

February 7, 2017

Governor's Tax Bill

*State Taxes Only – See Separate Analysis
of Property Tax Provisions*

| | Yes | No |
|----------------------------------|-----|----|
| DOR Administrative Costs/Savings | x | |

Department of Revenue
Analysis of S.F. 726 (Chamberlain) As Proposed to be Amended (A17-0038)

| | Fund Impact | | | | |
|---|--------------------|------------------|-----------------------------|------------------|------------------|
| | F.Y. 2017 | F.Y. 2018 | F.Y. 2019 (000's) | F.Y. 2020 | F.Y. 2021 |
| Individual Income Tax | | | | | |
| Child and Dependent Care Credit | | | | | |
| Equal to Federal Credit, Refundable, Phased out over \$77,000 (1/1/17) | \$0 | (\$28,400) | (\$31,400) | (\$34,500) | (\$37,700) |
| Working Family Credit Expansion (1/1/17) | \$0 | (\$46,200) | (\$47,000) | (\$48,200) | (\$49,100) |
| Angel Investment Credit | \$0 | \$0 | (\$10,000) | \$0 | \$0 |
| Past Military Service Credit (1/1/17) | \$0 | (\$2,600) | (\$2,700) | (\$2,900) | (\$3,000) |
| Military Pension Subtraction – Interaction | \$0 | \$1,300 | \$1,400 | \$1,500 | \$1,500 |
| Corporate Franchise Tax | | | | | |
| Base-Year Percentage for Research | | | | | |
| Credit (1/1/17) | \$0 | (\$900) | (\$900) | (\$900) | (\$900) |
| Prevent Tax Evasion (1/1/17) | \$0 | \$0 | \$300 | \$1,500 | \$2,500 |
| Modify the Definition of Financial | | | | | |
| Institution (1/1/17) | \$0 | \$5,000 | \$5,000 | \$5,000 | \$5,000 |
| Accelerate Gain on the Sale of a Business | | | | | |
| for Nonresidents (1/1/17) | \$0 | \$1,100 | \$2,200 | \$3,300 | \$4,400 |
| Treatment of Insurance Companies Used | | | | | |
| to Shelter Income (1/1/17) | \$0 | \$2,000 | \$2,000 | \$2,000 | \$2,000 |
| Equal Treatment for Apportionment of | | | | | |
| Mutual Fund Manager Income (1/1/17) | \$0 | \$300 | \$300 | \$300 | \$300 |
| Reduce Dividend Received Deduction for | | | | | |
| Debt-Financed Stock (1/1/17) | \$0 | \$100 | \$100 | \$100 | \$100 |
| Disallow Dividend Received Deduction for | | | | | |
| Subpart F Income (1/1/17) | \$0 | \$37,300 | \$28,700 | \$28,700 | \$28,700 |
| Insurance Gross Premiums Tax | | | | | |
| Equalize Insurance Premiums Tax Rates | | | | | |
| for Nonadmitted Insurance Sold Directly and Through a Surplus Lines Agent (1/1/18) | \$0 | \$200 | \$200 | \$200 | \$200 |
| Estate Tax | | | | | |
| No Recapture Tax for Property Acquired | | | | | |
| by Eminent Domain (7/1/11) | \$0 | (\$50) | (\$50) | (\$50) | (\$50) |

| | Fund Impact | | | | |
|--|-------------------------|-------------------------|------------------------------------|-------------------------|-------------------------|
| | <u>F.Y. 2017</u> | <u>F.Y. 2018</u> | <u>F.Y. 2019</u> (000's) | <u>F.Y. 2020</u> | <u>F.Y. 2021</u> |
| Cigarette and Tobacco Tax | | | | | |
| Excise Tax on Vapor Products (1/1/18) | \$0 | \$730 | \$1,800 | \$1,900 | \$2,000 |
| General Sales and Use Tax | | | | | |
| Services and Labor to Install | | | | | |
| Pre-written Software (1/1/18) | \$0 | \$1,200 | \$3,000 | \$3,200 | \$3,300 |
| Expand Definition of | | | | | |
| Other Digital Products (7/1/17) | \$0 | \$440 | \$550 | \$630 | \$720 |
| Containers for Deceased | | | | | |
| Not for Burial (7/1/17) | \$0 | (\$340) | (\$400) | (\$420) | (\$440) |
| Expand Exemption for 501(c)(3) | | | | | |
| Organizations (7/1/17) | \$0 | (\$5,900) | (\$6,600) | (\$6,800) | (\$7,000) |
| Exemption for MN State | | | | | |
| High School League Events (7/1/17) | \$0 | (\$820) | (\$840) | (\$860) | (\$880) |
| Exemption for City of Madelia | | | | | |
| Building Materials and Supplies (7/1/16 – 6/30/18) | \$0 | (\$170) | \$0 | \$0 | \$0 |
| Exemption for Siding Production | | | | | |
| Facility (7/1/16 – 6/30/20) | \$0 | (\$1,400) | (\$2,800) | (\$1,400) | \$0 |
| Transfer of Sales Tax on Motor | | | | | |
| Vehicle Leases Based on 6.5% Rate | \$5,000 | \$5,300 | \$5,600 | \$5,800 | \$5,800 |
| Interaction – Excise Tax on | | | | | |
| Vapor Products (1/1/18) | \$0 | (\$100) | (\$240) | (\$250) | (\$270) |
| Solid Waste Management Tax | | | | | |
| Weight-to-Volume Conversion Rate | | | | | |
| for Construction Debris (7/1/17) | \$0 | \$130 | \$140 | \$140 | \$150 |
| Appropriations to Department of Revenue | | | | | |
| Dependent Care and Working Family | | | | | |
| Credits | \$0 | (\$775) | (\$1,101) | (\$1,101) | (\$1,101) |
| Tobacco and Vapor Provisions | \$0 | (\$398) | (\$371) | (\$429) | (\$316) |
| Sales Tax Provisions | <u>\$0</u> | <u>(\$22)</u> | <u>(\$22)</u> | <u>(\$22)</u> | <u>(\$22)</u> |
| General Fund Total | \$5,000 | (\$32,975) | (\$53,134) | (\$43,562) | (\$44,109) |
| Environmental Fund | | | | | |
| Solid Waste Management Tax | | | | | |
| Weight-to-Volume Conversion Rate for Construction Debris (7/1/17) | \$0 | \$300 | \$330 | \$340 | \$350 |

| | Fund Impact | | | | |
|---|-------------------------|-------------------------|------------------------------------|-------------------------|-------------------------|
| | <u>F.Y. 2017</u> | <u>F.Y. 2018</u> | <u>F.Y. 2019</u> (000's) | <u>F.Y. 2020</u> | <u>F.Y. 2021</u> |
| Natural Resources and Arts Funds | | | | | |
| Services and Labor to Install | | | | | |
| Pre-written Software (1/1/18) | \$0 | \$100 | \$200 | \$200 | \$200 |
| Expand Definition of | | | | | |
| Other Digital Products (7/1/17) | \$0 | \$30 | \$30 | \$40 | \$40 |
| Containers for Deceased | | | | | |
| Not for Burial (7/1/17) | \$0 | (\$20) | (\$20) | (\$20) | (\$30) |
| Expand Exemption for 501(c)(3) | | | | | |
| Organizations (7/1/17) | \$0 | (\$400) | (\$400) | (\$400) | (\$400) |
| Exemption for MN State | | | | | |
| High School League Events (7/1/17) | \$0 | (\$50) | (\$50) | (\$50) | (\$50) |
| Exemption for City of Madelia | | | | | |
| Building Materials and Supplies | | | | | |
| (7/1/16 – 6/30/18) | \$0 | (\$10) | \$0 | \$0 | \$0 |
| Exemption for Siding Production | | | | | |
| Facility (7/1/16 – 6/30/20) | \$0 | (\$80) | (\$160) | (\$80) | \$0 |
| Excise Tax on Vapor Products | | | | | |
| Sales Tax Interaction (1/1/18) | <u>\$0</u> | <u>(\$5)</u> | <u>(\$10)</u> | <u>(\$10)</u> | <u>(\$20)</u> |
| Natural Resources and Arts Funds Total | \$0 | (\$435) | (\$410) | (\$320) | (\$260) |
| Highway User Tax Distribution Fund | | | | | |
| Reduce Motor Fuel Tax Rate for | | | | | |
| Compressed Natural Gas (7/1/17) | \$0 | (\$120) | (\$140) | (\$140) | (\$140) |
| County State Aid Highway Fund | | | | | |
| Transfer of Sales Tax on Motor | | | | | |
| Vehicle Leases Based on 6.5% Rate | (\$2,500) | (\$2,650) | (\$2,800) | (\$2,900) | (\$2,900) |
| Greater MN Transit Account | | | | | |
| Transfer of Sales Tax on Motor | | | | | |
| Vehicle Leases Based on 6.5% Rate | (\$2,500) | (\$2,650) | (\$2,800) | (\$2,900) | (\$2,900) |
| Health Care Access Fund | | | | | |
| Extend 2% Tax on Gross Receipts | | | | | |
| of Health Care Providers | | | | | |
| and Drug Distributors (1/1/20) | | | | | |
| | <u>\$0</u> | <u>\$0</u> | <u>\$0</u> | <u>\$242,700</u> | <u>\$756,500</u> |
| Total – All Funds | \$0 | (\$38,530) | (\$58,954) | \$193,218 | \$706,541 |

EXPLANATION OF THE BILL

See the separate summary prepared by the Appeals and Legal Services Division of the Department of Revenue.

REVENUE ANALYSIS DETAIL

Dependent Care Credit

- The House Income Tax Simulation (HITS 6.5) Model was used to estimate the tax year revenue impact. These simulations assume the same economic conditions used by Minnesota Management and Budget for the forecast published in November 2016. The model uses a stratified sample of 2014 individual income tax returns compiled by the Minnesota Department of Revenue.
- Tax year impact would be reflected in the following fiscal year.
- Some taxpayers who now pay for child care using pre-tax accounts could reduce their tax burden by paying with after-tax dollars and claiming the federal and state credits instead. Data from the Tax Incidence Study database shows that 15,600 taxpayers could save more than \$200 in combined state and federal taxes annually (an average of almost \$370) by making such a switch. The estimate assumes that some will shift to use of credits each year, increasing the cost by \$2,500,000 in FY 2019, \$5,000,000 in FY 2020, and \$7,500,000 in FY 2021.
- For tax year 2017, the number of returns receiving the credit will increase from 33,000 to 94,700. Approximately 74,800 returns will receive an average increase in credit of \$379. These estimates exclude the number who would benefit from deemed expenditures or from switching from pre-tax accounts to the federal and state credits.

Working Family Credit Expansion

- The House Income Tax Simulation (HITS 6.5) Model was used to estimate the tax year revenue impact. These simulations assume the same economic conditions used by Minnesota Management and Budget for the forecast published in November 2016. The model uses a stratified sample of 2014 individual income tax returns compiled by the Minnesota Department of Revenue.
- Tax year impacts are allocated to the following fiscal year.
- Under the bill, about 372,000 tax returns would be affected in tax year 2017. The average reduction in tax would be about \$124. The number of returns eligible for the credit would increase by 107,000.

Angel Investment Credit

- It is assumed that all of the added \$10 million of credit allowed in tax year 2018 would be allocated.
- Tax year impact is allocated to the following fiscal year.

REVENUE ANALYSIS DETAIL (Cont.)

Past Military Service Credit

- To be eligible for the credit, an individual must be separated from military service by the end of the taxable year and must satisfy at least one of three criteria: have served at least 20 years in the military; have a 100% disability rating for a service-connected disability; or have been determined to be eligible for a military service pension.
- A subtraction of military pension income from Minnesota taxable income was enacted in 2016. A taxpayer can claim either the subtraction or the credit, whichever is more advantageous, but not both. The increased credit for past military service will reduce the fiscal cost of the military pension subtraction because some veterans will switch from the subtraction to the enhanced credit.
- About 3,570 taxpayers would claim the credit.
- An annual growth rate of 5% is assumed.
- Tax year impacts were allocated to the following fiscal year.

Base-Year Percentage for Research Credit

- Based on an analysis of filed 2013 data, Minnesota R&D expenditures are estimated to average \$2.5 billion per year. It is assumed that newly eligible taxpayers account for 2% of those expenditures (\$50 million). It is assumed that 50% of the R&D expenditures of those newly eligible taxpayers would qualify for the credit.
- There are two tax credit percentages. The first-tier credit rate (10%) applies to creditable R&D up to \$2 million. The second-tier rate (2.5%) applies to creditable R&D greater than \$2 million. The average credit rate for newly eligible expenditures is assumed to be 7%.
- Because the credit is nonrefundable, the revenue loss is reduced by 50%.

Prevent Tax Evasion

- Revenue estimates are based on the magnitude of revenue gains associated with similar economic substance cases decided in Minnesota and other states.
- The estimate assumes most of the revenue gain will be delayed until corporate taxpayers are audited in fiscal years 2020 and 2021.

Modify the Definition of Financial Institution

- Revenue estimates are based on an analysis of current returns to identify businesses whose Minnesota apportionment percentage would increase under the proposal.

REVENUE ANALYSIS DETAIL (Cont.)

Accelerate Gain on the Sale of a Business for Nonresidents

- The estimate is based on Statistics of Income data on the dollar value of capital gains from the sale of pass-through interests. It is assumed 1.8% of the entire U.S. gains represents activity in Minnesota.
- It is assumed 10% of long-term capital gains are reduced by long-term capital losses.
- It is assumed in 50% of sales that the gains are reported using installment reporting.
- It is assumed 50% of the Minnesota activity represents gains from a taxpayer's full liquidation, and it is assumed that 50% of the gains are realized by nonresidents and former resident taxpayers without connections to Minnesota after the sale.
- It is assumed another 25% reduction reflects S corporation stock gains by nonresidents that are not taxable in Minnesota.
- It is assumed that all taxpayers will elect installment reporting. The estimate assumes the total dollars subject to installment reporting will be paid in equal parts over five years.
- An average tax rate of 8% is assumed. Gains from activity in a tax year are reflected in the collections during the following fiscal year.
- The additional revenue will increase to \$5.5 million in fiscal year 2022, and it will remain stable in years after fiscal year 2022.

Treatment of Insurance Companies Used to Shelter Income

- Revenue estimates are based on analysis of current tax returns to identify businesses currently defined as insurance companies (exempt from tax) but that have less than half of their business in insurance.

Apportionment of Mutual Fund Manager Income

- This provision will primarily affect non-corporate Mutual Fund Service Providers (MFSPs) located outside Minnesota and not currently filing tax returns. The proposal would require these current non-filers to file and pay tax in Minnesota.
- The estimate assumes that there are very few non-corporate MFSPs with a mutual fund located in Minnesota that currently apportion 100% of their income to Minnesota and would apportion less under the proposal.

Reduce Dividend Received Deduction for Debt-Financed Stock

- The reduction of the dividend received deduction affects only domestic dividends.
- Data published by the federal government shows less than 2% of domestic dividends are from debt-financed stock. The estimate apportions these dividends to Minnesota. The estimate assumes that the dividend received deduction for those dividends is reduced by an average of 50 percent.

REVENUE ANALYSIS DETAIL (Cont.)

Disallow Dividend Received Deduction for Subpart F Income

- Subpart F information from the 60 companies claiming the largest dividend received deductions was gathered to make this estimate. The information was from federal Form 1120, Schedule C, line 14(a), *Income from controlled foreign corporations under subpart F*. These 60 companies accounted for two thirds of total dividend received deductions in the 2014 data.
- The tax (before credits) of these 60 corporations was recomputed after reducing their dividend received deduction by any amounts claimed for subpart F income. After apportioning subpart F income to Minnesota, the estimate assumes 80% of this income would become subject to tax. The other 20% of this income is already subject to tax under current law. The revenue gain from the 60 corporations was scaled up to estimate the total revenue gain from all companies. The estimate was reduced by 10% to account for the effect of the R&D tax credit.
- Federal data shows that subpart F income accounts for one third of all dividend-like income reported. Data gathered from Minnesota corporate returns indicate a similar portion is subpart F income.
- No growth in subpart F income was assumed. Recent data indicates little growth in subpart F income.
- Due to a retroactive effective date, 100% of the tax year 2017 revenue gain (vs. 70% without a retroactive date) is allocated to fiscal year 2018. Other tax year impacts are allocated 30/70 to fiscal years.

Equalize Insurance Premiums Tax Rates for Nonadmitted Insurance

- Data from tax years 2012-2015 is used in this estimate. Earlier data is non-comparable due to changes enacted in the NRRA (Nonadmitted and Reinsurance Reform Act of 2010).
- The estimate is the average of the revenue gain from taxing *direct* purchases of nonadmitted insurance at a 3 percent rate rather than the current law 2 percent rate.
- Revenue estimate for fiscal year 2018 was reduced due to the calendar year 2018 effective date.

No Recapture Tax for Property Acquired by Eminent Domain

- Because the recapture tax is 16% of the total amount of the property deducted, even if only a portion was taken by eminent domain, an estate would likely not claim property as qualified if there were any indication that the property might be taken by eminent domain within the three-year period following the decedent's death. Under the bill, the estate probably would claim the property as qualified, resulting in a revenue loss to the state.
- This situation is not expected to occur frequently. If on average one additional piece of qualified property valued at \$500,000 were deducted each fiscal year, the revenue loss could be 10% of the value of the property, or \$50,000.

REVENUE ANALYSIS DETAIL (Cont.)

Excise Tax on Vapor Products

- The change is expected to primarily impact the tax collections for liquid nicotine solutions. The tax on manufactured vapor products would apply on the consumable nicotine solutions rather than on the non-consumable product.
- It is estimated that excise tax collections for vapor products were \$5.7 million for fiscal year 2016.
- Because the future impact of recent FDA deeming regulations on tobacco products is uncertain, no adjustment was made to account for their effect.
- The sales of liquid nicotine solutions are estimated to account for 50% of the Minnesota vapor market.
- Sales volume was adjusted using a price elasticity factor of -0.9.
- A growth rate of 5% is assumed.
- The fiscal year 2018 estimate is adjusted for five months of collections.

Services and Labor to Install Pre-written Software

- It is assumed that all charges for installation labor would be taxable.
- The estimates are based on information from the 2012 Economic Census for sales of technology technical support services by Minnesota companies.
- Growth rates from the Department of Revenue Consumption Tax Model are used to estimate sales from 2013 to 2021.
- The estimate for fiscal year 2018 is adjusted for five months of collections.

Expand Definition of Other Digital Products

- Estimates of United States retail e-commerce sales for 2016 to 2020 are from eMarketer.
- The national estimates are scaled to Minnesota using Minnesota's population share.
- The estimate assumes that 0.1% of total e-commerce sales would become taxable under the proposal.
- Estimates for fiscal year 2018 are adjusted for eleven months of collections.

Containers for Deceased Not for Burial

- The number of cremations is reported by the Minnesota Center for Health Statistics.
- The number of cremations grew at an annual rate of 5.4% between calendar years 2004 and 2014. Growth is assumed to continue at that rate.
- The National Funeral Directors Association reports an average charge of \$1,000 for a ceremonial or rental casket that is not intended for burial.
- The estimate assumes that 20% of cremations use a rental casket.
- The fiscal year 2018 estimate is adjusted for eleven months of collections.

REVENUE ANALYSIS DETAIL (Cont.)

Expand Exemption for 501(c)(3) Organizations

- The IRS reports that there are approximately 33,000 501(c)(3) organizations in Minnesota.
- It is estimated that the number of nonprofit organizations registered with the Department of Revenue as a qualifying 501(c)(3) organization would increase by approximately 1,700.
- It is assumed that exempt purchases by nonprofit organizations will increase by 3% annually.
- Fiscal year 2018 estimates are adjusted for eleven months of impact.

Exemption for Minnesota State High School League Events

- The MSHSL provided information on the value of the previous exemption for fiscal years 2007 to 2015. For fiscal year 2015, the amount was \$810,000.
- Between fiscal years 2011 and 2015, the amounts increased by an average of 2.35% per year. The estimates assume an increase of 2.35% annually.

Exemption for City of Madelia—Building Materials and Supplies

- The estimate is based on information from the construction contractor.
- The total project costs were \$4.306 million, including site demolition and preparation.
- The estimate assumes that materials would be 60% of the total construction costs.
- It is assumed that refund claims would be paid in fiscal year 2018.

Exemption for Siding Production Facility

- Information for the proposed project was provided by representatives of the Iron Range Resources and Rehabilitation Board (IRRRB).
- The proposed project is assumed to have a total cost of \$245 million.
- It is estimated that 35% of the total project cost will be for items exempted under the proposal (machinery and equipment used in production are already exempt as capital equipment).
- It is assumed that 25% of the refunds would be claimed and paid in fiscal year 2018, 50% in fiscal year 2019, and 25% in fiscal year 2020.
- It is expected that only one facility will qualify for the exemption.

Motor Vehicle Leases—Adjust Transfer from General Fund

- The sales tax on motor vehicle leases is estimated in June of each year.
- Growth is based on November 2016 national growth rates published by Global Insights, Inc. for nominal consumer spending on new motor vehicles.

REVENUE ANALYSIS DETAIL (Cont.)

Reduce Motor Fuel Tax Rate for Compressed Natural Gas

- The Petroleum Tax Unit of the Department of Revenue reports that there were approximately 5,044,000 gallons, or 575,574,000 cubic feet, of CNG subject to tax in fiscal year 2016.
- Total excise tax collections for CNG in fiscal year 2016 were approximately \$1,400,000.
- An annual growth rate of 2% is applied, based on forecast information from the Energy Information Administration Annual Outlook 2016.
- The fiscal year 2018 estimate is adjusted for eleven months of collections.

Weight-to-Volume Conversion Rate for Construction Debris

- The base for the estimates is the average tax revenue from the solid waste management tax (SWMT) for calendar years 2014 and 2015. The total average tax revenue from the solid waste management tax for all rates is \$74,259,000.
- Average revenue from non-mixed municipal solid waste, for the two-year period, was approximately \$5,610,000. The amount attributed to construction and demolition debris is 95%. It is estimated that 10.5% of this waste, or \$560,000, is being taxed by ton rather than by cubic yard.
- The Department of Revenue estimates the per-ton tax rate to be set at \$3.50, which is the rate used for the estimate. The bill would increase revenue from tax paid by the ton to about \$980,000, for a gain of \$420,000.
- Annual growth was based on the November 2016 state revenue forecast of the SWMT.
- The fiscal year 2018 estimate is adjusted for eleven months of collections.
- Seventy percent of the total proceeds from the solid waste management tax are deposited in the state Environmental Fund and thirty percent are deposited in the General Fund.

Extend 2% Tax on Health Care Providers, Hospitals, Surgical Centers, and Drug Distributors

- The estimates are based on the November 2016 Health Care Access Fund forecast.
- It is assumed that the tax rate will remain at 2% for the forecast period.
- The fiscal year 2020 estimate is for a partial year of impact.

Source: Minnesota Department of Revenue
Tax Research Division
www.revenue.state.mn.us/research_stats/Pages/Revenue-Analyses.aspx