

Tax Decisions in the 2001 Legislative Session

Perhaps one of the most contentious bills during the 2001 legislative session and subsequent special session was the omnibus tax bill. In the end, significant changes were made to Minnesota's property tax system and the way certain government services are funded. The bill provides \$759 million in general fund tax reductions for the 2002-03 biennium and a \$1.955 billion reduction for 2004-05, as well as a \$791 million rebate.

This summary describes the major decisions made in the areas of property taxes and government financing reform, the rebate, income and corporate taxes, sales taxes, health care taxes, and taxes on nonprofits. Throughout, provisions with an impact on low- and moderate-income families are emphasized.

Property Taxes and Government Financing Reform

The centerpiece of the 2001 tax bill is property tax and government financing reform and relief. Statewide, property taxes are predicted to be \$987.5 million lower in 2002 as a result of the omnibus tax bill. At the same time, the state takes on new commitments to education and transportation needs that were previously funded through property taxes. This portion of the bill has a net cost to the state's general fund of \$625 million in the 2002-03 biennium and \$1.959 billion in 2004-05. The bill makes major changes in what services are funded by property taxes, in determining the total amount of property taxes to be raised, and in how the property tax burden is distributed among taxpayers.

Education and Transit: Property Taxes Replaced by Other Funding

One principle guiding the Ventura administration's tax reform process is that state mandated services should be funded by state revenue sources and local services by local property taxes. The most significant example of this philosophy is the bill's elimination of the general education levy, which is approximately \$800 million of K-12 education funding that is determined by the state but is raised by local property taxes. The state will now pay for basic education directly through state revenue sources. The bill also exempts cabins and farmland from paying voter-approved property tax increases, known as *referenda levies*, passed by school districts and other local units of government.

This reduction is partially offset by a new statewide property tax on businesses, cabins, and commercial resorts, which will collect \$592 million in 2002. The \$592 million initial levy will go into the state's general fund; however, the amount by which the levy increases each year due to inflation is dedicated to education (\$44.8 million in 2004-05).

Transit operating expenses also will no longer be funded through property taxes. The omnibus tax bill replaces property tax revenues with a portion of the funds raised by the sales tax on motor vehicles (21.75% of revenues collected in 2003 and 23.75% of revenues in following years). This means that \$116 million in transit funding is removed from the property tax levy for 2003, mainly in the metro area.

Changes to Local Government Revenues

The omnibus tax bill makes considerable changes to how much local government revenue comes from property taxes and how much from state aids. The bill provides for the state

takeover of the cost of certain services currently paid by county property taxes, with the intention of replacing general state aid with more targeted aid programs. Counties will see a reduction in the amount of state aid called Homestead and Agricultural Credit Aid (HACA) they receive, but will be reimbursed for court costs and a percentage of their costs for day training for the developmentally disabled and out-of-home placement.¹

State aid programs for cities and towns are also significantly altered. The tax bill ends HACA for all local governments except counties. This eliminates \$200.3 million of aid in FY 2003 for cities, \$29.3 million for townships, \$28.7 million for special districts, and \$9.3 million for school districts. The other main aid program, Local Government Aid (LGA), is increased by \$140 million for cities, but will no longer be distributed to towns, who face a \$3.8 million aid reduction in 2003.² The net effect is a \$60.3 million loss in aids to cities as a whole and a \$33.1 million loss for towns. However, because of modifications to the LGA formula, some cities will receive more aid than under current law. Cities are likely to adjust their property tax collections up or down, depending on whether they receive a cut or an increase in their aids. However, the omnibus tax bill also includes levy limits, which puts a cap on how much a local government's total revenues from property taxes and state aids can grow from one year to the next.

Property Taxes on Individual Properties

Not only does the omnibus tax bill change what the property tax pays for, it also modifies the way that property taxes on individual properties are calculated. The formula for determining property taxes is as follows:

$$\text{assessed taxable market value} \times \text{class rate} = \text{tax capacity}$$

$$(\text{tax capacity} \times \text{total local tax rate}) - \text{property tax credits} = \text{net property tax}$$

While this formula remains in place, changes have been made in how the individual pieces are determined. The combined effect is significant property tax reductions in 2002 for all property types.

The starting point for calculating the property tax is the ***assessed taxable market value*** of the property. The omnibus tax bill changes the amount of assessed value subject to tax for certain properties. Under the current Limited Market Value law, market value increases on agricultural, residential, 1 to 3 unit rental, and cabin properties are limited to 8.5% of the property's market value in the previous year or 15% of the increase in value, whichever is greater. The limited market value law was set to expire after tax year 2002; however, the 2001 tax bill provides that limited market value will be gradually phased out over the next six years. That means that for properties affected by limited market value, more of the total value will be taken into account in determining the amount of tax, until limited market value is completely eliminated for taxes paid in 2008.

Minnesota is one of about 30 states that impose different ***property classification rates***, or ***class rates*** for short. Classes are described by the legislature and are based on

¹ The bill proposes to reimburse counties for a portion of their non-federally reimbursed out-of-home placement costs — either 30% or the percentage needed so the amount of takeover does not exceed the amount of HACA received for any metro county, whichever is less. This provision will only go into effect if the Commissioners of Human Services and Corrections certify that there is accurate data available to determine the appropriate aid payment amounts.

² The bill sets aside \$14 million in an LGA reform account. An additional \$14 million plus an inflation adjustment will be added each year until the LGA program is changed.

a property's use. The class rate describes what percentage of the property's market value will be used in calculating its share of local property taxes. The omnibus tax bill lowers nearly all class rates, except those for home value under \$76,000 and homestead resorts, whose class rates remain the same, and farm value under \$115,000 and low-income apartments, who actually receive a class rate increase. Low-income (4d) apartments are particularly hard hit. The 4d property class, which provides a lower class rate for multifamily housing in return for the property owner agreeing to certain rent and income restrictions, is eliminated in the omnibus tax bill. Properties currently classified as 4d can continue to receive a lower class rate for taxes paid in 2002 and 2003, but no additional properties will be accepted into the program, which ends completely in 2004.

There were two goals in reducing class rates: to reduce rates on particular property types whose taxes were considered unusually high, such as apartments, and secondly, to treat similar property types more alike (putting all apartment types at the same class rate; taxing homesteads, rental homes, duplexes/triplexes, and cabins more similarly). The changes in the bill are called *compression*, since they reduce the differences between class rates. The table below lists the changes to major class rates.

	Current Law	Omnibus Tax Bill		
Residential Homestead				
Value less than \$76,000	1%	1%		
Value \$76,000 - \$500,000	1.65%			
Value over \$500,000		1.25%		
Residential Non-homestead				
Value less than \$76,000	1.2%	1%		
Value \$76,000 - \$500,000	1.65%			
Value over \$500,000		1.25%		
Commercial/Industrial				
Value less than \$150,000	2.4%	1.5%		
Value over \$150,000	3.4%	2%		
Seasonal Recreational Residential (Cabins)				
Value less than \$76,000	1.2%*	1%		
Value \$76,000 - \$500,000	1.65%			
Value over \$500,000		1.25%		
Seasonal Recreational Commercial (Resorts)				
Homestead Resorts	1%	1%		
Seasonal – value under \$500,000	1.65%	1%		
Seasonal – value over \$500,000		1.25%		
Farm Land – Homestead				
Value less than \$115,000	0.35%	0.55%		
Value \$115,000 - \$600,000	0.8%			
Value over \$600,000	1.2%	1%		
Farm – Non-homestead	1.2%	1%		
Multifamily Residential		2002	2003	2004
2-3 Units	1.65%	1.5%	1.25%	1.25%
4 or more units	2.4%	1.8%	1.5%	
4 or more units – Small City	2.15%			
Low Income (4d) Apartments	1%	0.9%	1%	
New Construction – Apartments	2.4%	1.25%	1.25%	

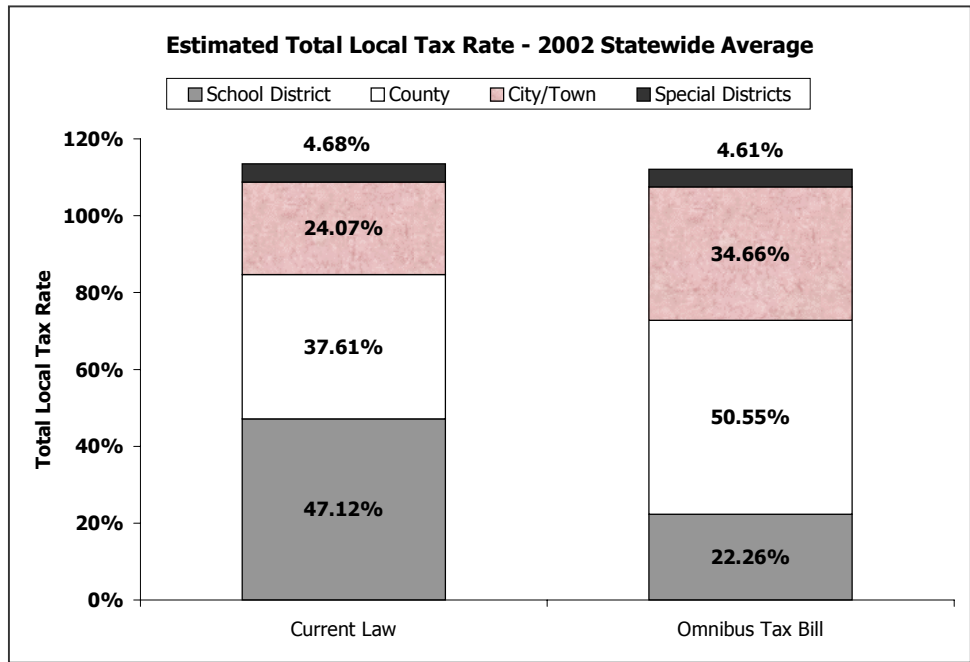
* For purposes of the statewide property tax, the first \$76,000 of value for cabins has a 0.4% rate. This is the only class with a different rate for local property taxes and the statewide property tax.

Multiplying the class rate by the assessed value gives a property's **tax capacity**. By itself, the reduction in class rates means a lower tax capacity. However, the reduction will be partially offset by any increases in value, whether due to the phase out of limited market value or simply because of increasing property values.

The **local tax rate** is determined by local units of government. Each local unit of government looks at its projected budget for the year and sees how much revenue can be expected from other sources (state aids, fees, etc.). The amount that remains must be raised from property taxes and is called the **levy**. Dividing the levy by the total tax capacity of all property in that taxing jurisdiction will determine the local tax rate. Each property is located in multiple jurisdictions (county, city, school district, special taxing districts), and therefore the local tax rates for each jurisdiction are added together to get the **total local tax rate**.

Although actual local tax rates will not be known until local units of government set their levies, legislative analysis does not predict a significant change in the statewide average total local tax rate in 2002 — from 113.48% under current law to 112.08% under the omnibus tax bill.

However, what will change is how the rate is apportioned to different units of government. The share of the total local tax rate due to schools will decline considerably, while the share corresponding to counties, cities, and towns will increase. This does not necessarily mean, however, that the



amount of property taxes collected by counties, cities, and towns, will go up dramatically. Because total tax capacity has been reduced by rate compression, local governments would have to increase their local tax rates in order to collect the same dollar amount.

The tax capacity is multiplied by the total local tax rate to get the gross property tax, and then **property tax credits** are subtracted to get the final amount of tax owed.³ Under current law, homesteads receive the Education Homestead Credit and farmland receives the Education Agricultural Credit, both of which are a portion of the general education levy that the state pays to the school district on the behalf of the taxpayer. The omnibus bill eliminates these credits along with the general education levy. In their place, the bill creates a Residential Homestead Market Value Credit equal to 0.4% of market value, up to a maximum of \$304, and an Agricultural Homestead Market Value Credit of 0.2% of the

³ These credits are different from those based on ability to pay, such as the Circuit Breaker or Renter's Credit.

market value of farmland, up to a maximum of \$230. These taxes are paid by the state to school districts on behalf of taxpayers, thereby reducing their property tax bills.

Impact of Property Tax Changes

When these changes are combined together, all property types are expected to pay lower property taxes on average in 2002 than under current law. The amount of reduction in 2002 differs among property types and is listed below.

Table 2: 2002 Property Tax Reductions – Statewide Average	
Property Type	Percentage Reduction
Agricultural Homestead – House	27.6%
Residential Non-homestead – 1 unit	27.5%
Apartments	24.9%
Residential Homestead	23.5%
Agricultural Homestead – Land	18.9%
Public Utility ⁴	18.6%
Agricultural Non-homestead	15.9%
Low-income Apartments (4d)	14.5%
Residential Non-homestead – 2-3 units	12.7%
Seasonal Recreational	11.6%
Commercial Industrial	10.6%
All property	18.4%

The reductions above are the statewide average reductions for the whole property class. How much any specific taxpayer receives in tax cuts will depend on their particular situation. In isolated instances, individual properties may see an increase in taxes.

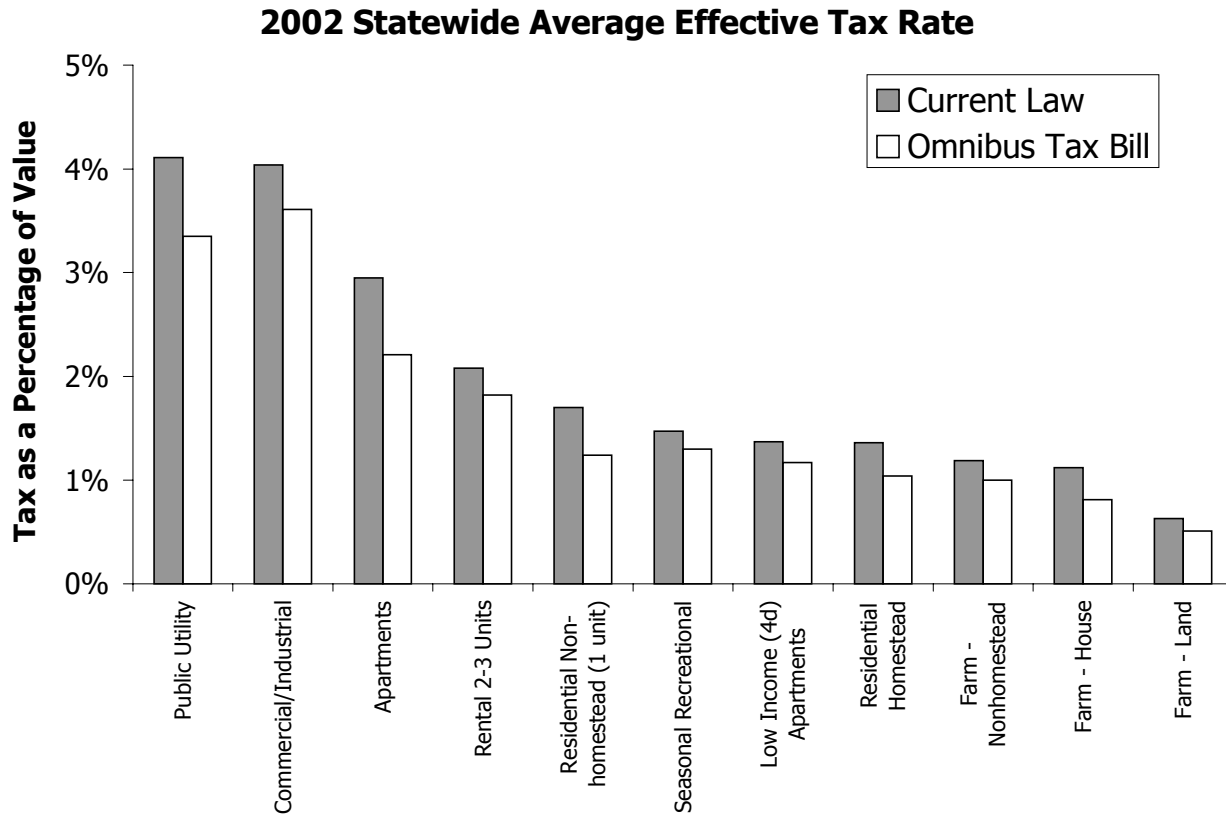
It is important to note that the amount of reduction may be significantly different in future years than in 2002. Additional class rate reductions will take place in 2003 and 2004 for most rental properties, while low-income (4d) apartments have class rate increases in these years. In addition, the effects of the limited market value phase out will become more pronounced in the future. Due to the nature of the property tax in which the total amount to be collected is determined first, then divided among taxpayers, any additional reductions for one property type means a shift of the burden onto other types.⁵

While all property owners will see tax cuts, one group of property taxpayers who receive no direct benefit from the omnibus tax bill is renters. While renters help pay the property taxes on their residences through their rents, there is little reason to expect that the tax savings will be passed on to them in the form of lower rents, given the tight rental market. It was argued throughout the session that renters will benefit in the long term as property tax reductions encourage new housing production, thereby easing the housing shortage. Whether this actually occurs remains to be seen.

⁴ Electric generating public utility property receives a reduction of 36.8%; all other types receive an average cut of 12.5%.

⁵ For example, an analysis of the city of Minneapolis by the [Property Tax Study Project](#) shows that tax relief declines over time for homes and 1-3 rental unit properties and increases for apartments and commercial/industrial properties. Holding values and levies constant, low- and average-value homes in Minneapolis will have higher property tax bills than they would under current law when the tax bill is fully in effect.

The 2001 tax bill does not dramatically alter the relationship among property types in 2002. One way to compare property tax burdens across property types is the Effective Tax Rate, which measures the tax as a percentage of value. When we sort the different property types from highest to lowest based on their effective tax rates, we see that those property types with relatively higher effective tax rates still have higher effective tax rates in 2002, and those on the low end of the scale still have lower effective tax rates, as shown in the graph below.



Circuit Breaker Increased for Low- and Moderate-Income Homeowners

As mentioned above, the impact on individual taxpayers will depend on the specifics of their situation. To guard against significant tax increases to homeowners with a limited ability to pay, the omnibus tax bill increases the Property Tax Refund (PTR) for homeowners, which provides tax relief to low- and moderate-income households whose property taxes are high in relation to their income. The PTR is commonly called the Circuit Breaker when it applies to homeowners and the Renter’s Credit when it applies to renters. The PTR is not administered through the property tax system — taxpayers must file an application with the Department of Revenue, and the refund comes as a check from the state, rather than as a reduction in property taxes owed to local government.

Taxpayers are eligible for a PTR when their property taxes reach a certain percentage of income, called the threshold. (For renters, 19% of total rent paid is considered their property tax amount.) The taxpayer is also responsible for a co-payment. Both the threshold and co-payment amounts increase as household income rises. The omnibus tax bill lowers thresholds and co-payments for the Circuit Breaker, thereby providing larger refunds to households with incomes below \$50,000. The bill also nearly triples the

maximum refund to \$1,500 and increases the income ceiling to \$80,000. No changes were made to the Renter's Credit.⁶

2001 Sales Tax Rebate

As in the last several years, the 2001 omnibus tax bill includes a Sales Tax Rebate, structured similarly to the 2000 rebate. A total of \$791 million in rebates will be sent to Minnesotans in late August, ranging from \$213 to \$2,967 for married filing jointly and head-of-household filers and from \$108 to \$1,484 for other filers. The rebate uses the total amount of surplus remaining at the end of the 2001 fiscal year.

Most Minnesota residents will automatically receive a rebate calculated on a schedule based on their 1999 filing status and taxable income. To receive a rebate based on the schedule, the taxpayer must have at least \$1 of state income tax liability before refundable credits or at least \$5 in federal tax liability on their 1999 Minnesota income tax return, and not be a dependent.

The following groups of persons will also receive rebates, but not calculated on the rebate schedule (all criteria describe the taxpayer's status for 1999):

- Dependents with earned income who filed a 1999 income tax return with at least \$1 in Minnesota tax liability or \$5 in federal tax liability will receive 35% of the rebate amount for non-dependents of the same income level.
- Full-year residents over age 18 who receive social security, railroad retirement benefits, or a public pension are eligible for the minimum rebate amount (does not include dependents).
- Persons who filed a 1999 Minnesota income tax return to receive a refund of withholding or to claim a refundable credit but did not have tax liability, or filed for a 1999 Minnesota property tax refund (the Circuit Breaker or Renter's Credit), will receive the minimum rebate amount for their filing status (does not include dependents).
- Non-residents who paid at least \$10 in Minnesota sales tax on non-business purchases in 1999 can apply for a rebate of a percentage of the sales tax paid. This rebate cannot exceed the amount a Minnesota resident of the same income level would receive.

Taxpayers who have not already filed their 1999 income tax or property tax refund forms still have until November 30, 2001, to do so to qualify for a rebate. **Low-income and other disadvantaged persons needing assistance filing their returns can contact AccountAbility Minnesota at (651) 287-0187.**

Income and Corporate Taxes

Although the omnibus bill contains relatively few changes to individual income and corporate taxes, a number of factors lead to a reduction in these taxes. The recent federal tax law will result in cuts in total individual income and corporate taxes. At the same time, because property taxes can be taken as an itemized deduction, a decrease in property taxes leads to an increase in taxable income, and thus in income taxes, for those who itemize.⁷

⁶ For more information, see Minnesota Budget Project, *The Renter's Credit/Circuit Breaker Property Tax Refund Program*.

⁷ The impact is relatively small: a \$967.5 million reduction in property taxes in 2002 results in a \$35 million increase in income taxes in 2003.

Overall, there is a net decrease in income and corporate taxes of \$44.7 million in the 2002-03 biennium and a \$37.5 million reduction in 2004-05.

Individual taxpayers will note a few changes on their 2001 income tax returns. These include:

- Allowable expenses for the K-12 education credit and subtraction are expanded to include the purchase of musical instruments. However, the credit is reduced from 100% of allowable expenses to 75% of allowable expenses. Combined, these two provisions will reduce the credit and subtraction by \$7.85 million in 2002-03 and \$18.3 million in 2004-05.⁸
- Active duty military personnel stationed outside Minnesota will be exempt from state income taxes. This will save eligible taxpayers \$4.4 million per year.

The bill also adjusts the Working Family Credit to conform to federal changes that provide marriage penalty relief. Currently, families are eligible for the Working Family Credit based on earned income; families are eligible with incomes up to \$10,380 if there are no eligible children in the home, up to \$27,413 if there is one child, and \$31,152 if two or more children.⁹ Starting in the 2002 tax year, certain married filing joint filers will receive a larger credit and can remain eligible to a higher income level.

Sales Taxes

The omnibus bill provides a \$74.5 million decrease in sales taxes in 2002-03 and a \$93.6 million increase in 2004-05. This portion of the bill primarily makes a number of definitional and process changes in accordance with the Streamlined Sales Tax, a national effort that may enable the states to eventually begin collecting the sales tax due on items purchased over the internet or from catalogs.¹⁰

Another technical change is the repeal of the June accelerated sales tax. Currently, merchants must remit a portion of their estimated sales tax collections for June in advance. This has the effect of moving some of the sales tax revenues into the prior fiscal year. Repealing the accelerated payment has a one-time cost of \$154.2 million in the 2002-03 biennium, which is largely a matter of moving the June sales tax payments back into the appropriate fiscal year.

Provisions Affecting Nonprofit Organizations

The Governor had originally proposed a number of changes in his tax reform plan that would have directly affected the tax-exempt status of nonprofits. There are no significant changes to nonprofits' tax status in the final omnibus bill.

⁸ Subtractions reduce the amount of income subject to tax, while credits reduce the amount of tax owed. The K-12 credit is refundable, so if the amount of credit is greater than the taxpayer's tax liability, the excess is refunded to the taxpayer. Families with household income below \$37,500 can receive a credit for eligible education expenses up to \$1,000 per child, up to a maximum of \$2,000 per family. The K-12 subtraction has no income ceiling and allows a subtraction for the same types of educational expenses as for the K-12 credit, but also includes private school tuition.

⁹ The income eligibility amounts for this credit are adjusted each year for inflation. These describe the most recent eligibility figures.

¹⁰ Such purchases are currently subject to the sales tax. However, states have difficulty in collecting the tax from out-of-state retailers.

Some provisions relating to nonprofits include:

- A \$200,000 appropriation for the 2002-03 biennium for grants to nonprofits providing volunteer tax assistance to low-income and disadvantaged taxpayers.
- A new sales tax exemption for nonprofits (and local government entities) for construction materials to build, improve, or expand qualified low-income housing.
- A property tax exemption for certain property owned by 501(c)(3) agricultural historical societies.
- Changes to the current sales tax exemption for tickets to arts events: to receive the exemption, nonprofit arts organizations need to meet a number of criteria, including receiving a certain percentage of their total revenues from charitable donations. Non-arts related nonprofits will no longer be able to “lend” their tax-exempt status to event promoters.
- A clarification that fundraising sales for combined campaigns are not taxable — for example, a company that sells cookbooks to their employees to raise money for United Way would not have to collect sales tax on the cookbooks.
- For corporate taxes, the bill eliminates the charitable contribution modification and federal special deduction in order to conform to the federal definition of taxable net income. This eliminates incentives for Minnesota-based charitable giving.

Health Care Taxes

Although there was a great deal of discussion over the legislative session about replacing health care provider taxes with another revenue source, no major changes were made in the structure of health care taxes. The MinnesotaCare provider tax is frozen at 1.5% until January 1, 2004 (without action, it would have increased to 2%), and the HMO premiums tax is delayed until this date. Adult day care centers were exempted from the provider tax.

The primary resources for this document include House Research's [Act Summary and Property Tax Simulations](#), Minnesota Department of Revenue's [Sales Tax Rebate 2001 Fact Sheet](#), and [House Fiscal Analysis spreadsheets](#).