

Tax Incidence Analysis

Prepared by the Tax Research Division, Minnesota Department of Revenue

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SENATE 2013 Omnibus Tax Bill

HF 667 -- First Unofficial Engrossment

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

- **Income Tax**
 - Raise the current-law top bracket tax rate from 7.85% to **9.4%**.
 - Enact a refundable clothing credit, which varies by family composition and phases out with income.
- **Corporate Tax:** Increase income subject to corporate tax, primarily by (1) repealing the foreign operating corporation (FOC) provisions, (2) repealing the foreign royalty subtraction, (3) including Minnesota sales made by *all* members of a unitary group in the Minnesota sales factor, and (3) indexing minimum fees for inflation. This is mostly offset by (1) reducing the tax rate from 9.8% to **9.0%**, and (2) increasing the R&D credit rate (2nd tier).
- **Cigarette & tobacco taxes:** Increase the cigarette tax by **\$0.94** per pack and raise the tax rates on most other tobacco products.
- **Sales Tax:** Broaden the sales tax base to include clothing, personal services, repair services, over-the-counter drugs, storage & warehousing services, magazine subscriptions, and telecommunications equipment. This is mostly offset by reducing the state tax rate from 6.875% to **6.0%**.
- **Estate Tax:** Modify the subtraction for small business and farms.
- **Property Taxes**
 - Decrease school property tax levies by **\$250 million** per year.
 - Increase local government aid by **\$80 million**, county aid by **\$40 million**, and payments in lieu of taxes by **\$5 million**. Also create a new township aid of **\$5 million** per year. These aid increases will reduce local property taxes
 - Increase state business property tax levy by **\$111 million** in calendar year 2014 (and adjust for inflation in later years).
- **Property Tax Refunds:** Increase property tax refunds by **\$19 million** for renters. Reduced property taxes on homes will cause homeowner refunds to *fall* by **\$14 million**.

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**
 - **Rate Increase:** The impact of the increase in the top bracket rate was modeled using the House Income Tax Simulation Model for tax year 2015. Minnesota residents would pay **\$539 million** (92%) of the \$584 million of net income tax revenue raised through these changes.
 - **Income Tax Credit for Clothing Sales Tax:** This would reduce the tax burden by an estimated **\$45 million**.
- **Corporate Tax:** The impact of the net \$26 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 **\$17 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.
- **State Sales Tax:** The impact is modeled with the Minnesota Consumption Tax Model.
 - **Tax on Consumer Purchases:** The net tax burden on Minnesota consumers is estimated to **rise by \$239 million** (91%) of the \$263 million net increase in tax on consumer purchases. The incidence of the \$263 million net tax increase is modeled in three parts: (1) the benefits of the reduced rate on products taxed under current law (\$402 million), (2) tax on newly taxed items at the 6% tax rate that can be modeled from Consumer Expenditure Survey data (\$610 million), and (3) other tax changes for consumer purchases (increase of \$55 million).
 - **Tax on Business Purchases:** The incidence of the \$54 million reduction is modeled in three parts: (1) the benefits of the reduced rate on products taxed under current law (\$279 million), (2) the tax on newly taxed items at the 6% tax rate (\$244 million), and (3) the net reduction in tax paid on business purchases from other tax changes (\$19 million). The net tax burden on Minnesota residents is estimated to fall by slightly more, at **\$56 million**. This occurs because the share of the tax changes borne by residents is on average higher for tax reductions than it is for the tax cuts.
- **Local Sales Taxes:** The broader base for the sales tax will increase local sales tax revenue by an estimated \$53 million (15.2%). Of the total, \$32 million will be on consumer purchases and \$22 million on business purchases. This is estimated to increase the burden on Minnesota residents by **\$48 million** (91% of the total).
- **Cigarette and Tobacco Tax:** Minnesota residents would pay **\$164 million** (95%) of the of the estimated \$173 million increase
- **Estate Tax:** Modifications to the small business and farmer exemptions are expected to increase the tax burden by **\$18 million**.

- **Property Taxes:** Property taxes are expected to fall by \$205 million, including \$188 million for owner-occupied homes and \$43 million for rental property. However, property taxes on nonresidential business property would **rise** by \$32 million. Because the share of the tax *increases* borne by Minnesota residents is less than the share of tax *reductions* that benefit Minnesota residents, the net reduction in resident tax burdens – at **\$213 million** – exceeds the net change in tax.
- **Property Tax Refunds:** Minnesota residents will benefit from an additional **\$19 million** in renter refunds, but homeowner refunds will fall by **\$14 million** due to lower home property taxes.

Law Changes Not Included in the Analysis

- Several relatively small **income tax provisions** cannot be modeled effectively using the income tax model. They include changes in angel investment, past military service and combat zone credits as well as two new credits (for certain dental providers and for greater Minnesota internships).
- The bill would replace sales tax refunds with an **upfront exemption for capital equipment**. This is omitted because it generally changes only the timing of tax payments.
- The bill would exempt most purchases by **cities and counties** from the sales tax, which would reduce their tax liability by an estimated \$124 million at the current 6.875% tax rate. Because this would reduce local government costs relative to current law, it is likely to result in somewhat lower local property taxes. Given the lack of a clear method to model such changes, any such impact is omitted from this analysis.

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 **\$704 million**. Of that increase, **81%** would fall on the top 10% (with 42% of total income), **77%** on the top 5% (with 31% of total income), and **56%** on the top 1% (with 16% of total income).
- Minnesota state and local tax burdens would rise by an average of **0.33%** of income. Tax burdens rise by less than that average in the 2nd through 9th decile and in the lower half of the 10th decile. The tax burden rises by **0.63%** of income for the top decile and by **1.12%** 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%	30.6%	0.60%
2	10,938 to 19,316	10%	12.6%	12.8%	0.25%
3	19,317 to 26,397	10%	11.4%	11.5%	0.12%
4	26,398 to 35,600	10%	11.0%	11.1%	0.11%
5	35,601 to 46,507	10%	11.7%	11.8%	0.10%
6	46,508 to 59,998	10%	11.9%	12.0%	0.09%
7	59,999 to 77,704	10%	12.0%	12.0%	0.09%
8	77,705 to 101,616	10%	11.8%	11.9%	0.08%
9	101,617 to 146,400	10%	11.6%	11.7%	0.09%
10	146,401 & over	10%	10.3%	10.9%	0.63%
All Households		100%	11.3%	11.6%	0.33%

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	10.9%	11.0%	0.12%
Next 4%	202,408 to 510,005	4%	10.6%	11.1%	0.47%
Top 1%	510,006 & over	1%	9.6%	10.7%	1.12%
Full Decile	146,401 & over	10%	10.3%	10.9%	0.63%

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, 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 **10.9%** -- still well below any other decile. The effective tax rate for the top 1% would rise from 9.6% to **10.7%**.

- The Suits index for the net tax change is **+0.517**, which is very progressive. It is significantly more progressive than the current income tax (+0.200). Only the estate tax is more progressive.
 - The Suits index for the income tax third bracket rate increase alone is **+0.756**, compared to **+0.879** for the clothing credit, **+0.829** for the estate tax changes, **+0.244** for the property tax reductions combined with PTR increases, **-0.178** for the corporate tax, **-0.208** for the sales tax, and **-0.610** for the cigarette and tobacco tax increases.
 - In the absence of the proposed increases in cigarette & tobacco taxes, the Suits index would be **+0.858**.
- With the proposed tax changes, the Suits index for all Minnesota state and local taxes would become less negative, rising from **-0.049** to **-0.033**. Though still regressive, this would be less regressive than in recent years (since 2006) as well as 1998, and about the same as in 2000 and 2004.
- As shown in **Table 2**, total Minnesota state and local tax burdens would rise by **2.9%**. The increases would be **6.1%** for the top decile and **11.7%** for the top 1%. Tax burdens rise by 1.0% or less in the 3rd through 9th deciles. The percentage increase in tax burden is below the 2.9% average (at 2.0%) in the 1st and 2nd deciles.

Table 2.
Dollars of Minnesota State and Local Tax Burden
Impact of 2013 Senate 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
1	10,937 & under	10%	0.8%	537,928	548,733	10,805	1.5%	2.0%
2	10,938 to 19,316	10%	1.9%	514,797	524,951	10,154	1.4%	2.0%
3	19,317 to 26,397	10%	2.9%	707,921	715,150	7,229	1.0%	1.0%
4	26,398 to 35,600	10%	4.0%	945,145	954,480	9,335	1.3%	1.0%
5	35,601 to 46,507	10%	5.3%	1,334,108	1,345,821	11,713	1.7%	0.9%
6	46,508 to 59,998	10%	6.9%	1,756,088	1,770,083	13,995	2.0%	0.8%
7	59,999 to 77,704	10%	8.9%	2,277,516	2,295,266	17,750	2.5%	0.8%
8	77,705 to 101,616	10%	11.5%	2,916,622	2,937,516	20,894	3.0%	0.7%
9	101,617 to 146,400	10%	15.6%	3,902,773	3,933,902	31,129	4.4%	0.8%
10	146,401 & over	10%	42.2%	9,346,791	9,917,865	571,074	81.1%	6.1%
ALL MINNESOTA HOUSEHOLDS		100%	100.0%	24,239,689	24,943,770	704,081	100.0%	2.9%

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	11.0%	2,578,683	2,606,064	27,381	3.9%	1.1%
Next 4%	202,408 to 510,005	4%	15.0%	3,413,204	3,564,888	151,684	21.5%	4.4%
Top 1%	510,006 & over	1%	16.3%	3,354,904	3,746,914	392,010	55.7%	11.7%
Full Decile	146,401 & over	10%	42.2%	9,346,791	9,917,865	571,074	81.1%	6.1%

- Table 3 shows dollar tax changes by tax type. The reduction in the property tax burden (**down by \$218 million**) offsets **24%** of the increased burden attributed to other taxes. The net added burden from other taxes totals **\$922 million**. Income and estate tax account for **55%** of that increase, sales taxes for **25%**, excise taxes on cigarettes and tobacco for **18%**, and corporate tax for **2%**.

Table 3.
Change in Minnesota State and Local Tax Burden by Tax Type
Impact of Senate 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 & Local Sales Tax	Cigarette & Tobacco Tax	Property Taxes Net of PTR	Total
1	10,937 & under	10%	0.8%	(8,373)	441	6,127	19,764	(7,154)	10,805
2	10,938 to 19,316	10%	1.9%	(8,785)	571	8,640	17,949	(8,220)	10,154
3	19,317 to 26,397	10%	2.9%	(9,997)	728	10,560	17,622	(11,684)	7,229
4	26,398 to 35,600	10%	4.0%	(7,687)	904	12,811	17,378	(14,071)	9,335
5	35,601 to 46,507	10%	5.3%	(5,485)	1,122	15,104	17,195	(16,224)	11,713
6	46,508 to 59,998	10%	6.9%	(3,208)	1,325	18,229	16,814	(19,165)	13,995
7	59,999 to 77,704	10%	8.9%	(967)	1,644	23,702	15,996	(22,625)	17,750
8	77,705 to 101,616	10%	11.5%	252	2,055	30,385	15,457	(27,255)	20,894
9	101,617 to 146,400	10%	15.6%	8,381	2,715	39,718	14,632	(34,316)	31,129
10	146,401 & over	10%	42.2%	546,635	5,038	65,490	10,734	(56,822)	571,074
ALL MINNESOTA HOUSEHOLDS		100%	100.0%	510,765	16,543	230,767	163,542	(217,535)	704,081

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	11.0%	14,758	1,775	25,526	6,167	(20,844)	27,381
Next 4%	202,408 to 510,005	4%	15.0%	140,810	2,060	29,421	3,934	(24,542)	151,684
Top 1%	510,006 & over	1%	16.3%	391,066	1,203	10,543	633	(11,436)	392,010
Full Decile	146,401 & over	10%	42.2%	546,635	5,038	65,490	10,734	(56,822)	571,074

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 **17%** (\$91 million) of the \$538 million increase in Minnesota income taxes paid by Minnesota residents. However, higher federal income taxes would offset **10%** (\$22 million) of the benefit from reduced home property taxes net of PTR (\$218 million). As a result, the changes in itemized deductions would reduce federal taxes by **\$69 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 **\$81 million** for those in the top decile and by **\$77 million** for the top 1%.

Table 4.
Dollar Change in Minnesota State and Local *and* Federal Tax Burden
Impact of Senate 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 Deductions for State Income Taxes*	Change in Federal Itemized Deductions for Home Property Taxes	
1	10,937 & under	10%	10,805	4	5	10,815
2	10,938 to 19,316	10%	10,154	12	19	10,185
3	19,317 to 26,397	10%	7,229	32	65	7,326
4	26,398 to 35,600	10%	9,335	49	190	9,574
5	35,601 to 46,507	10%	11,713	72	502	12,288
6	46,508 to 59,998	10%	13,995	119	1,136	15,250
7	59,999 to 77,704	10%	17,750	45	2,228	20,022
8	77,705 to 101,616	10%	20,894	(60)	3,372	24,206
9	101,617 to 146,400	10%	31,129	(1,971)	5,924	35,082
10	146,401 & over	10%	571,074	(89,343)	8,224	489,956
ALL MINNESOTA HOUSEHOLDS		100%	704,081	(91,041)	21,665	634,704

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	32,146	(3,353)	4,672	33,466
Next 4%	202,408 to 510,005	4%	157,051	(8,250)	2,465	151,266
Top 1%	510,006 & over	1%	395,118	(77,740)	1,087	318,464

*Positive values in this column are due to increased Clothing Tax Credit received by itemizers.

- Although the proposal would increase the burden of *Minnesota* state and local taxes by \$704 million, it would increase the total burden of *federal plus Minnesota* state and local tax burdens by **\$635 million**.
- When both federal and state taxes are considered, tax burdens would increase by an average of **0.29%** of income (rather than 0.33%). The tax burden would rise by **0.54%** of income (rather than 0.63%) in the 10th decile and by **0.90%** of income (rather than 1.12%) 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 +0.517 to **+0.455**, which is still very progressive.

Table 5
Change in Minnesota State and Local *and Federal* Tax Burden as Percent of Income
Impact of Tax Proposals in Senate 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%	0.60%	0.000%	0.000%	0.60%
2	10,938 to 19,316	10%	0.25%	0.000%	0.000%	0.25%
3	19,317 to 26,397	10%	0.12%	0.001%	0.001%	0.12%
4	26,398 to 35,600	10%	0.11%	0.001%	0.002%	0.11%
5	35,601 to 46,507	10%	0.10%	0.001%	0.004%	0.11%
6	46,508 to 59,998	10%	0.09%	0.001%	0.008%	0.10%
7	59,999 to 77,704	10%	0.09%	0.000%	0.012%	0.11%
8	77,705 to 101,616	10%	0.08%	0.000%	0.014%	0.10%
9	101,617 to 146,400	10%	0.09%	-0.006%	0.018%	0.10%
10	146,401 & over	10%	0.63%	-0.098%	0.009%	0.54%
ALL MINNESOTA HOUSEHOLDS		100%	0.33%	-0.042%	0.010%	0.29%

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	0.12%	-0.014%	0.020%	0.12%
Next 4%	202,408 to 510,005	4%	0.47%	-0.026%	0.008%	0.45%
Top 1%	510,006 & over	1%	1.12%	-0.222%	0.003%	0.90%

Note: Because amounts paid in Minnesota estate tax are deducted in calculating federal estate tax, a substantial portion of the \$18 million burden from the Minnesota estate tax (perhaps \$6 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: 35% shifted to Minnesota consumers, 27% shifted to Minnesota workers, 0.4% borne by Minnesota owners, and 37% borne by nonresidents and the federal government.
 - Business property tax increases for nonresidential nonfarm property: 34% of the benefits to Minnesota consumers, 19% to Minnesota workers, 5% borne by Minnesota owners, and 43% to nonresidents and the federal government.
 - Farm land tax reductions: 77% to Minnesota owners, 3% to Minnesota workers, and 20% to 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 (net reduction): 80% to Minnesota consumers, 16% by Minnesota workers, 0.3% by Minnesota owners, and 4% by nonresidents.