Income Tax Reciprocity Benchmark Study

Minnesota Department of Revenue

March 1, 2013

MINNESOTA · REVENUE

March 1, 2013

To: Governor Mark Dayton
Senator Rod Skoe, Chair, Senate Committee on Taxes
Representative Ann Lenczewski, Chair, House Taxes Committee
Senator Julianne Ortman, Ranking Minority Member, Senate Committee on Taxes
Representative Greg Davids, Ranking Minority Member, House Taxes Committee

From: Myron Frans, Commissioner of Revenue MF

Attached is the Income Tax Reciprocity Benchmark Study mandated under Laws 2011, First Special Session, Chapter 7, Article 1, Section 9. The Wisconsin Department of Revenue participated in the study as required by the law.

Minnesota Statutes, Section 3.197, specifies that a report to the Legislature must include the cost of its preparation. The total cost of the study summarized in this report, including computer system changes, information capture from returns, and hiring of temporary employees, was $605,000.

Table of Contents

Introduction 1

Summary of Results:
- Minnesota Study 3
- Wisconsin Study 4

Overall Impact of Reciprocity on Minnesota and Wisconsin Revenues 5

Map of Minnesota Returns with Income Subject to Reciprocity,
By County of Residence, Tax Year 2011 6

Impact of Income Tax Reciprocity on Individual Taxpayers 7

History of Minnesota-Wisconsin Income Tax Reciprocity 8

Additional Information on the 2011 Income Tax Returns and Instructions 10

Methodology Used:
- Minnesota Study 11
- Wisconsin Study 12

Appendix A - Minnesota Law Requiring the Income Tax Reciprocity
Benchmark Study 13

Introduction

The Income Tax Reciprocity Benchmark Study was mandated by Minnesota Law enacted in the 2011 Special Session on July 20, 2011 (Chapter 7, Article 1, Section 9, included in Appendix A). The requirement for the study was contingent on the Wisconsin Secretary of Revenue notifying the Minnesota Commissioner of Revenue that the Wisconsin Department of Revenue would fully participate in the study. That written notice was received on February 8, 2012.

The law requires that the study be based on income tax returns for tax year 2011 and determine:

- The number of residents of each state who earned personal service income in the other state;
- The total personal service income earned by residents of each state in the other state; and
- The change in tax revenue in each state that would occur if an income tax reciprocity agreement had been in effect between Minnesota and Wisconsin.

The study was actually two studies: Minnesota conducted a study of the 2011 Minnesota income tax returns, and Wisconsin conducted a study of the 2011 Wisconsin income tax returns. Because no reciprocity agreement was in effect for 2011, each state had income tax returns for both Wisconsin residents working in Minnesota and Minnesota residents working in Wisconsin.

The two states agreed that the impact of reciprocity would be measured against the 2011 returns as they were actually filed. No attempt was made to correct returns that were filed incorrectly or to adjust the results to account for non-filers. Each state identified its returns that had reciprocity income, determined how much reciprocity income was reported on each return, and recalculated the tax for that return as if reciprocity had been in effect. The difference between the tax reported on the return and the recalculated amount was the impact of reciprocity for that return. The information each state had from its own income tax returns was supplemented with income tax return and W2 information exchanged between the two states. The exchanged information was used to help identify returns with reciprocity income that might otherwise have been missed. It enabled each state to compare its calculations of the impact of reciprocity on that state's return with the calculation made for the same taxpayer by the other state.

Minnesota's study used the funds appropriated to ensure complete and accurate results. Care was taken to identify every return that had reciprocity income. More than 138,000 Minnesota returns were reviewed in order to identify the 79,683 Minnesota returns with reciprocity income. Most returns had to be evaluated one-by-one rather than by applying a computer algorithm. Particular attention was paid to returns filed by part-year residents and to returns that reported self-employment income. The Minnesota analysis provides the most complete and accurate measure ever done of the impact of reciprocity.

Wisconsin's analysis was also completed with care, but it depended primarily on the application of a computer algorithm rather than a one-by-one review of returns. Given this limitation, the Wisconsin study was unable to identify reciprocity income on several types of returns, including: 1) filers with self-employment personal service income, 2) Wisconsin residents with reciprocity income but no Minnesota tax liability, and 3) part-year residents who claimed a Minnesota credit for tax paid to Wisconsin.

Due to these differences, the results of the two studies are comparable but not identical. The same type of information was not always available from the returns, and some returns were identified as reciprocity returns in one state but not the other. Results also differ in cases where returns were filed incorrectly.

Additionally, some returns were in the Minnesota study but not the Wisconsin study because Wisconsin residents working in Minnesota could claim one or more of Minnesota's low-income refundable credits. The credits could more than offset their Minnesota tax and result in a refund. These taxpayers would not have claimed a credit on their Wisconsin return for tax paid to Minnesota because they had no Minnesota tax even though they had reciprocity income. This situation did not apply to Minnesota residents working in Wisconsin because Wisconsin's low-income refundable credits are available only to full-year Wisconsin residents.

The results of the Minnesota and Wisconsin studies are summarized on the following three pages, followed by:

- a description of how a reciprocity agreement affects individual taxpayers;
- the history of Minnesota-Wisconsin reciprocity; and
- a more detailed description of the methodology used in the Minnesota and Wisconsin studies.

Minnesota Department of Revenue Study: Summary of Results

Wisconsin Residents Working in Minnesota
For tax year 2011, 55,743 Minnesota income tax returns were filed by Wisconsin residents who earned personal service income of $2.434 billion in Minnesota. Of that total, 45,290 returns incurred a Minnesota tax liability on their personal service income.

Minnesota Residents Working in Wisconsin
For tax year 2011, 23,940 Minnesota returns were filed by Minnesota residents who earned personal service income of $718 million in Wisconsin. Of that total, 18,224 returns claimed a credit on their Minnesota return for tax paid to Wisconsin on their personal service income.

Revenue Impact
There are more than twice as many Wisconsin residents who work in Minnesota as Minnesota residents who work in Wisconsin. For this reason, Minnesota would have a revenue loss under reciprocity.

Minnesota's net revenue loss would be the net of two amounts: the loss of the Minnesota tax on Wisconsin residents working in Minnesota and the gain from not providing to Minnesota residents a credit for tax paid to Wisconsin.

Table 1

Estimated Impact of Reciprocity on Minnesota Tax Revenue Tax Year 2011	
Loss of the Minnesota tax on Wisconsin residents working in Minnesota	($104.1 million)[1]
plus: Gain from not providing to Minnesota residents a credit for tax paid to Wisconsin	+ $30.4 million
equals: Minnesota net revenue loss due to reciprocity	($73.7 million)

Table 1 summarizes the impact on Minnesota tax revenue if reciprocity had been in effect for tax year 2011. The impact would be expected to increase in future years with the growth in (a) the number of taxpayers with reciprocity income and (b) the average amount of such income. The revenue impact is before any payment that Wisconsin would make to Minnesota.

[1] The revenue loss of $104.1 million is a net number. The total loss of $105.3 million was offset by $1.2 million for returns where the low-income refundable credits reduced the tax below zero.

Wisconsin Department of Revenue Study: Summary of Results

Minnesota Residents Working in Wisconsin
For tax year 2011, 24,346 Wisconsin income tax returns were filed by Minnesota residents who earned personal service income of $717 million in Wisconsin. Of that total, 18,413 returns incurred a Wisconsin tax liability on their personal service income.

Wisconsin Residents Working in Minnesota
For tax year 2011, 50,577 Wisconsin returns were filed by Wisconsin residents who earned personal service income of $2.357 billion in Minnesota. Of that total, 38,534 returns claimed a credit on their Wisconsin return for tax paid to Minnesota on their personal service income.

Revenue Impact
Wisconsin would have a revenue gain under reciprocity because there are more than twice as many Wisconsin residents who work in Minnesota as Minnesota residents who work in Wisconsin.

Wisconsin's net revenue gain would be the net of two amounts: the loss of the Wisconsin tax on Minnesota residents working in Wisconsin and the gain from not providing to Wisconsin residents a credit for tax paid to Minnesota.

Table 2

Estimated Impact of Reciprocity on Wisconsin Tax Revenue Tax Year 2011	
Loss of the Wisconsin tax on Minnesota residents working in Wisconsin	($35.7 million)
plus: Gain from not providing to Wisconsin residents a credit for tax paid to Minnesota	+ $103.0 million
equals: Wisconsin net revenue gain due to reciprocity	$67.3 million

Table 2 summarizes the impact on Wisconsin tax revenue if reciprocity had been in effect for tax year 2011. The impact would be expected to increase in future years with the growth in (a) the number of taxpayers with reciprocity income and (b) the average amount of such income. The revenue impact is before any payment that Wisconsin would make to Minnesota.

Overall Impact of Reciprocity on Minnesota and Wisconsin Revenues

The impact of reciprocity on individual taxpayers is explained on page 7. The impact of reciprocity for all individual taxpayers results in its impact on the total revenues of the two states.

Under reciprocity:

- Some taxpayers would pay the same amount of total tax to the two states,
- Some taxpayers would pay less in total tax to the two states, and
- No one would pay more.

Because some taxpayers pay less tax and no one pays more, reciprocity would result in reduced total revenue for the two states combined. The results of the study show that the combined net impact of reciprocity on Minnesota and Wisconsin revenues would have been a loss of $6.4 million for tax year 2011. The net revenue loss would occur each year an agreement is in effect and would be expected to increase in subsequent years.

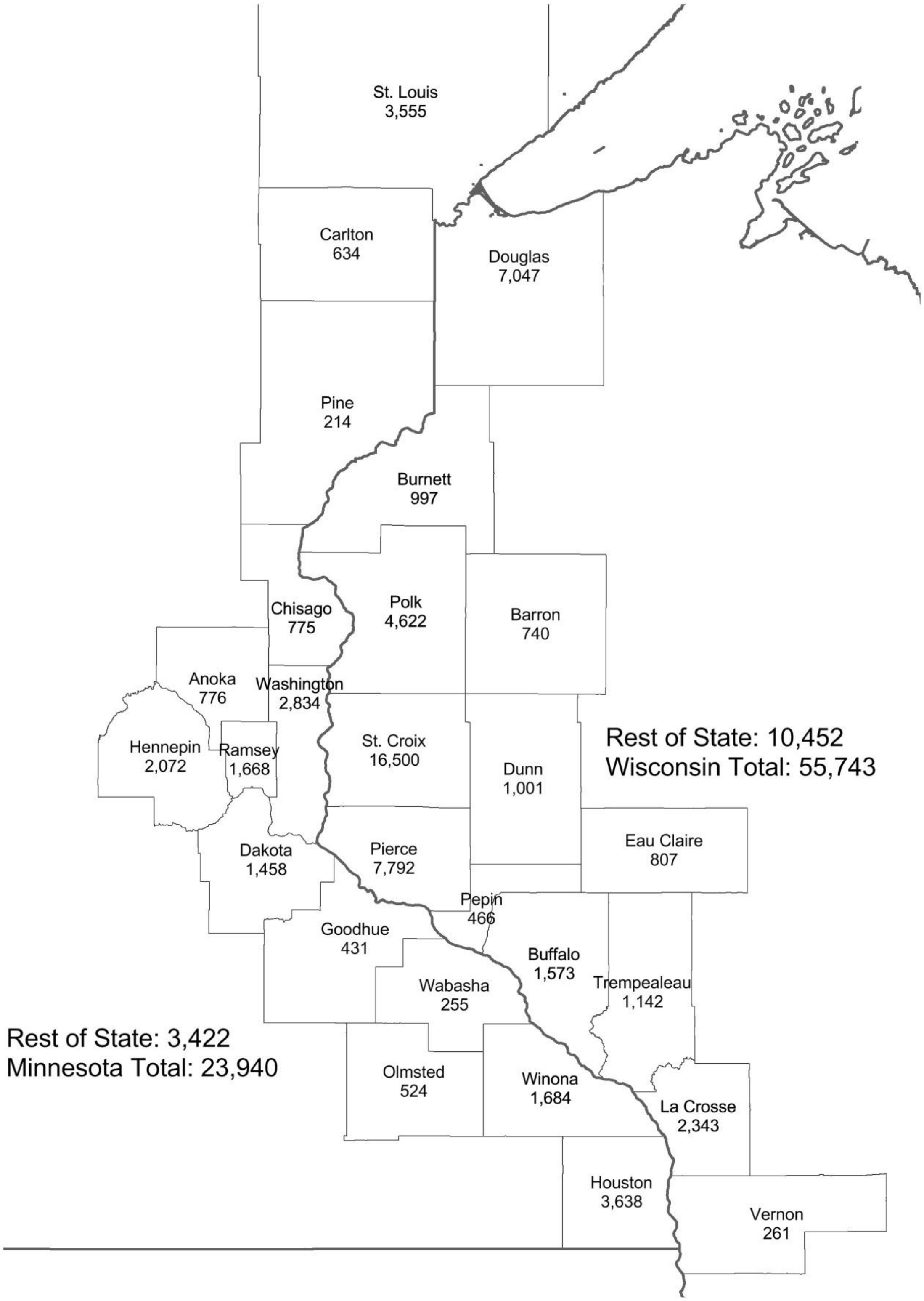
Table 3

Combined Net Impact of Reciprocity Tax Year 2011	
Minnesota net revenue loss	($73.7 million)
Wisconsin net revenue gain	$67.3 million
Combined net impact of reciprocity	($6.4 million)

The purpose of reciprocity is generally put forth as a convenience for taxpayers, that they file one state income tax return instead of two. However, when reciprocity results in reduced revenues in the two states combined, that convenience comes at a price to the two states. The fact that reciprocity would reduce the combined revenues of the two states means that the states would be providing a subsidy to the affected taxpayers.

With reciprocity, each state would lose revenue because residents of the other state would no longer be paying taxes to that state. Each state would also have a gain because its residents would no longer be claiming a credit for tax paid to the other state. For both states, the credit is nonrefundable and cannot exceed the tax in the state of residence. Therefore, the gain from the credit that would not be claimed for one state is less than the revenue the other state would lose under reciprocity, which is the reason for the combined net revenue loss for the two states.

Minnesota Returns with Income Subject to Reciprocity



Tax Research Division

Impact of Income Tax Reciprocity on Individual Taxpayers

Reciprocity is an exception to the general rule of how personal service income is allocated by state. For a resident, the general rule is that all income is subject to tax in the state of residence, and a nonrefundable credit is allowed for tax paid to another state on the same income. For a nonresident, the general rule is that wage and other personal service income is subject to tax in the state in which it is earned.

If two states have an income tax reciprocity agreement, wage and other personal service income is not subject to tax in the state in which it is earned. The income is subject to tax only in the state of residence, and no credit is claimed for tax paid to the other state.

Without reciprocity, a taxpayer pays in total the higher of the tax of the state of employment or the state of residence. With reciprocity, the taxpayer pays the tax in the state of residence.

The following examples show the impact of reciprocity on a taxpayer whose only income was wages in the other state.

Wisconsin Resident Working in Minnesota	Without Reciprocity	With Reciprocity	Difference Due to Reciprocity
MN tax	$1,000	$0	
WI tax	$1,250	$1,250	
Credit for tax paid to MN	-$1,000	$0	
WI tax after credit	$250	$1,250	
Total tax for both states	$1,250	$1,250	$0

Minnesota Resident Working in Wisconsin	Without Reciprocity	With Reciprocity	Difference Due to Reciprocity
WI tax	$1,250	$0	
MN tax	$1,000	$1,000	
Credit for tax paid to WI	-$1,000	$0	
MN tax after credit	$0	$1,000	
Total tax for both states	$1,250	$1,000	($250)

In the above examples, the Wisconsin tax is higher than the Minnesota tax on the same income, which is the typical case for taxpayers over a wide range of income. The Minnesota tax can be higher than the Wisconsin tax, which typically occurs at the lowest and highest income ranges. For a given taxpayer, the extent to which the tax for the two states differs varies with that person's income, filing status, number of dependents, and other factors. The structure of the Wisconsin tax is very different from the Minnesota tax, and a comparison based on tax rates alone does not give a complete picture of the levels of tax in the two states.

History of Minnesota-Wisconsin Income Tax Reciprocity

Minnesota and Wisconsin had an income tax reciprocity agreement that was in effect for tax years 1968 through 2009.

In 1967 a provision was added to Minnesota Statutes to allow Minnesota to enter into a reciprocity agreement with another state. Minnesota and Wisconsin signed a reciprocity agreement on November 14, 1967, effective beginning with tax year 1968.[2]

Due to more Wisconsin residents working in Minnesota than Minnesota residents working in Wisconsin, the agreement resulted in a net revenue loss to Minnesota. For this reason, in 1973 Minnesota Governor Wendell Anderson proposed that reciprocity be repealed. A bill for repeal was moving through the Minnesota Legislature, but Wisconsin wanted to retain reciprocity. Negotiations between Governor Anderson and Wisconsin Governor Patrick Lucey resulted in a proposal which would accomplish the goals of both states: reciprocity would be retained and Minnesota would be compensated for its net revenue loss. Provisions were added to the statutes of both states that required Wisconsin to reimburse Minnesota annually for its net revenue loss due to reciprocity, effective with tax year 1973.

Under the agreement, the payment for a tax year was due on December 1st of the following year, an average of seventeen months later than revenues would be received through income tax withholding. For example, the payment for tax year 2001 was due on December 1, 2002.

In 2002 Minnesota Governor Jesse Ventura proposed the termination of the agreement because of the negative impact of the timing of the payment on Minnesota revenues and a dispute over the calculation of the payment. The agreement was not terminated, but the Minnesota statute was amended to require that the payment include interest as a condition of retaining the agreement. Interest would be calculated from July 1 of the tax year to the payment date, approximately seventeen months. The agreement was modified to specify the interest requirement, and interest was included in the payments for tax years 2001 through 2009.

In 2009 Minnesota Governor Tim Pawlenty asked Wisconsin to accelerate the timing of the reciprocity payments as a condition of retaining the agreement. Because Wisconsin would not agree to the accelerated payments specified by Governor Pawlenty, the Minnesota Commissioner of Revenue terminated the agreement on September 18, 2009, effective with tax year 2010.

[2] Minnesota has had income tax reciprocity with North Dakota since 1969 and with Michigan since 1984. Neither of these agreements involves reimbursement from one state to the other.

Although the payment for tax year 2009, the last year of the agreement, was due on December 1, 2010, Wisconsin did not make the payment until July 12, 2011. The payment included interest for the period from July 1, 2009, to July 12, 2011.

A 2011 Minnesota Law required the Commissioner of Revenue to initiate negotiations with the Wisconsin Secretary of Revenue with the objective of entering into an income tax reciprocity agreement effective beginning with tax year 2012. Negotiations were initiated, but it was determined that there was not enough lead time to finalize an agreement to be in place by January 2012. Negotiations then proceeded with the goal of an agreement beginning in tax year 2013, but no agreement was reached.

Additional Information on the 2011 Income Tax Returns and Instructions

In preparation for the study, the Minnesota and Wisconsin Departments of Revenue coordinated the additional information requested on the 2011 income tax return of each state. The wording and format were essentially the same for both states.

Questions were added to the first page of the income tax returns for each state. Both questions appeared on the Minnesota individual income tax return, Form M1. The first question appeared on the Wisconsin resident individual income tax return, Form 1, and both questions appeared on the Wisconsin nonresident and part-year resident return, Form 1NPR. The following are the questions as they appeared on the Minnesota return.

Wisconsin Residents Working in Minnesota:
Was any of your income from personal or professional services performed in Minnesota while a Wisconsin resident? No ☐ Yes ☐ If yes, enter Minnesota income: __________

Minnesota Residents Working in Wisconsin:
Was any of your income from personal or professional services performed in Wisconsin while a Minnesota resident? No ☐ Yes ☐ If yes, enter Wisconsin income: __________

For both states, notice was given at the beginning of the income tax instruction booklet of the additional information requested, with reference to the page that contained detailed information. In addition to instructions on how to complete the questions on the return, the instructions included an explanation and examples of the types of income that should be reported. The following wording was in the Minnesota income tax instruction booklet.

Personal service income includes income earned as an employee, independent contractor, self-employed person or partner, as long as you personally performed the service in the other state. The income can be in the form of wages, salaries, tips, commissions, bonus, fees, or similar compensation. It can also be net income from federal Schedule C or a guaranteed payment and/or distributive share from a partnership on Schedule E.

Include the following as personal service income earned in the other state:

- Income from work done at your employer's location in the other state, such as at an office, factory, restaurant, store, clinic, or similar place of employment.
- Income from work done at various locations in the other state, such as a job site, construction site, or a customer's location, including income from service performed as a plumber, carpenter, repairman, consultant , traveling salesperson, life insurance agent, real estate agent, or professional, such as a doctor or lawyer.

Do not include the following as personal service income earned in the other state:

- Income earned as an interstate truck driver, railroad worker, airline employee, or member of the military.
- Pensions and annuities; unemployment compensation.
- Rental income, royalties, capital gains, interest, and dividends.
- Income earned as a self-employed person and/or partnership income if the income results mostly from the sale of goods or from the services of employees.

Methodology for the Minnesota Department of Revenue Study

The Minnesota Department of Revenue received an appropriation of $605,000 for the study. A portion of the appropriation was used for systems changes and additional data entry during processing. The rest of the appropriation was used for additional personnel who reviewed returns and determined the income that would be subject to reciprocity for each return.

The responses to the two reciprocity questions on the M1 were captured for both the paper and electronically-filed returns. The responses were entered during processing for all returns, not just those marked "yes".

Wisconsin residents filing a Minnesota return must complete Schedule M1NR for Nonresidents and Part-Year Residents. Minnesota residents claiming a credit for tax paid to Wisconsin must complete Schedule M1CR, Credit for Income Tax Paid to Another State. For electronically-filed returns, existing procedures provided for the capture of all information from the schedules. For paper returns, it was necessary to capture additional information during processing from Schedules M1NR and M1CR.

A separate work group was established to review the returns. An experienced employee from the Income Tax Division took a mobility position as project manager. Six temporary personnel were hired to work full time for the duration of the study. A conference room was converted into their work space. Work stations were set up with computers and access to the systems necessary to complete the task.

A computer program was written to select returns for review. The program identified all returns that *potentially* had reciprocity income. The manual review then identified the returns that *actually* had reciprocity income. Each of the temporary personnel was assigned returns to review. For each return, a determination was made if the return would be affected by reciprocity. If so, the amount of income that would be subject to reciprocity was determined and entered. For paper returns, additional information from the M1NR and M1CR was also entered.

Several sources of information were used to determine the income that would be subject to reciprocity, including information provided by the Wisconsin Department of Revenue. In addition to the Minnesota income tax return, the determination included review of W2s filed by Minnesota employers, data from Wisconsin income tax returns, and W2s filed by Wisconsin employers.

It was determined that certain returns did not need to be reviewed individually. For returns filed electronically by full-year Wisconsin residents whose only Minnesota-source income was wages, the impact of reciprocity could be determined with certainty from the available information. The study includes 39,632 returns for which the impact of reciprocity was determined in this manner.

For Wisconsin residents working in Minnesota who had income that would be subject to reciprocity, a program was written to determine the amount of Minnesota income tax that was attributable to reciprocity income. The tax calculated is the tax after all credits, both nonrefundable and refundable. For Minnesota residents working in Wisconsin who had income that would be subject to reciprocity, a program was written to determine the amount of the credit for tax paid to Wisconsin that was attributable to reciprocity income.

Methodology for the Wisconsin Department of Revenue Study

The Wisconsin Department of Revenue study relied more on computer programming and less on the examination of returns by personnel. Wisconsin's data warehouse routinely captures more data from the Wisconsin paper returns. This provides more information electronically than was the case for Minnesota. As additional funding was not provided as part of the Wisconsin legislation requiring the Wisconsin Department of Revenue to study the impact of individual income tax reciprocity, the department internally funded its study. Therefore, Wisconsin selectively examined individual returns.

A computer program identified returns with reciprocity income. The primary indicator for Minnesota residents with Wisconsin reciprocity income was a nonresident return indicating Minnesota as the state of residence and indicating wages taxable to Wisconsin. The primary indicator for Wisconsin residents with Minnesota reciprocity income was the presence of a credit schedule for tax paid to another state, listing Minnesota wages.

Multiple data exchanges were crucial to identifying additional reciprocity related returns as well as for purposes of data cleansing of previously identified returns. The Minnesota Department of Revenue identified a number of returns that Wisconsin could then verify programmatically or by assigning personnel to review the returns. Wisconsin retained one temporary employee to selectively examine returns as necessary.

The three main return categories that were not otherwise incorporated from Wisconsin data are: 1) filers with self-employment personal service income, 2) Wisconsin residents with reciprocity income but no Minnesota tax liability, and 3) part-year residents who claimed a Minnesota credit for tax paid to Wisconsin.

The Wisconsin revenue gain from income tax reciprocity was calculated by writing a computer program that computed the impact of removing the credit for tax paid to Minnesota on reciprocity income. Similarly, the Wisconsin revenue loss from income tax reciprocity was calculated by writing a computer program that computed the impact of excluding the reciprocity income of Minnesota residents from Wisconsin income tax.

Appendix A
Minnesota Law Requiring the Income Tax Reciprocity Benchmark Study

Sec. 9. **INCOME TAX RECIPROCITY BENCHMARK STUDY**
(a) The Department of Revenue, in conjunction with the Wisconsin Department of Revenue, must, provided the conditions of paragraph (d) are satisfied, conduct a study to determine at least the following:
(1) the number of residents of each state who earn income from personal service in the other state;
(2) the total amount of income earned by residents of each state who earn income from personal services in the other state; and
(3) the change in tax revenue in each state if an income tax reciprocity arrangement were resumed between the two states under which the taxpayers were required to pay income taxes on the income only in their state of residence.
(b) The study must use information obtained from each state's income tax returns for tax year 2011, and from any other source of information the departments determine is necessary to complete the study.
(c) No later than March 1, 2013, the Department of Revenue must submit a report containing the results of the study to the governor and to the chairs and ranking minority members of the legislative committees having jurisdiction over taxes, in compliance with Minnesota Statutes, sections 3.195 and 3.197.
(d) The department shall conduct the study only if the commissioner of revenue receives notice from the secretary of revenue that the Wisconsin Department of Revenue will fully participate in the study.
EFFECTIVE DATE. This section is effective the day following final enactment.

Sec. 12. **APPROPRIATIONS.**
$291,000 in fiscal year 2012 and $314,000 in fiscal year 2013 are appropriated from the general fund to the commissioner of revenue for the income reciprocity benchmark study required under section 9. The appropriations under this section are one time and are not added to the agency's base budget.
EFFECTIVE DATE. This section is effective the day following final enactment.

Laws 2011, First Special Session, Chapter 7, Article 1, Sections 9 and 12