A "Tax Reform Friendly" Tax Expenditure Report

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Minnesota Department of Revenue

FTA Revenue Estimation and Forecasting Conference
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Uses of the TEB

- **Budget Perspective**: Compare effectiveness of direct expenditures and tax expenditures that have a similar purpose.
- **Revenue Options Perspective**: How can we raise more revenue without raising tax rates?
- **Tax Reform Perspective**: How much could we lower the tax rate if we repealed or modified selected tax expenditures?

1. Tax Reform Perspective: All Taxes

Tax Expenditure Impacts Should Always be Shown in Two Ways:

- Foregone Revenue
- Foregone Reduction in Rates

4.02 CLOTHING AND WEARING APPAREL

Current Tax Rate: 6.875%

Minnesota Statutes, Section 297A.67, Subd. 8 and 27

Clothing for general use is exempt from the sales and use tax. The exemption includes inner and outer wear, footwear, headgear, gloves and mittens, neckwear, belts, hosiery, and similar items. Also exempted are fabrics, thread, buttons, zippers, and similar items which are to be directly incorporated into wearing apparel.

The exemption does not apply to jewelry, handbags, billfolds, fur clothing, sports clothing sold for exclusive use in a sporting activity, or work-related safety articles.

The exemption for clothing was included in the sales and use tax statutes enacted in 1967. It was last changed in 2008.

	Fiscal Year Impact			
	2012	2013	2014	2015
All Funds	$312,100,000	$322,800,000	$331,100,000	$341,500,000

Revenue Neutral Rate Reduction: -0.41 percentage points

1.64 HOME MORTGAGE INTEREST

Current Income Tax Rates: 5.35%/ 7.05%/7.85%

Internal Revenue Code, Sections 63(d) and 163(h)
Minnesota Statutes, Section 290.01, Subd. 19

A taxpayer may take an itemized deduction for interest paid on debt secured by a principal or second residence. Although some restrictions apply, most taxpayers can deduct the full amount of their mortgage interest. This deduction is one of several deductions subject to the limitation of itemized deductions for higher-income taxpayers.

Mortgage interest is deductible on up to $1 million of debt used to buy, build, or improve a principal or second residence. If the debt is used for any other purpose, the limitation is $100,000 of debt. If more than one home is involved, the limitations apply to the total amount.

Home mortgage interest was deductible without limitation until the current restrictions were enacted in 1987. The limitation of certain itemized deductions was made permanent in 1993, and in 2001 the limitation was phased out from tax year 2006 through 2010. In 2010 the repeal of the limitation was extended to tax years 2011 and 2012 for federal tax purposes, but Minnesota did not adopt the extension of the repeal.

This deduction reduces the state income tax on an estimated 735,700 returns in tax year 2011.

	Fiscal Year Impact			
	2012	2013	2014	2015
State General Fund	$353,700,000	$341,500,000	$361,100,000	$382,100,000

Revenue Neutral Income Rate Reduction	Bottom	Middle	Top
Proportional reduction in all rates:	-0.21%	-0.27%	-0.30%

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Proportional reduction in all rates:	-0.21%	-0.27%	-0.30%
Distributionally neutral rate reduction:	**-0.22%**	**-0.37%**	**-0.09%**

Distributionally Neutral Rate Reduction

	Dollars (at current rates)	Percentage Point Reduction in Tax rate: Bottom Rate (now 5.35%)	Middle Rate (now 7.05%)	Top Rate (now 7.85%)
Mortgage Interest	$325 million	-0.22%	-0.37%	-0.09%
Property Taxes	$164 million	-0.15%	-0.15%	-0.07%
Charitable Contributions	$191 million	-0.11%	-0.16%	-0.19%
Personal Property	$ 17 million	-0.02%	-0.02%	0.00%
Interaction (four above)	-$216 million			
All four of the above	$481 million	-0.29%	-0.46%	-0.26%
Medical Expenses	$ 62 million	-0.15%	0.03%	-0.01%
Casualty Losses	$ 2 million	0.00%	0.00%	0.00%
Business Expenses	$ 78 million	-0.07%	-0.07%	0.00%
Interaction (all)	-$286 million			
Repeal all itemized deductions	$553 million	-0.36%	-0.50%	-0.27%

Total combined tax paid by all whose last dollar is taxed at each rate (after base broadening) is the same as would be paid under current law.

2. Tax Reform Perspective: Income Taxes

Focus on tax expenditures that are relevant for state-only tax reform.

- **"Timing Issues"**
  - MN piggybacks on many federal provisions that affect the *timing* of taxes.
  - Decoupling from federal law would require keeping two sets of books – often for a very long time.
  - *Examples: Accelerated depreciation, deferred compensation, pension contributions, IRAs.*

- **“Information Issues”**
  - If (1) not taxed federally, (2) not reported on the federal tax return, and (3) not subject to federal reporting requirements, the taxpayer may not know the amount to report and DOR will struggle with compliance.
  - *Examples: Many employee fringe benefits, Medicare benefits*.

Implications of Timing and Information Issues

- If base expansion is contingent on federal action, not relevant for *state-only* tax reform discussions.
  - If included in report, the administrative difficulty of repealing these provisions should be made clear.
  - Note that the distinction is NOT "federal provisions" vs. "state provisions."

Tax Reform Perspective

Broaden Tax Base & Lower the Tax Rate

Individual Income Tax			($ millions) FY 2013
Gross Revenue			**$ 12,986.4**
Tax Expenditures*			**4,720.2**
Repeal would pose few or no administrative problems	**1,365.6**	29%	
Repeal would create significant administrative problems	3,354.6	71%	
Net Revenue			**$ 8,266.2**

*Adjusts for interactions among itemized deductions.

Tax Reform Perspective

Broaden Tax Base & Lower the Tax Rate

Individual Income Tax			57% of collections	($ millions) FY 2013
Gross Revenue				**$ 12,986.4**
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57% of collections

17% of collections

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Simple sum of all tax expenditures overstates the extent to which action *by Minnesota alone* can broaden the tax base.

Tax Reform Perspective

Broaden Tax Base & Lower the Tax Rate

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17% of collections

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Simple sum of all tax expenditures overstates the extent to which action *by Minnesota alone* can broaden the tax base.

Repeal all would cut rates by 14%, not 36%.

Tax Reform Perspective
Broden Tax Base & Lower the Tax Rate

($ millions)

Corporate Franchise Tax				FY 2013
Gross Revenue			**$**	**1,717.8**
Tax Expenditures				**828.5**
Repeal would pose few or no administrative problems	**703.8**	85%		
Repeal would create significant administrative problems	124.7	15%		
Net Revenue			**$**	**889.3**

Note: No adjustment for interactions.

Tax Reform Perspective

Broaden Tax Base & Lower the Tax Rate

Corporate Franchise Tax				($ millions) FY 2013
Gross Revenue			93% of collections	**$ 1,717.8**
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Net Revenue				**$ 889.3**

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Tax Reform Perspective

Broaden Tax Base & Lower the Tax Rate

Corporate Franchise Tax			($ millions) FY 2013
Gross Revenue	79% of collections	93% of collections	**$ 1,717.8**
Tax Expenditures			**828.5**
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Repeal would create significant administrative problems	124.7	15%	
Net Revenue			**$ 889.3**

Note: No adjustment for interactions.

Base broadening has *potential* to reduce rate from 9.8% to roughly 5.5% *without decoupling from federal timing provisions (depreciation, etc.).*

3. Tax Reform Perspective: Sales Taxes

Minnesota has defined tax expenditures to include any "nontaxable sale of *tangible personal property or services* to the final user."

- For both **capital equipment** and **business services**, a business is generally the "final user".
- Those who define the sales tax as a *consumption* tax argue that these should not be defined as tax expenditures.

Tax Reform Perspective
Broaden Tax Base & Lower the Tax Rate

			($ millions)
General Sales Tax (All Funds)			**FY 2013**
Gross Revenue			**$ 11,557.0**
Tax Expenditures			**6,531.6**
Purchases by Consumers (primarily)	**3,035.3**	46%	
Purchases by Government	166.5	3%	
Purchases by Nonprofits	184.2	3%	
Purchases by Businesses	3,145.6	48%	
Net Revenue			**$ 5,025.4**

Tax Reform Perspective

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Purchases by Nonprofits	184.2	3%	
Purchases by Businesses	3,145.6	48%	
Net Revenue			**$ 5,025.4**

130% of collections

60% of collections

Base broadening has potential to reduce rate from 6.875% to below 4.5% *even if base expansion were limited to consumer goods and services* -- and limited to consumer services listed in the TEB (not medical, educational, or housing services).

Omit all exemptions for business purchases?

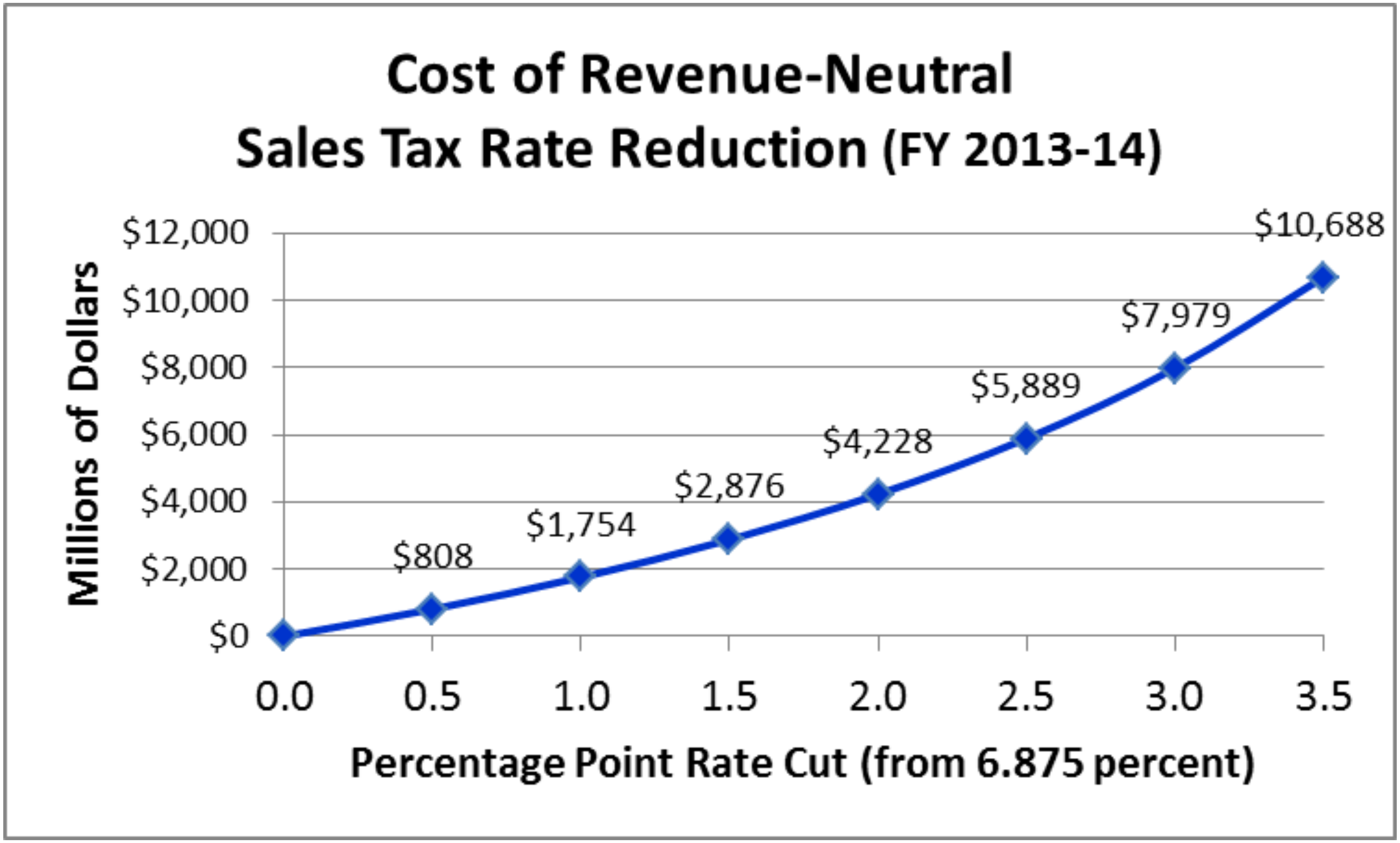
- Even if business purchases should all be exempt, **narrowly defined** sales tax exemptions for business may be bad policy.
- Separate section on business exemptions?
    - Capital equipment exemptions
    - Construction material exemptions
    - Nontaxable business services
  - Focus on business purchases that ARE taxable as well as those that are not.

4. Tax Reform Perspective: Miscellaneous

- Interactions – direct and indirect
  - Itemized deductions, added standard deduction for seniors
  - Otherwise not as important as with more progressive federal tax rate structure.
- Revenue estimates differ from TEB numbers.
  - Steady-state vs. newly taxable
  - Collectability issues (including nexus)
- Completeness? (for sales tax -- medical, education, construction services; digital goods.)
- Overly broad categories? (drugs; business services)

Tax Committee Handout as Example

- Shows foregone rate reduction
  - Not linear, so not additive
- Identifies timing and information issues for income and corporate tax
- Adjusts for some income tax interactions
- Identifies business exemptions for sales tax
  - But does not group by type of business exemption
- Some adjustment for sales tax collectability



Cost measured as increase in revenue from base expansion at 6.875% rate

5. Models of Base Expansion

Base Expansion Sales Tax (BEST) Model

- User selects items to add to sales tax base.
- Model identifies percentage of the added tax base that is from business purchases.
- Model calculates revenue neutral state sales tax rate.
  - Also revenue gain if all added revenue not used to broaden the base.

Base Expansion for Sales Tax (BEST) Simulation Model

Version 9.1

Based on February 2012 Forecast (adjusted for actions taken in the 2012 session) and February 2012 Tax Expenditure Budget

Updated 10/19/12

Minnesota Department of Revenue

All estimates should be considered preliminary. Questions? Contact Paul Wilson at 651 556-6138

	Calendar Month (1 to 12)	Year
Effective Date for Change in Base and Rate:	7	2013
Added months for selected items due to administrative difficulty:		6

TEB Number	Service Added/Exemption Repealed	Consumer Share	On/Off Switches	Adjustment for effective date	FY 2014-15 Estimated General Fund Revenue Change ($000s) at 6.5% rate
4.01	*Food Products*	100%	Off	96%	0
4.02	*Clothing & Wearing Apparel*	100%	On	96%	609,800
4.03 (part)	*Prescription Drugs*	100%	Off	96%	0
4.03 (part)	*Over-the-Counter Drugs*	100%	On	96%	69,700
4.04	*Medical Devices*	100%	Off	96%	0
4.05	*Prescription Eyeglasses*	100%	Off	96%	0
4.06	*Baby Products*	100%	Off	96%	0
4.07	*Feminine Hygiene Items*	100%	Off	96%	0
4.08	*Caskets and Burial Vaults*	100%	Off	96%	0
4.09	*Publications (adjusted for nexus)*	100%	On	96%	53,700
4.10	*Textbooks Required for School Use*	100%	Off	96%	0
4.11	*Personal Computers Required for School Use*	100%	Off	96%	0
4.12	*Digital Products*	100%	On	96%	12,400
4.13	*De Minimus Use Tax Exemption for Individ (assume 10% compliance)*	100%	On	96%	2,800
4.14	*Motor Fuels [Question: Constitutionally dedicated for highways?]*	56%	Off	96%	0
4.15	*Residential Heating Fuels*	100%	On	96%	255,800
4.16	*Residential Water Service*	100%	On	96%	38,800
4.17	*Sewer Services*	90%	On	96%	96,400
4.19 (part)	*Car Repair*	78%	On	96%	326,200

4.59	*Hospitals and Outpatient Surgical Centers*	0%	Off	96%	0
4.61	*Construction Materials for Low-Income Housing*	0%	Off	96%	0
4.73	*Isolated Sales*	50%	Off	96%	0
4.56	*Trade In Allowances*	80%	Off	96%	0
	All Other Tax Expenditures in Book	4%	Off	96%	0
	Added amount for others, adjusted for effective date [3]	N/A	Off	100%	0

End of 2012 Session

	Rate changes	Adjusted for effective date
Total Estimated FY 2014-15 General Fund Revenue Increase at 6.5%		1,909,000
Added revenue from 3/8% tax on new tax base [4]		112,000
Percent of Increase from Business Purchases		13%
Percent increase in tax base		*20%*
Revenue-Neutral Rate (ignoring use of any added revenue at 3/8% rate -- current rate 6.5%)	-1.103%	**5.397%**
Revenue-Neutral Rate (including dedicated legacy funds -- current rate 6.875%)	-1.167%	**5.708%**
Note: Revenue neutral Legacy Fund rate would be:	-0.064%	0.311%
Alternative General Fund Rate Above Revenue Neutral Rate *(can differ from 6.50%)*	-0.811%	**5.689%**
Added Revenue at Alternative Rate (including added revenue at 3/8% rate)		**506,000**
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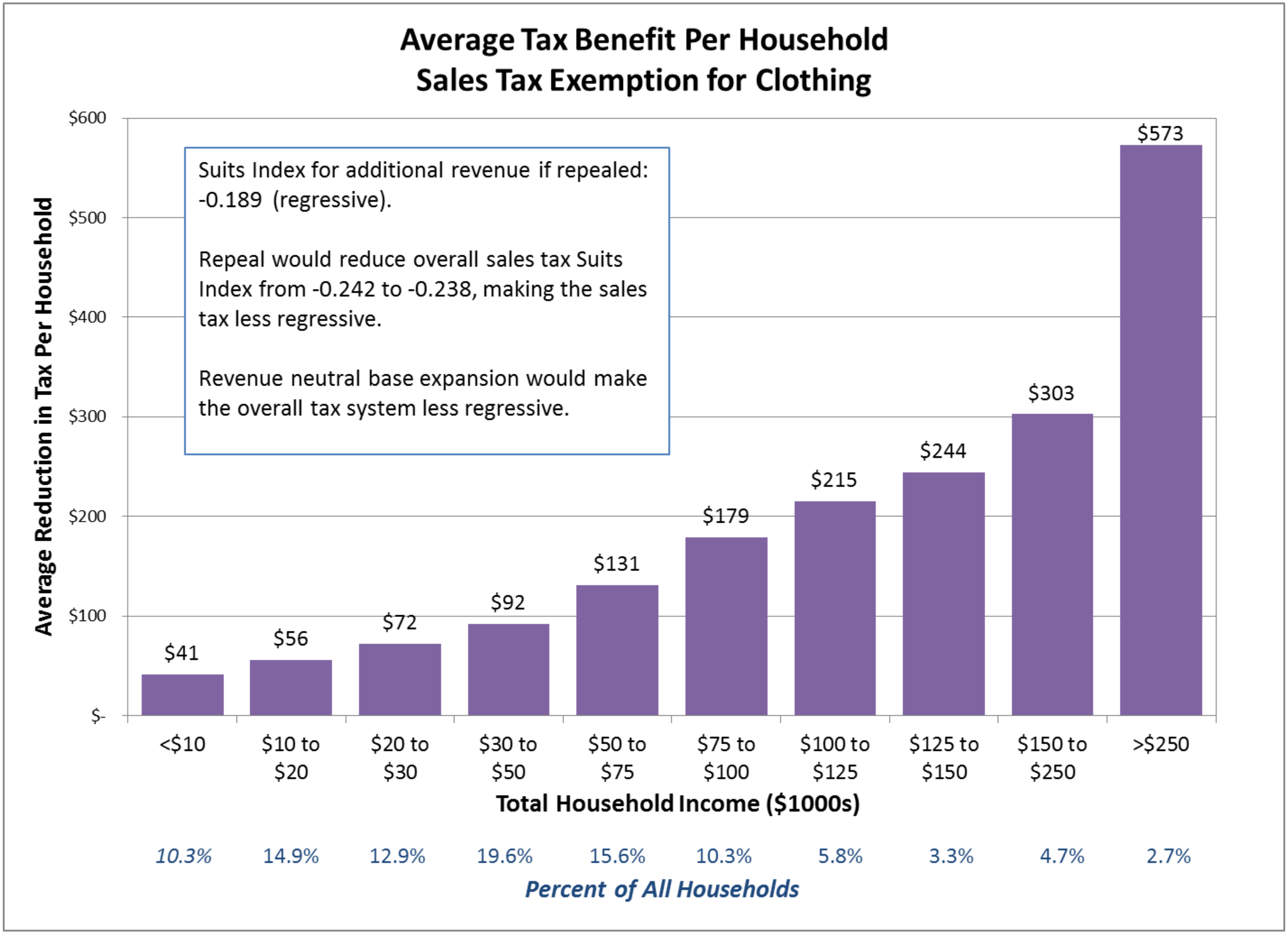
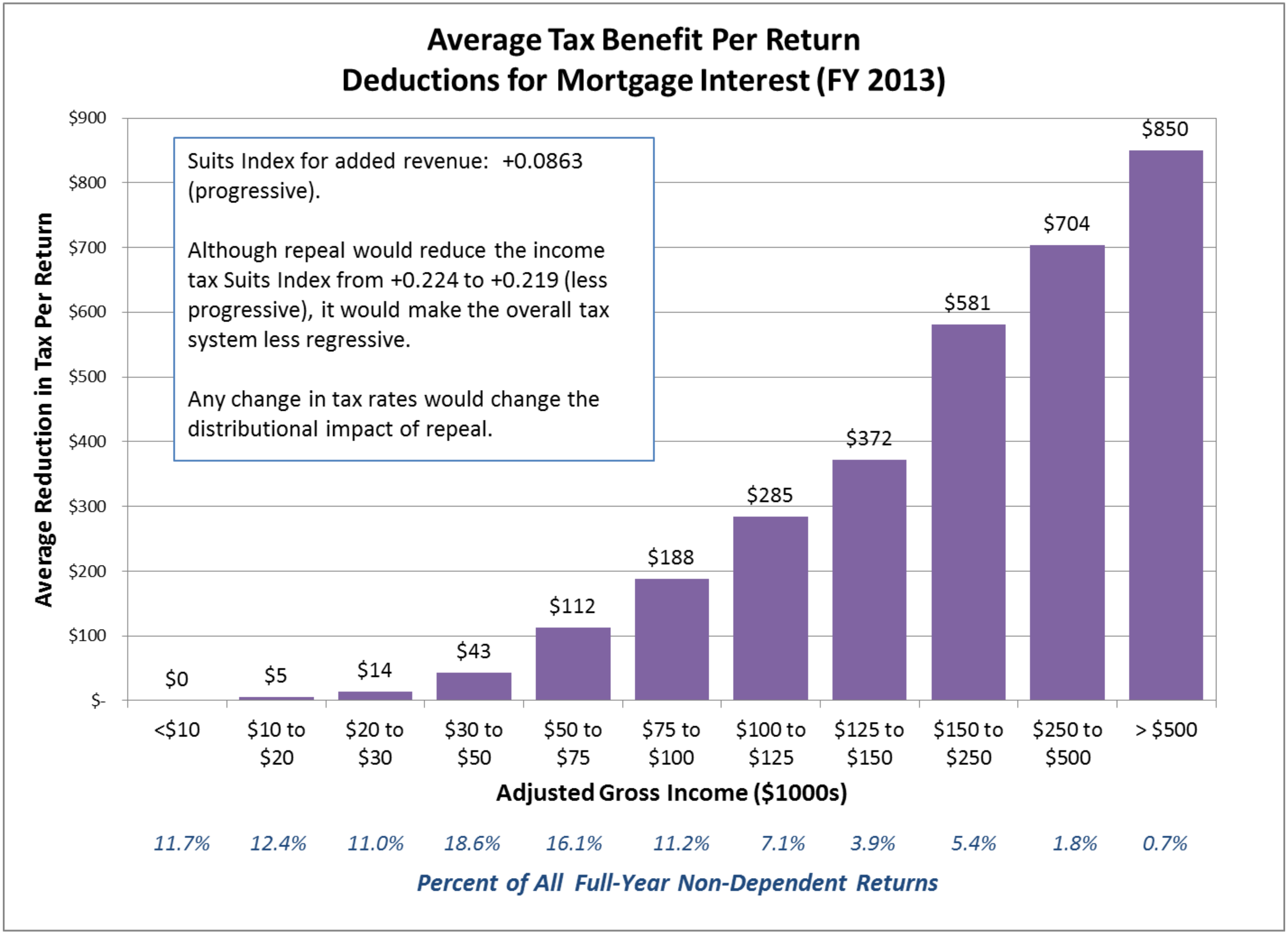
End of 2012 Session

6. Tax Reform Perspective: Distribution of Benefits

- If known, include distributional information
  - Income tax simulation model
  - Sales tax distributional work

- Presentation Issues
  - Income measure and categories
  - Total dollars, average dollars per-return, or percent of income?
  - Compare to current tax base?


Average Tax Benefit Per Household
Sales Tax Exemption for Clothing
Average Reduction in Tax Per Household
$600
$500
$400
$300
$200
$100
$-
Suits Index for additional revenue if repealed: -0.189 (regressive).
Repeal would reduce overall sales tax Suits Index from -0.242 to -0.238, making the sales tax less regressive.
Revenue neutral base expansion would make the overall tax system less regressive.
$41
$56
$72
$92
$131
$179
$215
$244
$303
$573
<$10
$10 to $20
$20 to $30
$30 to $50
$50 to $75
$75 to $100
$100 to $125
$125 to $150
$150 to $250
>$250
Total Household Income ($1000s)
10.3%
14.9%
12.9%
19.6%
15.6%
10.3%
5.8%
3.3%
4.7%
2.7%
Percent of All Households


Average Tax Benefit Per Return
Deductions for Mortgage Interest (FY 2013)
Suits Index for added revenue: +0.0863 (progressive).
Although repeal would reduce the income tax Suits Index from +0.224 to +0.219 (less progressive), it would make the overall tax system less regressive.
Any change in tax rates would change the distributional impact of repeal.
Average Reduction in Tax Per Return
$900
$800
$700
$600
$500
$400
$300
$200
$100
$-
$0
$5
$14
$43
$112
$188
$285
$372
$581
$704
$850
<$10
$10 to $20
$20 to $30
$30 to $50
$50 to $75
$75 to $100
$100 to $125
$125 to $150
$150 to $250
$250 to $500
> $500
Adjusted Gross Income ($1000s)
11.7%
12.4%
11.0%
18.6%
16.1%
11.2%
7.1%
3.9%
5.4%
1.8%
0.7%
Percent of All Full-Year Non-Dependent Returns

Summary: "Tax Friendly" TE Report

- Show foregone rate reductions.
- Focus on provisions relevant for state-only reforms (income and corporate tax).
- Focus on consumer expenditures (sales tax).
- Identify significant interactions.
- Note when revenue estimates will will vary greatly from tax expenditures.
- Create accessible models of base expansion.
- Show distributional impact when possible.