VARIOUS TAXES
Tax-Free Zones

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

February 18, 2003

Department of Revenue
Analysis of H.F. 3 (Magnus)

	Revenue Gain or (Loss)			
	F.Y. 2004	**F.Y. 2005**	**FY2006**	**FY2007**
		(000's)		
Individual Income Tax Exemption	0	($120)	($320)	($410)
Corporate Franchise Tax Exemption	0	($110)	($260)	($360)
General Sales & Use Tax Exemption	($1,500)	($3,120)	($2,890)	($3,390)
Property Tax Refund	0	0	0	($10)
Appropriation to Dept. of Trade & Economic Development			Undesignated	
Appropriation to Dept. of Revenue			Undesignated	
Tax-free Zone Aid	0	0	0	0
General Fund Total	($1,500)	($3,350)	($3,470)	($4,170)

Tax-free zone definitions and development plans effective the day following final enactment.
Corporate franchise and income tax exemptions effective beginning with tax year 2004.
Sales tax exemptions effective for sales made after December 31, 2003
Property tax exemptions effective beginning with property taxes payable in 2005.
Tax-free zone aid effective beginning with aid based on property taxes payable in 2005.

EXPLANATION OF THE BILL

Current Law: There are no provisions for tax-free zones in Minnesota. Some tax exemptions and credits are available in border city zones.

Proposed Law: The Commissioner of Trade and Economic Development would designate up to ten tax-free zones and five agricultural processing facility zones. A zone may not exceed 5,000 acres and must be located outside the seven-county metropolitan area.

A tax-free zone must be located within the boundaries of the local unit(s) of government that request the zone. Each zone may have up to six noncontiguous subzones. In each subzone no more than one-half of the real property may be owned by the same person or related entity. There are no ownership restrictions for agricultural processing facility zones. Areas in an existing border city zone do not qualify, but property may be removed from the border city zone and become part of a tax-free zone.

EXPLANATION OF THE BILL (cont.)

The bill defines "qualified business" as a person carrying on a trade or business within a tax-free zone. A business that relocates to a tax-free zone can qualify if it increases full-time employment by at least 20% in the first full year of operation in the zone or if it makes a capital investment equivalent to 10% of the gross revenues for the year immediately preceding the taxable year. The maximum duration of a tax-free zone, including an agricultural processing facility zone, is twelve years.

Property Tax Exemption: Property in a tax-free zone would be exempt from the local property tax and, if applicable, the state general levy. This exemption is limited to improvements and personal property, and does not include land. The exemption does not apply to debt service levies or similar levies to pay general obligation bonds if the bonds were issued before the zone is designated. For class 3 (commercial and industrial) property to qualify, the owner or lessee of the property must be a qualified business.

Individual Income Tax Exemption: A subtraction from federal taxable income would be allowed for the income of an individual who is a resident of the zone. A subtraction would also be allowed for the income of an individual who operated or invested in a trade or business located in the zone. Rental income derived from multi-housing units would also be exempt from the individual income tax. A similar subtraction would be allowed in computing alternative minimum taxable income.

Corporate Franchise Tax Exemption: A subtraction from federal taxable income would be allowed for income derived from the operation of a business in the tax-free zone. The subtraction would also be allowed in computing alternative minimum taxable income and the factors for the minimum fee.

Sales Tax Exemption: An exemption from the sales and use tax would be allowed for tangible personal property and taxable services used by a trade or business located in a tax-free zone. An exemption would also be allowed for construction materials and supplies for the improvement to real property of a trade or business in the zone, regardless of whether purchased by the business or a contractor. These transactions would also be exempt from local sales and use taxes.

Motor Vehicle Sales Tax Exemption: An exemption from motor vehicle sales tax would be allowed for the purchase of a vehicle by a person engaged in a trade or business located in the zone if the vehicle is garaged in the zone and used primarily for the business operation in the zone. These vehicles would also be exempt from local sales and use taxes.

Repayment: Section 17 provides for the repayment of tax reductions if a business relocates into a tax-free zone and then ceases to operate the facility within the zone. A business must repay the amount of tax reduction or local contribution received during the two years immediately before it ceased to operate in the zone.

EXPLANATION OF THE BILL (cont.)

Tax-free Zone Aid: Each city and county is eligible for aid equal to one half of the amount by which exempt net tax capacity exceeds 3% of the city's total taxable net tax capacity for taxes payable for 2003, multiplied by the city's or county's average local tax rate for taxes payable in 2003. An amount sufficient to pay this aid is appropriated.

Direct Appropriations: Section 19 appropriates unspecified amounts to the Department of Trade and Economic Development for the costs of designating the zones and to the Department of Revenue for the costs of administering the tax provisions.

REVENUE ANALYSIS DETAIL

- The state revenue forecast is based on a projection of all economic activity in the state, including that which may occur in tax-free zones. Therefore, projected state revenues would be reduced if one or more state tax exemptions were enacted for tax-free zones.

- This analysis assumes that the maximum fifteen tax-free zones would be utilized the first four years (ten tax-free zones plus five agricultural processing facilities zones). The zones will consist of vacant land when they are designated.

- Data from the Michigan Renaissance Zone program is used to estimate the first four years of investment and employment in the tax-free zones. This analysis assumes the four-year investment total to be $29.5 million per zone. This investment per zone is characterized by class, with $20.4 million towards industrial development, $1.9 million for residential, $3.1 for retail, and $4.1 million towards commercial non-retail.

- Data from the Department of Trade and Economic Development regarding investment per job for rural Minnesota is used to calculate the number of jobs in tax-free zones, assuming just under $91,000 of investment per job. Employment during the first four years is assumed to be 323 jobs per zone. This employment per zone is characterized by class, with industrial accounting for 204 jobs, retail accounting for 71 jobs, and commercial non-retail accounting for 48 jobs.

- Based on recent projects, it was assumed that the average investment per agricultural processing facility zone would equal $2.5 million, and each facility would employ an average of 30 individuals.

- These investment and employment totals are apportioned based on the annual experience similar to the Michigan zones during the first four years of its Renaissance Zone program, with 40% of total investment occurring the first calendar year and 20% annually thereafter.

REVENUE ANALYSIS DETAIL (cont.)

Corporate Franchise Tax
- Based on state revenue forecast data for corporate franchise tax collections and statewide employment, a per-job tax collection amount was calculated.
- This amount was adjusted based on a rural-to-metro wage ratio to compensate for the rural locations of the tax-free zones. The per-job corporate franchise tax collection figure is $159 in FY 2005, $155 in FY 2006, and $150 in FY 2007.
- This per-job corporate franchise tax collection number was aggregated based on tax-free zone employment estimates.
- This analysis assumes a one-half year impact in FY 2005 and full impact thereafter.

Individual Income Tax
- Data from Michigan Renaissance Zone residential development is used to estimate the number of residents living in tax-free zones.
- Assumptions regarding the value of multi-housing investment in zones and a per-unit cost rendered the number of multi-housing units built in the tax-free zones. The analysis assumes one income tax return per unit.
- Based on monthly rent and a ratio relating rent to household income, an average income per unit amount was derived, equaling $48,000 per year.
- Multiplying tax-free zone resident income by an average effective tax rate of 4% provides an estimate of income tax exemptions.
- It is assumed that 40% of the rent receipts from residential property would be net rental income subject to the individual income tax at a marginal tax rate of 7%.
- This analysis assumes a one-half year impact in FY 2005 and full impact thereafter.

General Sales Tax
- The revenue impact from sales tax exemptions is calculated for two categories, initial construction and ongoing purchases.
- Construction materials and initial furnishings were calculated as 45% of total project investment.
- An estimate for ongoing purchases, such as office furnishings, utilities, and supplies, was based on state revenue forecast data for sales tax collections and statewide employment to calculate a per-job tax collection number.
- The per-job sales tax figure equals $624 in FY 2005, $649 in FY 2006, and $671 in FY 2007.

- Combined with projected annual employment in the zones, an estimate for sales tax exemptions for ongoing purchases was calculated.

REVENUE ANALYSIS DETAIL (cont.)

Property Tax

- The local property tax exemption would result in a shift to other properties. The increased tax on homeowners would increase the state cost for homeowner property tax refunds.
- Investment data for industrial/commercial and residential property was apportioned to calculate the total property tax exemption for real property building costs.
- The total property tax shift equaled $240,000, and 2.6% of this total tax shift results in the expected increase in property tax refunds.
- For taxes payable in 2006, the increase in property tax refunds would have a revenue impact beginning in FY 2007.
- The exemption from the state general levy would have no impact on state revenues. The tax rate would be adjusted to yield the amount of revenue required by statute.

Tax-free zone aid

- For taxes payable in 2003, an average for the 25 rural cities with the largest taxable net tax capacity was calculated.
- Based on investment and taxable net tax capacity of the tax-free zones, the 3% threshold would not be reached, and there is no revenue impact from tax-free zone aid during the forecast period.

Number of Taxpayers Affected: By FY 2007, 158 businesses and 188 individuals would be directly affected by the tax-free zones.

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

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