VARIOUS TAXES
Tax Credits & Exemptions

February 15, 2002

	Yes	No
Separate Official Fiscal Note Requested		X
Fiscal Impact		
DOR Administrative Costs/Savings	X	

Department of Revenue
Analysis of H.F. 2715 (Goodno)/S.F. 2613 (Langseth)

	Revenue Gain or (Loss)			
	F.Y. 2002	**F.Y. 2003**	**F.Y. 2004**	**F.2. 2005**
		(000's)		
General Fund				
Homeowner PTR Reduction	($0)	($0)	($0)	Negligible
Income Tax	($0)	($0)	(Unknown)	(Unknown)
Corporation Franchise Tax	($0)	($0)	(Unknown)	(Unknown)
Sales tax	$0	*	*	*

*No cost for additional property and sales tax exemptions due to funding from previous allotments of tax reductions (see section Cap on Amount of Tax Reductions).

Property tax provision: effective for taxes payable 2004 and thereafter
Sales tax provision: sales made after June 30, 2002
Income tax provision: effective for taxable years beginning after December 31, 2002

EXPLANATION OF THE BILL

The border cities of Moorhead, Breckenridge, Dilworth, East Grand Forks and Ortonville are authorized to designate development zones to encourage economic development. The authorization for the extent of the zones varies from all or part of the city in the case of Breckenridge and East Grand Forks, to not more than 100 acres in Dilworth, Moorhead and Ortonville. City governments in border cities may grant taxpayers any combination of property tax exemptions, sales tax exemptions or income tax credits.

Cap on Amount of Tax Reductions

Current Law: A 1998 law limits the total dollar value to $1,970,000 of the exemptions and credits granted by border city governments. It appears that border cities have used up the 1998 allotment of tax reduction money.

During the 2001 session the legislature authorized an additional $1,500,000 allotment to fund both the tax credits mentioned above and another set of credits authorized by M.S. 469.171, enterprise zones. Before the 2001 allotment, the M.S. 469.171 program had an estimated $400,000 in unused allotments. It appears that $1,190,000 of the 2001 allotment will be distributed to fund tax credits authorized by M.S. 469.171. The unused part of the 2001 allotment is $710,000 ($400,000 + $1,500,000 – $1,190,000). The unused allotment may be applied to tax exemptions or credits described below or it may be applied to tax credits authorized by M.S. 469.171.

Proposed Law All tax provisions in current and proposed law, except the proposed income tax provision, remain subject to the current law cap on tax reductions. Except for one provision, the proposed law allows for more options to expend the current law allotment of tax reductions so that the proposed law does not have an additional revenue loss effect.

Property tax provision:

Current Law: If determined by the border city municipality, they may exclude from property taxes commercial and industrial property within the zone, and such property located outside the zone. For property located outside the zone, it is exempt from property tax, except for levies for payment of debt obligations or taxes levied by a school district (except for certain equalized levies). The exemption outside the zone may be granted only if exemption is necessary for a business to expand in a zone or to attract a business to the zone.

Proposed Law: As originally intended by the authors, the proposal expands the property eligible for a property tax exemption in a border city development zone to include class 1 (residential homestead) and class 4 (rental residential) property that is newly constructed after the effective date of this proposal, beginning with assessment year 2003. The entire property tax amount for housing properties may be exempted.

The proposal also allows a new use of tax exemptions for both designated border cities and for other cities located in the same counties as those originally identified for development zones. The new authority allows all cities in the county containing a border city to grant a full property tax exemption during the duration of a border city zone in the county to newly constructed class 1 (residential homestead) property, class 2 (farm homestead house, garage and one acre), or class 4 (rental residential). The exemption is effective for the first two assessment years after the property is newly constructed and occupied, or the assessor increases the value for new improvements at least $25,000, whichever occurs first. The exemption must be approved before building permits are issued.

Income tax provision:
Current Law: If determined by the border city municipality, they may grant a job tax credit against the individual income tax or the corporate franchise tax. This job credit is based on 1% of wages paid by a new manufacturing plant. The employee's principle place of employment must be in the border city but outside of border city development zone.

Proposed Law: This bill permits an individual income tax and a corporate franchise tax exclusion of net rents from an apartment building located in a border city development zone not to exceed $10,000 per year for each rental unit and only for the first five taxable years after the building is constructed. This exclusion is in addition to the income tax provisions granted by current law. Unlike the other provisions in this bill and in current law, there is no cap on the revenue loss from this exclusion.

Sales tax provision:
Current Law: If determined by the border city municipality, they may grant a sales tax exemption. A sales tax exemption may be granted for machinery and equipment purchases used in a trade or business. Also, a sales tax exemption may be granted for construction materials used to construct a facility for used in a trade or business.

Proposed Law: In addition to the sales tax provisions granted by the current law, a border city municipality may grant a sales tax exemption for construction materials used to construct housing that is located in a border city development zone.

REVENUE ANALYSIS DETAIL

Cap on the Amount of Tax Reductions:

- It is assumed that a survey conducted by the Department of Trade and Economic Development requesting projections from border cities of enterprise zone spending represents only the projected use of enterprise zone tax credits, M.S. 469.171, and the projections do not include any border city development zone credits covered by this bill. The survey showed $1,190,000 of projected spending of M.S. 469.171 tax reduction allotments.
- Sources at the Department of Trade and Economic Development estimated a forward balance of $400,000 of M.S. 469.171 credits before the 2001 $1,500,000 allotment.

Property tax provision:

- Based on contact with local officials, the purpose of the proposal is to provide incentives for new housing construction both in border cities, and other cities located in the same counties.
- The incentive could increase construction in 2002, and the tax exemption would begin with assessment year 2003 (taxes payable 2004).
- Information from building permit data reported by the Bureau of the Census indicates that housing construction in the five border cities averaged $22.5 million per year between 1998 and 2000. Assuming that this historical trend continues to assessment year 2003, with an additional 5% growth incentive from this proposal, a total exemption in the five border cities could reach $25 million for taxes payable 2004.
- If all border cities offered the exemption, the total property tax exemption for new housing in taxes payable 2004 could approach $300,000.
- The total increase of homeowner property tax refunds because of the tax shift to other homes would be offset by a reduction in PTR because of the tax exemptions, with a negligible net difference in PTR expenditures by the state.

Income tax provision

- Despite the exclusion of the new income tax provision from the total cap on tax reductions the chances for a revenue loss appear to be near zero.
- It is assumed that most apartment buildings do not generate a positive federal taxable income during the first five years of their existence. Most newly constructed apartment buildings do not generate a positive federal taxable income because of large interest expenses and large depreciation deductions.
- It is assumed that in order to take advantage of the income exclusion, an owner must not take out a mortgage to build the building and hence have no interest expense. In addition, the owner must depreciate the building on a straight-line basis. Depreciation methods other than straight-line generate large depreciation deductions in the initial few years of the life of a building. Even with the five year income tax exclusion, it is unknown whether using the no mortgage / straight-line depreciation method is more advantageous than the traditional method of a large mortgage and large initial depreciation deductions.
- Because there is not enough information to determine whether it would be financially advantageous to use the income exclusions in the bill, the revenue effect of this provision is unknown.

Sales tax provision:

- If all border cities offered the exemption for construction materials used in housing construction, sales tax revenues could be reduced by about $700,000 per year. This estimate is based on building permit data from the border cities. There is no cost for the additional sales tax exemption due to the funding from previous allotments of tax reductions (see section Cap on Amount of Tax Reductions).

- Construction materials are assumed to represent 45% of the cost of residential housing,

ADMINISTRATIVE/OPERATIONAL IMPACT

There will be administrative or operational costs to DOR in administration of this bill. There will be the need for additional funding for form changes along with processing and editing work that will need to be completed for this proposed bill.

Source: Minnesota Department of Revenue
Tax Research Division
http://www.taxes.state.mn.us/polic.html#analyses

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