law does not define this term, and therefore it has been determined over time through a series of lawsuits. Revenue wants to provide more uniformity of definition across jurisdictions and better instructions to assessors on how to determine if a property is exempt.

Options under consideration are:

1. Use a more narrowly defined definition (focusing more on meeting the basic needs of the poor).
2. Put into law the “North Star” test. North Star is the current case law definition to determine exempt status, which looks at seven factors, including the organization’s purpose, whether it is supported by donations and gifts, and whether recipients of the charity are required to pay for services.
3. Adopt 501c3 criteria.

Revenue seems to be leaning towards tightening up the definition. Option 1 would significantly narrow the exemption. Option 2 may also be a significant narrowing of the exemption, depending on how it is put into law. Option 3 would expand the definition and make it more like the exemption for sales and income taxes.

### ***Local fees/payments in lieu of taxes***

Currently, some organizations that are exempt from the property tax enter into voluntary agreements with local governments to make payments in lieu of taxes. Revenue believes changes are needed to allow local units of government to diversify funding sources and address the principle that taxes paid should reflect services received.

Options under consideration include:

1. Allow local governments to require payments in lieu of taxes or other “service fees” on nonprofits, whether exempt from property taxes or not.
2. Continue current “voluntary” system with state oversight.

Option 1 would have significant impact on all nonprofits owning property, although the level of impact would depend on whether local governments decide to charge a payment, and how large that payment might be.

### ***Other Options Under Consideration:***

- Expand eligibility for exemption from sales tax on purchases — eliminate the current application process for sales tax exemption certificates and use some other recognizable status (such as 501c3). This would mesh with many nonprofits’ belief that because they are exempt for federal income tax purposes, they are exempt from sales tax.
- Exempt more purchases made by exempt entities — entities exempt from paying the sales tax currently still must pay tax on meals, lodging, motor vehicles, and gambling equipment. Revenue may exempt these purchases from the sales tax.
- Special exemptions from the sales tax of certain sales by nonprofits, particularly those seen as competing with the private market, may be eliminated. This could include ticket sales to arts events, memberships at YMCAs and similar organizations, certain fundraising sales by youth and senior groups, and certain golf tournaments.
- Require exempt entities to obtain a sales and use tax identification number.

## **SALES TAX**

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### ***Broaden the base and lower the rate***

Revenue is considering “base broadening” in the sales tax area, which would mean expanding the sales tax to items not currently taxed, such as services. Expansion of the base would allow

a lower rate, but how much lower will be determined by how much the base is broadened, and whether the amount of tax raised by the sales tax would be the same as under current law or increased.

Revenue has indicated that it is not inclined to extend the sales tax to items such as food, clothing, child care, medical services, and school tuition.

It is unclear what the impact of sales tax changes will be on individual Minnesotans' tax bills. The sales tax is the biggest part of the state tax bill for low- and moderate-income families. If the rate is lowered significantly, this may lessen the burden on struggling families. However, if the tax is extended to services that make up a significant part of family budgets, their sales tax burden may increase.

***Other Options Under Consideration:***

- Changes to rates, due dates, payments. Options include: eliminate/phase out the June accelerated sales tax payment; have the same sales tax rate on all items (liquor and rental cars have different rates); and changes to time of month that sales tax payments are due.
- Exempt business inputs.
- Exempt capital equipment.
- Exempt state and local government from the sales tax.

## **HEALTH CARE TAXES AND HEALTH-RATED EXCISE TAXES**

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The provider tax, which funds the MinnesotaCare program, has received a lot of attention from the legislature in recent years, and the House Republicans have made it a priority to repeal the tax. Revenue has considered the issue of the MinnesotaCare tax, but appears to prefer reform. Options include changing to a flat rate, credits, subjecting certain medical services to the general sales tax, or eliminating some exemptions for MinnesotaCare tax.

Revenue also is looking at the excise tax on cigarettes. Minnesota has a relatively low tax on cigarettes and the funds raised are used for general purposes. One possibility is to increase the tax on cigarettes and devote at least some of the proceeds for health care. Generally, Revenue is keeping an eye on the overall balance of the tax system to make sure it does not become more regressive. However, the cigarette tax is one that Revenue may be willing to increase, despite the fact that such an increase would hit low-income people hardest. Similarly, Revenue may consider increasing the taxes on beer and table wine.

***Other Options Under Consideration:***

- Repeal premium tax on nonprofit health plans
- Repeal wholesale drug distributor tax

## **CORPORATE TAX REFORM**

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***Change the apportionment formula***

When determining what portion of corporate income is subject to Minnesota tax, current law uses a formula based on 75% sales, 12.5% property, and 12.5% payroll. Revenue has studied a number of possible changes, including an equally weighted three factor formula, double weighted sales factor, single sales factor, flexible apportionment formula, or keeping the current

formula. Revenue's corporate tax reform team mainly studied the single sales factor and flexible apportionment formula.

### ***Change of tax base***

This looks at eliminating preferences to specific taxpayers. Among the options are:

- Eliminate the percentage depletion and cost depletion modifications, certified pollution control facilities modifications, and modification related to intangible drilling costs. These existed in the past because Minnesota's definition of net income did not match the federal definition of federal taxable income.
- Eliminate two environmental tax modifications (because the federal government has repealed the federal environmental tax.)
- Eliminate the charitable contribution modification and federal special deduction in order to conform to federal definition of taxable net income.
- Eliminate foreign operating corporation provisions.
- Eliminate foreign royalty deduction (because of the unintended consequence that it provides incentives to manufacture in foreign companies).

### ***Corporate tax deductions***

Options considered include repealing the Minnesota dividend received deduction, changing the contributions deduction, and changing net operating loss deduction. The change to the Minnesota dividend received deduction would mean a contribution deduction for all contributions up to the 10% federal limitation, but would no longer favor contributions made to Minnesota charitable organizations.

### ***Corporate tax credits***

Options include modifying credit for increasing research and development and elimination of the credit that funds the Job Training Program Credit and replace it with an appropriation.

The Jobs Training Program Credit currently funds a single job training program. To obtain the credit, the job training program issues a certificate, the taxpayer must file a claim for a refund. Eliminating the credit responds to a perceived need for this program to be coordinated with other state-funded job training programs, but may have a large impact on the nonprofit organization that the credit was specifically designed for.

### ***Other Items Under Consideration:***

- Business entity tax
- Changes to AMT/Minimum Fee