

Tax Incidence Analysis

Prepared by the Tax Research Division, Minnesota Department of Revenue
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HOUSE 2013 Omnibus Tax Bill

HF 677 (Lenczewski) – 3rd Engrossment

The 2013 House Omnibus Tax Bill proposes the following tax law changes:

- **Income Tax**
 - Create new 4th income tax bracket – **8.49%** tax rate on Minnesota taxable income over \$400,000 joint, \$226,200 single, and \$340,700 head of household starting in 2013. The new tax bracket is indexed for inflation.
 - Replace the **charitable contributions** deductions with an 8% income tax credit for contributions in excess of certain thresholds.
 - Conform to federal law changes that include the following for tax year 2015: (1) increase in the standard deduction for married filers; and (2) increased Working Family Credit for some married couples.
 - Adjust income tax brackets to raise revenue to cover the costs of federal conformity.
 - Repeal the long-term care insurance credit.
- **Corporate Tax:** Increase income subject to corporate tax, primarily by (1) repealing the foreign operating corporation (FOC) provisions, (2) reducing the foreign royalty subtraction from 80% to 50%, (3) including Minnesota sales made by *all* members of a unitary group in the Minnesota sales factor, (3) indexing minimum fees for inflation, (4) making the R&D credit nonrefundable, and (5) taxing some income in tax havens. Also increase the taconite occupation tax rate from 2.45% to 4.9% (half of the corporate tax rate).
- **Cigarette & tobacco taxes:** Increase the cigarette tax by **\$1.60** per pack and raise the tax rates on other tobacco products.
- **Alcohol Taxes:** Increase alcohol excise taxes by the equivalent of **7 cents per drink**.
- **Sales Tax:** Enact several relatively small sales tax provisions.
- **Estate Tax:** Increase revenue by enacting a parallel gift tax, including more property owned by nonresidents in the tax base, and modifying the small business and farm subtractions.
- **Property Taxes:** Increase local government aid by **\$80 million** per year (and index for inflation); increase county aid by **\$30 million** per year. These are expected to reduce local property taxes.
- **Property tax refunds:** Increase by **\$159 million** for homeowners and **\$16 million** for renters.

These tax law changes would modify the burden of state and local taxes compared to what it would be under current law. The bill's impact can be estimated using the database and underlying models developed for the *Minnesota Tax Incidence Study*. **Because that study projects income and taxes to calendar year 2015, this analysis generally estimates the impact of law changes in that year.** Note that dollar estimates are for calendar year rather than fiscal year. The analysis is also limited to **permanent** changes in tax law.

A change in state and local taxes will in some cases have a direct impact on **federal taxes** – either by changing federal itemized deductions or by changing state and local taxes deducted on federal returns filed by businesses. **As has been true for all incidence analyses completed for proposed law changes in past years, this analysis takes those direct changes in federal taxes into account.**

Impact of Law Changes Included in the Analysis on Minnesota State & Local Tax Burden

- **Income Tax Changes:** The impact of the new 4th tier tax rate, tax bracket changes, changes related to charitable contributions, repeal of the long term care insurance credit, increased married joint standard deduction, and change to the Working Family Credit are modeled using the House Income Tax Simulation Model for tax year 2015. Minnesota residents would pay **\$158 million** (91%) of the \$173 million of net income tax revenue raised through these changes.
- **Corporate Tax Changes:** The burden of the estimated \$162 million increase in corporate tax is modeled using the corporate tax incidence model. Some of the burden would be borne in higher prices, some in lower wages, and some in lower returns to business owners. Tax burdens for Minnesota residents would rise by an estimated **\$100 million** (about 62% of added revenue). The remainder would be borne by nonresidents or the federal government (in lower federal corporate tax revenue). These estimates apply to the long-term burden, after businesses have fully adjusted to the change in tax burdens.
- **Cigarette and Tobacco Tax Changes:** Minnesota residents would pay **\$204 million** (95%) of the estimated \$215 million increase.
- **Alcohol Taxes:** Minnesota residents would pay **\$171 million** (93%) of the estimated \$185 million increase.
- **State Sales Tax:** The tax burden on Minnesota consumers is estimated to rise by **\$23 million** (91%) of the \$25 million increase.
- **Estate Tax:** The tax burden on Minnesota residents is estimated to rise by **\$47 million** (86%) of the \$55 million increase.
- **Property Taxes:** Local property taxes are expected to fall by \$45 million, including \$19 million for owner-occupied homes. The tax burden on Minnesota residents is estimated to fall by **\$35 million** (77%) of the \$45 million reduction, including all of the reduction for owner-occupied homes.
- **Property Tax Refunds:** Minnesota residents will benefit from an additional **\$155 million** in homeowner refunds and **\$16 million** in renter refunds.

Law Changes Not Included in the Analysis

- **The 4% income tax surcharge** is limited to two years (tax years 2013 and 2014). This analysis estimates the impact of tax changes in 2015, when the surtax would no longer be in effect.

However, a summary of the impact of the surcharge is included in a box on page 6 to provide some insight into how the results might have differed if modeled for a year when the surtax was in effect.

- Except for changes in the Working Family Credit and married standard deduction, **federal conformity provisions** are not included in this analysis. The distributional impact of the other permanent changes that affect more than the timing of tax payments cannot be analyzed using the income tax model.
- The bill would replace sales tax refunds with an **upfront exemption for capital equipment**. This is omitted because it primarily changes only the timing of tax payments.

Results by Population Decile: Change in Minnesota State and Local Tax Burdens

- The Minnesota state and local tax burden on Minnesota taxpayers would rise by **\$475 million**. Of that increase, **65%** would fall on the top 10% (with 42% of total income), **55%** on the top 5% (with 31% of total income), and **42%** on the top 1% (with 16% of total income).
- Minnesota state and local tax burdens would rise by an average of **0.22%** of income. Tax burdens change very little for those in the 5th through 7th deciles, but tax burdens rise by more than the 0.22% average for the 1st through 3rd deciles and the 10th decile. The tax burden rises by **0.34%** of income for the top decile and by **0.57%** of income for the top 1% of taxpayers.

Table 1.
Change in Minnesota State and Local Tax Burden as Percent of Income
by Population Decile

2015 Population Decile	Income Range	Percent of All Households	Minnesota State and Local Tax Burden as Percent of Income		
			Current Law	Proposed Law	Change
1	10,937 & under	10%	29.9%	31.5%	1.58%
2	10,938 to 19,316	10%	12.6%	13.3%	0.66%
3	19,317 to 26,397	10%	11.4%	11.8%	0.38%
4	26,398 to 35,600	10%	11.0%	11.1%	0.16%
5	35,601 to 46,507	10%	11.7%	11.7%	0.00%
6	46,508 to 59,998	10%	11.9%	11.9%	0.00%
7	59,999 to 77,704	10%	12.0%	12.0%	0.01%
8	77,705 to 101,616	10%	11.8%	11.8%	0.06%
9	101,617 to 146,400	10%	11.6%	11.8%	0.17%
10	146,401 & over	10%	10.3%	10.6%	0.34%
All Households		100%	11.3%	11.5%	0.22%

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	10.9%	11.1%	0.20%
Next 4%	202,408 to 510,005	4%	10.6%	10.8%	0.20%
Top 1%	510,006 & over	1%	9.6%	10.1%	0.57%
Full Decile	146,401 & over	10%	10.3%	10.6%	0.34%

As discussed on page 17 of the 2013 Minnesota Tax Incidence Study, results for the first decile are overstated for several reasons.

- The corporate, sales, alcohol, and cigarette tax changes are regressive, but their impact is offset by the income tax and property tax changes. Under current law, the top 1% of taxpayers has the lowest effective tax rate (at 9.6% of income) and the drop in the effective tax rate between the 9th decile (11.6%) and the top 1% (9.6%) is significant. Under the proposal, the effective tax rates for the 10th decile would rise from 10.3% to **10.6%** -- still well below any other decile. The effective tax rate for the top 1% would rise from 9.6% to **10.1%**.

- The Suits index for the net tax change is **+0.274**, which is very progressive. It is quite a bit more progressive than the current income tax (+0.200). Only the estate tax is more progressive.
 - The Suits index for the income tax changes other than the Working Family Credit is **+0.935** and the Working Family Credit provision is **+0.898**, compared to **+0.829** for the estate tax changes, **+0.541** for the property tax reductions combined with PTR increases, **-0.164** for the corporate tax, **-0.214** for alcohol taxes, **-0.256** for the sales tax, and **-0.610** for the cigarette and tobacco tax increases.
 - In the absence of the proposed increases in cigarette, tobacco, and alcohol taxes, the tax burden would fall for those in deciles 1 through 8 (by \$161 million) and rise by \$15 million in the 9th and \$246 million in the 10th decile.
- With the proposed tax changes, the Suits index for all Minnesota state and local taxes would become less negative, rising from **-0.049** to **-0.043**. Though still regressive, this would be less regressive than in recent years (since 2006).
- As shown in **Table 2**, total Minnesota state and local tax burdens would rise by **2.0%**. The increases would be **3.3%** for the top decile and **5.9%** for the top 1%. Tax burdens would change only slightly in deciles 5-7. They would rise by less than average increase of 2.0% in deciles 4, 8, 9, and for all of the 10th decile other than those in the top 1%. The percentage increase in tax burden is well above the average for the lowest three deciles as well as the top 1%.

Table 2.
Dollars of Minnesota State and Local Tax Burden
Impact of 2013 House Omnibus Tax Bill

Estimated Calendar Year 2015 Impact

2015 Population Decile	Income Range	Percent of All Households	Percent of All Income	Minnesota State and Local Tax Burden				
				Current Law Tax (\$1000s)	Tax with Proposed Law (\$1000s)	Change in Tax (\$1000s)	Decile's Share of Total Change in Tax	Percent Increase in Tax Over Current Law Tax
1	10,937 & under	10%	0.8%	537,928	566,341	28,413	6.0%	5.3%
2	10,938 to 19,316	10%	1.9%	514,797	541,844	27,047	5.7%	5.3%
3	19,317 to 26,397	10%	2.9%	707,921	731,545	23,624	5.0%	3.3%
4	26,398 to 35,600	10%	4.0%	945,145	958,586	13,441	2.8%	1.4%
5	35,601 to 46,507	10%	5.3%	1,334,108	1,334,181	73	0.0%	0.0%
6	46,508 to 59,998	10%	6.9%	1,756,088	1,756,244	156	0.0%	0.0%
7	59,999 to 77,704	10%	8.9%	2,277,516	2,278,834	1,318	0.3%	0.1%
8	77,705 to 101,616	10%	11.5%	2,916,622	2,930,760	14,138	3.0%	0.5%
9	101,617 to 146,400	10%	15.6%	3,902,773	3,959,386	56,613	11.9%	1.5%
10	146,401 & over	10%	42.2%	9,346,791	9,656,766	309,975	65.3%	3.3%
ALL MINNESOTA HOUSEHOLDS		100%	100.0%	24,239,689	24,714,488	474,799	100.0%	2.0%

Detail for the Top Decile

Lower Half	146,401 to 202,407	5%	11.0%	2,578,683	2,625,369	46,686	9.8%	1.8%
Next 4%	202,408 to 510,005	4%	15.0%	3,413,204	3,478,265	65,061	13.7%	1.9%
Top 1%	510,006 & over	1%	16.3%	3,354,904	3,553,132	198,228	41.7%	5.9%
Full Decile	146,401 & over	10%	42.2%	9,346,791	9,656,766	309,975	65.3%	3.3%

- Table 3 shows dollar tax changes by tax type. The reduction in the property tax burden (**down by \$210 million**) offsets **31%** of the increased burden attributed to other taxes. The net added burden from other taxes totals **\$685 million**. Excise taxes on cigarettes, tobacco, and alcohol account for **55%** of that increase, income and estate taxes for **27%**, corporate tax for **15%**, and state sales tax for **3%**.

Table 3.
Change in Minnesota State and Local Tax Burden by Tax Type
Impact of House Omnibus Tax Bill

Estimated Calendar Year 2015 Impact, by Tax Type

Dollars in \$1000s

2015 Population Decile	Income Range	Percent of All Households	Percent of All Income	Change in Tax Burden					
				Income Tax & Estate Tax	Corporate Tax	State Sales Tax	Excise Taxes	Property Taxes Net of PTR	Total
1	10,937 & under	10%	0.8%	277	2,512	917	31,477	(6,771)	28,413
2	10,938 to 19,316	10%	1.9%	(80)	3,253	1,142	30,681	(7,948)	27,047
3	19,317 to 26,397	10%	2.9%	(1,451)	4,199	1,323	31,460	(11,907)	23,624
4	26,398 to 35,600	10%	4.0%	(7,579)	5,279	1,514	32,371	(18,144)	13,441
5	35,601 to 46,507	10%	5.3%	(10,608)	6,635	1,708	33,737	(31,399)	73
6	46,508 to 59,998	10%	6.9%	(6,562)	7,866	1,944	35,004	(38,096)	156
7	59,999 to 77,704	10%	8.9%	(7,536)	9,825	2,294	36,391	(39,656)	1,318
8	77,705 to 101,616	10%	11.5%	(4,122)	12,373	2,722	38,417	(35,252)	14,138
9	101,617 to 146,400	10%	15.6%	6,484	16,539	3,252	41,430	(11,093)	56,613
10	146,401 & over	10%	42.2%	218,276	31,311	5,833	64,231	(9,675)	309,975
ALL MINNESOTA HOUSEHOLDS		100%	100.0%	187,100	99,792	22,649	375,199	(209,942)	474,799

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	11.0%	13,761	10,898	1,949	23,339	(3,260)	46,686
Next 4%	202,408 to 510,005	4%	15.0%	29,839	12,774	2,116	24,323	(3,992)	65,061
Top 1%	510,006 & over	1%	16.3%	174,676	7,638	1,768	16,568	(2,423)	198,228
Full Decile	146,401 & over	10%	42.2%	218,276	31,311	5,833	64,231	(9,675)	309,975

4% Income Tax Surcharge

Because the 4% surcharge on any Minnesota taxable income above \$500,000 is proposed only for two years (2013 and 2014), it is not included in this analysis for calendar year 2015.

However, if that surtax were in effect in tax year 2015, it would increase Minnesota resident tax burdens by an additional **\$623 million**. Of that total, 99.93% would be borne by those in the top 1%. The surtax itself would have a Suits index of **+0.905** (extremely progressive).

The Suits index for the full package of changes would rise to **+0.639**, and the all-taxes Suits index would rise from the current-law **-0.049** to **-0.018** – still slightly regressive but roughly the same as in the early 1990s.

Results by Population Decile: Change in Both Minnesota and Federal Tax Burdens

Because homeowner property taxes and state income taxes can be claimed as itemized deductions on federal income tax returns, a change in these taxes will change federal tax liability. The change in federal tax will offset part of the change in Minnesota income taxes and homeowner property taxes. There is no federal offset for those who do not itemize deductions, nor is there any offset for a taxpayer who is subject to the federal alternative minimum tax (because property and state income taxes are not deductible). For those who itemize (and are not subject to the federal AMT), the portion of the change in Minnesota tax that is offset by the change in federal liability is generally equal to the federal tax rate on the last dollar of the taxpayer's income. The offset is 15% for a taxpayer in the 15% tax bracket and 36.9% for a taxpayer in the 36.9% tax bracket.

- The change in federal tax liability would offset **23%** (\$38 million) of the \$158 million increase in Minnesota income taxes paid by Minnesota residents. However, higher federal income taxes would offset **7%** (\$15 million) of the benefit from reduced home property taxes net of PTR (\$210 million). As a result, the changes in itemized deductions would reduce federal taxes by **\$23 million**.
- Although the overall federal tax change is relatively small, the impact on the top decile – and top 1% -- is substantial. Federal taxes would fall by **\$34 million** for those in the top decile and by **\$29 million** for the top 1%.

Table 4.
Dollar Change in Minnesota State and Local *and* Federal Tax Burden
Impact of House Omnibus Tax Bill

(Dollars in \$1000s)

2015 Population Decile	Income Range	Number of Households	Net Change in Minnesota Tax Burden	Net Change in Federal Taxes		Net Change in Minnesota <i>and</i> Federal Tax Burden (\$1000s)
				Change in Federal itemized Deductions for State Income Taxes*	Change in Federal Itemized Deductions for Home Property Taxes	
1	10,937 & under	10%	28,413	(0)	1	28,413
2	10,938 to 19,316	10%	27,047	1	33	27,081
3	19,317 to 26,397	10%	23,624	9	135	23,768
4	26,398 to 35,600	10%	13,441	69	419	13,930
5	35,601 to 46,507	10%	73	67	1,178	1,318
6	46,508 to 59,998	10%	156	(93)	2,354	2,417
7	59,999 to 77,704	10%	1,318	(176)	4,007	5,149
8	77,705 to 101,616	10%	14,138	(529)	4,238	17,848
9	101,617 to 146,400	10%	56,613	(1,663)	1,345	56,295
10	146,401 & over	10%	309,975	(35,332)	831	275,474
ALL MINNESOTA HOUSEHOLDS		100%	474,799	(37,647)	14,542	451,693

Detail for the Top Decile

Lower Half	146,401 to 202,407	5%	46,686	(3,261)	472	43,897
Next 4%	202,408 to 510,005	4%	65,061	(2,505)	249	62,804
Top 1%	510,006 & over	1%	198,228	(29,566)	110	168,772

*Positive values in this column are due to increased Working Family Credit received by itemizers.

- Although the proposal would increase the burden of *Minnesota* state and local taxes by \$475 million, it would increase the total burden of *federal plus Minnesota* state and local tax burdens by **\$452 million**.
- When both federal and state taxes are considered, tax burdens would increase by an average of **0.21%** of income (rather than 0.22%). The tax burden would rise by **0.30%** of income (rather than 0.34%) in the 10th decile and by **0.48%** of income (rather than 0.57%) for the top 1% of taxpayers.
- Because the net reduction in federal taxes is concentrated at high incomes, adjusting for the change in federal taxes reduces progressivity. The Suits Index for the proposed change in taxes falls from +0.274 to **+0.211**, which is still quite progressive (slightly more than the current income tax).

Table 5
Change in Minnesota State and Local *and Federal* Tax Burden as Percent of Income
Impact of Tax Proposals in House Omnibus Bill

(Dollars in \$1000s)

2015 Population Decile	Income Range	Percent of All Households	Net Change in Minnesota Tax Burden as Percent of Income	Net Change in Federal Taxes as Percent of Income		Net Change in Minnesota <i>and Federal</i> Tax Burden as Percent of
				Higher Itemized Deductions for Minnesota Income Tax	Lower Itemized Deductions for Home Property Taxes	
1	10,937 & under	10%	1.58%	0.000%	0.000%	1.58%
2	10,938 to 19,316	10%	0.66%	0.000%	0.001%	0.66%
3	19,317 to 26,397	10%	0.38%	0.000%	0.002%	0.38%
4	26,398 to 35,600	10%	0.16%	0.001%	0.005%	0.16%
5	35,601 to 46,507	10%	0.00%	0.001%	0.010%	0.01%
6	46,508 to 59,998	10%	0.00%	-0.001%	0.016%	0.02%
7	59,999 to 77,704	10%	0.01%	-0.001%	0.021%	0.03%
8	77,705 to 101,616	10%	0.06%	-0.002%	0.017%	0.07%
9	101,617 to 146,400	10%	0.17%	-0.005%	0.004%	0.17%
10	146,401 & over	10%	0.34%	-0.039%	0.001%	0.30%
ALL MINNESOTA HOUSEHOLDS		100%	0.22%	-0.017%	0.007%	0.21%

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	0.20%	-0.01%	0.00%	0.19%
Next 4%	202,408 to 510,005	4%	0.20%	-0.01%	0.00%	0.20%
Top 1%	510,006 & over	1%	0.57%	-0.08%	0.00%	0.48%

Note: Because amounts paid in Minnesota estate tax are deducted in calculating federal estate tax, a substantial portion of the \$47 million burden from the Minnesota estate tax (perhaps \$15 million) would be offset by lower federal tax liability. This is not included in Tables 4 and 5. Different exemption levels for the state and federal tax make it difficult to calculate the change in federal tax.

Technical Addendum

A. Assumptions about Changes in Local Property Taxes

- When general purpose aids to local governments are reduced, a portion of those aid cuts will result in property tax increases.
- For 2014 and future years we assume that non-school local governments will reduce taxes by 50% of any aid increases.

B. Estimating the Incidence of CHANGES in Business Taxes (“Incremental Incidence”)

- As explained on pages 60-61 of the 2013 Tax Incidence Study, the incidence of a change in the level of business taxes (“incremental incidence”) will differ from the average incidence of existing business taxes (“average incidence”). Average incidence divides an existing business tax into three parts – the national average tax on all capital, the sector differential, and the Minnesota differential. In contrast, a change in the level of a business tax is all treated as a change in the Minnesota differential.
- If the level of Minnesota business taxes changes, this will generally change the amount of *federal tax* paid by the business – either the federal corporate income tax or the federal individual income tax (for flow-through businesses). For a corporation paying federal tax at the 35% rate, each additional \$1000 in Minnesota tax will reduce the federal tax burden by \$350. So \$350 of the \$1000 of Minnesota tax burden is borne by the federal government in foregone tax revenue. The burden of the remaining \$650 in tax may be shifted to consumers in higher prices or to workers in lower compensation – or it may reduce the after-tax income of the business owner. This analysis assumes an average federal tax rate for business owners of 30% for corporate tax and 20% for individual income tax.
- The extent to which the tax burden will be shifted to consumers or workers will depend on the nature of the market. Minnesota tax changes are most likely to result in price changes if the market is local and close competitors see the same change in tax. Businesses selling in national or international markets are much less likely to shift the added cost to consumers by raising prices (or reduce their price in response to a tax cut). *As in the incidence study, the incidence results assume the market has time to fully adjust to any tax changes.*
- The incidence of the business tax changes in the bill (as modeled here) is as follows:
 - Corporate tax increases: 30% shifted to Minnesota consumers, 31% shifted to Minnesota workers, 0.6% borne by Minnesota owners, and 38% borne by nonresidents and the federal government.
 - Business property tax increases for nonresidential property: 29% of the benefits to Minnesota consumers, 9% to Minnesota workers, 15% by Minnesota owners, and 47% to nonresidents and the federal government.
 - Reduction in rental property taxes: 53% of the benefits to renters, 24% to Minnesota owners, and 23% to nonresidents and the federal government.
 - Business sales tax: 69% borne by Minnesota consumers, 23% by Minnesota workers, less than 1% by Minnesota owners, and 8% by nonresidents.