

What's At Stake in 2004: Revenues A Comparison of Legislative Proposals

One of the primary tasks before the Minnesota Legislature this session is addressing the state's budget deficit, measured at \$159.5 million in the 2004-05 biennium at \$442.2 million in 2006-07. This document looks at how revenues are being used to address the deficit in the House and Senate budget plans, and outlines other proposed changes to the state's tax system. Policymakers will need to determine which of these items to enact into law this session...or whether to leave them undone if a legislative compromise is not reached.

As shown in Table 1, the House and Senate budget plans vary significantly in the degree to which they raise revenues in the 2004 session. The House raises \$49.6 million in tax revenues in 2004-05 and \$12.1 million in 2006-07. An additional \$36.2 million in 2004-05 and \$109.0 million in 2006-07 are to be raised through a "racino" (slot machines at the Canterbury Downs horseracing track). The Senate would raise much more in revenues than the House: \$124.1 million in tax revenues in 2004-05, and \$282.3 million in 2006-07. As a result, the Senate budget plan does not make the kinds of spending reductions the House does, and in fact uses some of the revenues raised to reverse cuts made in the 2003 session. The Senate has not passed any bills to raise state funds through gambling at this point in the legislative session.

	2004-05		2006-07	
	House	Senate	House	Senate
Reserves and Fund Transfers	-68.2	-39.4	0.0	39.4
Spending	-10.0	4.3	-60.3	229.9
Revenues	-85.8	-124.1	-121.1	-282.3
Taxes	-49.6	-124.1	-12.1	-282.3
Racino	-36.2	0.0	-109.0	0.0
TOTAL:	-164.0	-159.2	-181.4	-12.9
Ending Balance (Surplus/Deficit)	4.5	-0.3	-260.8	-429.3

Source: Author's analysis of House and Senate Fiscal Analysis data

While there are many tax provisions on the table, this document highlights those that play a role in addressing the state's budget deficit or have an impact on low- and moderate-income Minnesotans. Provisions on these matters are contained in the House and Senate Omnibus tax bills (HF 2540), as well as the Senate's budget-balancing bill (HF 956) and the House's racino bill (HF 646).

Property Taxes

Property Tax Refund (Renter's Credit/Circuit Breaker)

The most significant proposed tax change impacting low- and moderate-income Minnesotans concerns the Property Tax Refund (PTR), which provides tax relief to households whose property taxes are high in relation to their income. The PTR is commonly called the Renter's Credit or Renter's Rebate when it applies to renters and the Circuit Breaker when applied to homeowners. The Senate omnibus tax bill would cut the Renter's Credit by \$10 million per year, while the House bill calls for a study that would outline possible future changes.

To be eligible for the PTR in 2003, renters must have household incomes less than \$44,990 and homeowners must have incomes less than \$83,390, and their property taxes must exceed a certain percentage of their income (called the threshold). Eligible taxpayers can receive a refund

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2314 University Avenue West #20, St. Paul, MN 55114 • (651) 642-1904 x230

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equal to the amount by which their property taxes exceed a copayment amount, up to a maximum. The threshold and copayment amounts increase as household income rises.¹

Both House and Senate omnibus tax bills have provisions that address the percentage of rent paid considered to be the renter's share of property taxes for purposes of calculating the Renter's Credit. This percentage is currently set at 19%. Since property class tax rates were reduced on market rate apartments in the 2001 property tax reform, some policymakers have suggested that a change in this percentage may be warranted.

The House omnibus tax bill funds a study to be conducted by the Department of Revenue that would include information about the percentage of rent that constitutes property tax throughout the state and make recommendations on the following:

- whether to change this percentage for purposes of calculating the Renter's Credit,
- whether to use different percentages for different regions,
- whether to use the actual percentage of rent constituting property tax for each renter, rather than use the same set percentage for everyone;
- a method for the Commissioner of Revenue to regularly recommend changes in the percentage, and
- statutory language authorizing the Commissioner of Revenue to regularly adjust the percentage based on survey research.

The Senate takes a different approach. It would reduce the percentage of rent paid considered property taxes from 19% to 17%. However, in cases where the actual percentage of rent constituting property taxes for a particular renter exceeds 17%, the actual percentage would be used. This means that most renters will receive smaller credits than under current law, although renters would receive larger credits than under current law if their actual percentage of rent constituting property taxes is above 19%. The net impact of the Senate changes is a \$10 million cut per year in the Renter's Credit.

The Minnesota Budget Project has opposed any reduction in the Renter's Credit, as this would raise taxes on those Minnesotans who are least able to shoulder the increased burden. This tax increase would add additional hardship on persons who are likely to have been harmed by service cuts made in the 2003 legislative session such as those to senior services, child care assistance, and state health care programs. A study by the Department of Revenue found that 29% of persons receiving the Renter's Credit were seniors or persons with disabilities.²

The House omnibus tax bill would make two additional changes in the PTR. First, it would allow property tax refunds to be paid up to 30 days earlier than under current law for taxpayers who file their PTR applications online. Secondly, fees and charges for police and fire services would be considered part of the homeowner's share of property taxes for purposes of calculating the PTR.³

Property Tax Treatment of Low-Income Housing

The Senate omnibus tax bill would reinstate a lower property tax class rate for affordable housing. The class rate describes what percentage of the property's market value is used in calculating its share of property taxes. The 2001 omnibus tax bill lowered nearly all class rates.

¹ For more on the PTR, see Minnesota Budget Project, *The Renter's Credit/Circuit Breaker Property Tax Refund Program*, www.mncn.org/bp/ptr.htm, and *The Renter's Credit/Circuit Breaker: Who Are The Recipients?*, www.mncn.org/bp/ptrpax.pdf.

² Minnesota Department of Revenue data for 1999 PTR filings.

³ This would not apply to charges for capital expenditures related to police and fire services or nuisance charges.

However, low-income apartments received a class rate increase. The “4d” property class, which provided a lower class rate for multifamily housing in return for the property owner agreeing to certain rent and income restrictions, was eliminated in the 2001 omnibus tax bill.⁴ The Senate omnibus tax bill would reinstate the 4d property class with a lower class rate than market rate apartments.

The Senate would also provide that the assessed value of low-income rental properties would reflect the fact that rents are limited to affordable levels, rather than being assessed at market rates.

Income Taxes

Alternative Minimum Tax (AMT)

Both House and Senate tax committees took steps to address the problem of more Minnesota taxpayers becoming subject to the state’s Alternative Minimum Tax, or AMT. The intended goal of the AMT is to ensure that taxpayers are not able to use exemptions and deductions to such an extent that they are able to shield much of their income from taxation. Taxpayers subject to the AMT calculate their income tax following the regular tax laws, then under the AMT rules (which allow many fewer deductions and exemptions), and pay the higher of the two tax amounts.

Over time, more persons have become subject to the AMT, and many of them are not the types of taxpayers the AMT was intended to address. In the 1995 tax year, only 5,277 Minnesota households paid Minnesota AMT. However, this had grown to 30,000 in 2001, and is projected to grow to 93,638 by 2007.⁵

Both omnibus tax bills make changes so that fewer Minnesotans will be subject to the AMT. The Senate takes a more aggressive approach: it makes changes that cost \$62.5 million in 2006-07, which it pays for by raising the top individual income tax rate from 7.85% to 8%. The House has no specific funding mechanism for AMT changes, and therefore makes smaller changes and phases them in over time to keep the cost of their AMT provisions to \$4.2 million in FY 2005 and \$20.7 million in 2006-07.

- Under current law, AMT filers can only deduct total charitable contributions that exceed 1% of their adjusted gross income. The Senate bill would eliminate the 1% floor in 2005, while the House would reduce it to 0.25% in 2004, 0.1% in 2005, and eliminate it in 2006.
- The standard exemption amount under the AMT would be increased under both plans. The Senate would raise it to \$66,300 for married filing joint taxpayers and \$33,150 for all other filing statuses in 2005, with a phase-out for high incomes.⁶ Under the House bill, the exemption for married joint filers would gradually increase in the 2004, 2005, and 2006 tax years to reach \$44,000 for married filing joint filers, \$33,000 for single filers, and \$22,000 for married filing separately. In both bills the standard exemption would be indexed for inflation in future years.
- The Senate would allow a new exemption under the AMT for federal dependent exemptions.

K-12 Education Credit

The K-12 Education Credit allows families to receive a refundable income tax credit for eligible educational expenses for their children. Eligible families have household incomes below \$37,500.

⁴ For more on the 2001 property tax reform, see Minnesota Budget Project, *Tax Decisions in the 2001 Legislative Session*, www.mncn.org/bp/taxes01.htm.

⁵ Minnesota Senate Office of Fiscal Policy Analysis.

⁶ The phase out begins at incomes over \$248,600 for married filing joint filers and over \$124,300 for other statuses.

Both omnibus tax bills would make changes in the maximum amount of credit. Under current law, the maximum amount of K-12 Education Credit is \$1,000 per qualifying child and \$2,000 per family. House bill keeps the maximum credit for a family with two or more qualifying children at \$2,000, but eliminates the \$1,000 maximum per child. This allows families to spread the expenses between children in the way that makes most sense for their family. The Senate omnibus tax bill similarly eliminates the \$1,000 maximum per child but also increases the maximum credit to \$1,000 times the number of eligible children in the family.

Corporate Taxes

Foreign Operating Corporations/Corporate Loopholes

Corporate taxes are under scrutiny this legislative session, particularly after the most recent Department of Finance *Economic Update* noted that corporate tax receipts are down despite rising corporate profits.⁷ While it is unclear why this is happening, some have questioned whether it indicates a need for adjustments in the state's corporate tax code.

The area receiving the most attention is Foreign Operating Corporations, or FOCs. This provision in current law provides a tax deduction on income generated from business activity conducted largely overseas. However, this provision has been used in unintended ways as a tax shelter. While the House and Senate agree that something needs to be done about FOCs, they disagree on how to go about it. The Senate would require that a company qualifying as a Foreign Operating Corporation have at least 80% of its property and payroll located outside the U.S., and have at least \$2 million of property and \$1 million of payroll located outside the U.S. This provision would raise \$56.2 million in FY 2005 and \$115.6 million in 2006-07.

The House takes a different approach. Under their bill, the Commissioner of Revenue may disqualify a FOC if it has no substantial business purpose other than tax reduction, has a significant number of transactions lacking economic substance, and income is predominately from domestic business activity. The Commissioner could also disallow individual transactions involving an FOC if they appear to have no purpose other than tax reduction. A 15% surtax would be collected on increased taxes resulting from these changes. The House bill provides additional funding to the Department of Revenue for enforcement and administration of these provisions, but there is no estimate yet of how much revenue would be raised.

Both the House and Senate have provisions to address another corporate tax shelter called LILO/SILO, which involve transactions in which a taxpayer leases or purchases property from a tax-exempt entity (such as a city) and then immediately subleases it back to the lessor.⁸ In their budget-balancing plan, the Senate included a few more corporate loophole provisions, and used the revenue from these, as well as from the FOC and LILO/SILO provisions, to repeal or modify some health and human services reductions made in 2003.

Single Sales Factor

Both bills would change what portion of a multistate corporation's income is subject to Minnesota's corporate income tax, which would result in tax cut for some Minnesota

⁷ Minnesota Department of Finance, *April 2004 Economic Update*, www.finance.state.mn.us/ffeu/updates/2004/0404update.pdf.

⁸ The LILO/SILO issue is explained in the PBS Frontline program *Tax Me If You Can*, which can be seen online at www.pbs.org/wgbh/pages/frontline/shows/tax/

corporations.⁹ Currently, Minnesota uses a three-factor apportionment formula that is based 75% on sales and 12.5% each on property and payroll. Both omnibus tax bills contain Single Sales Factor provisions that would base apportionment completely on sales.

In the House omnibus tax bill, Single Sales Factor is phased in gradually over eight years, resulting in a modest initial cost of \$1.9 million in corporate tax cuts in FY 2005 and \$23.9 million in 2006-07. The Senate implements Single Sales Factor all at once, and therefore has fiscal impact more representative of the true cost: \$13 million in FY 2005 and \$89.9 million in 2006-07.

The Minnesota Budget Project has opposed Single Sales Factor as an expensive corporate tax cut that is not an effective economic development tool. While proponents have argued that implementing Single Sales Factor will eliminate an “anti-jobs tax,” Single Sales Factor is not directly tied to job creation. There is no requirement that the corporations receiving a tax cut create jobs — or even maintain existing jobs — in Minnesota.

Claims for job growth resulting from Single Sales Factor should be looked on skeptically. A 1999 study by University of Chicago economist Austan Goolsbee estimated that 35,000 jobs would be created in Minnesota by adopting Single Sales Factor. In another study, Goolsbee predicted that Illinois would gain 155,000 manufacturing jobs if it adopted Single Sales Factor. In fact, Illinois lost 66,000 manufacturing jobs between the time it adopted Single Sales Factor (July 1998) and the end of the most recent economic boom (March 2001). It has lost an additional 133,000 manufacturing jobs since then, despite cutting corporate taxes by \$100 million annually due to Single Sales Factor.

While Single Sales Factor is advocated as a tool to improve the state’s business climate, in fact only 9% of businesses who file corporate tax returns in Minnesota — about 4,500 companies — would benefit. Companies receiving tax cuts include multistate corporations with a high percentage of their manufacturing facilities in Minnesota but lots of sales outside the state. Of those corporations who would benefit from Single Sales Factor, an estimated 130 companies would receive tax cuts averaging \$500,000 if Single Sales Factor were in effect in 2004. But 13% of corporations would pay higher taxes under Single Sales Factor, and the majority of corporations (78%) would see no change in their corporate taxes.

The Senate helps pay for the cost of Single Sales Factor through two other changes in business taxes. One of these is a “throwback rule,” which addresses the problem of multistate corporations having a portion of their income untaxed by any state. A throwback rule, for purposes of the corporate franchise tax, treats sales made in a state in which a corporation is not taxable as if they were made to customers in the state from which it was shipped.¹⁰ Of 46 states with corporate income taxes, 24 have a throwback rule and two have a similar “throw-out” rule. This closing of a corporate loophole has been suggested in the past by the Minnesota Budget Project as a good part of a deficit reduction plan.¹¹ On its own, the throwback rule is estimated to raise \$18.1 million in FY 2005 and \$37.2 million in 2006-07.¹²

⁹ For more in this issue, see Minnesota Budget Project, *Minnesota Cannot Afford Proposed Corporate Tax Cut: Legislature Should Reject Single Sales Factor*, www.mncn.org/bp/ssf.htm.

¹⁰ For more on this topic, see Center on Budget and Policy Priorities, *Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenues for Many States*, www.cbpp.org/4-9-02sfp.htm.

¹¹ See Minnesota Budget Project, *Options to Address Minnesota’s Budget Deficit*, www.mncn.org/bp/options.htm.

¹² The actual amount raised may be less, due to interactions between this provision and other corporate tax changes.

The second tax change used to pay for Single Sales Factor is an increase in the statewide property tax paid by businesses, which would raise \$37.1 million in FY 2005 and \$226.3 million in 2006-07.

The House hopes to raise \$16 million each year by appropriating \$3.7 million to the Department of Revenue for additional compliance activities, a portion of which is for corporate compliance related to FOCs. This provision requires the Department of Revenue to report to the legislative tax committees on noncompliance with the corporate tax system, the sales and use tax system, and taxes on insurance companies, including information on the number of noncompliant taxpayers and amount of taxes collected under this initiative.

Sales and Excise Taxes

Both bills include the primary revenue raisers proposed by the Governor. These raise revenues through a timing shift and a change of implementation, rather than by raising new taxes. They bring in revenue primarily in the short-term, rather than being a permanent source of new resources.

- The sales tax due on car leases would become payable in full at the beginning of the lease, instead of being paid gradually over the course of the lease. This provision does not raise new taxes so much as move taxes forward in time.¹³ The provision would raise \$35.6 million in FY 2005 and \$18.5 million in FY 2006, but only \$1.3 million in FY 2007.¹⁴
- Cigarette taxes are currently collected by retail sellers. Both House and Senate bills would collect the tax from wholesalers instead. It is hoped this will increase compliance with the tax, and raise \$10.5 million in FY 2005 and \$3.5 million each year in the next biennium.

Gambling Revenues

The House would raise an estimated \$36.2 million in 2004-05 and \$109.0 million in 2006-07 in unobligated general fund dollars by authorizing the Minnesota State Lottery to operate slot machines at the Canterbury Downs horseracing track (the “racino”). An additional \$3.5 million in FY 2005 and \$17.4 million in 2006-07 would be dedicated to fund compulsive gambling programs and for related corrections, courts, and public defense costs. \$832,000 in FY 2005 and \$4.2 million in 2006-07 would be generated for the Environmental Trust Fund.

There is some concern about using a revenue source like gambling, the revenues from which are volatile and hard to predict, to fund ongoing state funding needs. In addition, there are the negative social costs associated with gaming.

The Senate has not passed any bills that raise additional state funds from gaming.

Next Steps

In the final days of the 2004 legislative session, it is unclear what will happen next. These tax provisions may ultimately be decided in a conference committee that may meet during the next few days or in special session, or some of them may be part of a budget compromise deal agreed upon by legislative leaders. If there is no legislative resolution, these provisions could not be part of any budget solution implemented by the Governor, as he does not have the authority to change tax law on his own. In that case, we can only expect that most of these items will be part of the discussion when tax committees reconvene in 2005.

¹³ This change will be a tax increase for those consumers who terminate their leases early. They will have paid the entire sales tax, whereas under current law conditions, such a person would only have paid a portion of the total sales tax in their monthly lease payments.

¹⁴ The House provision exempts trucks over 10,000 pounds and as a result has a slightly smaller fiscal impact.