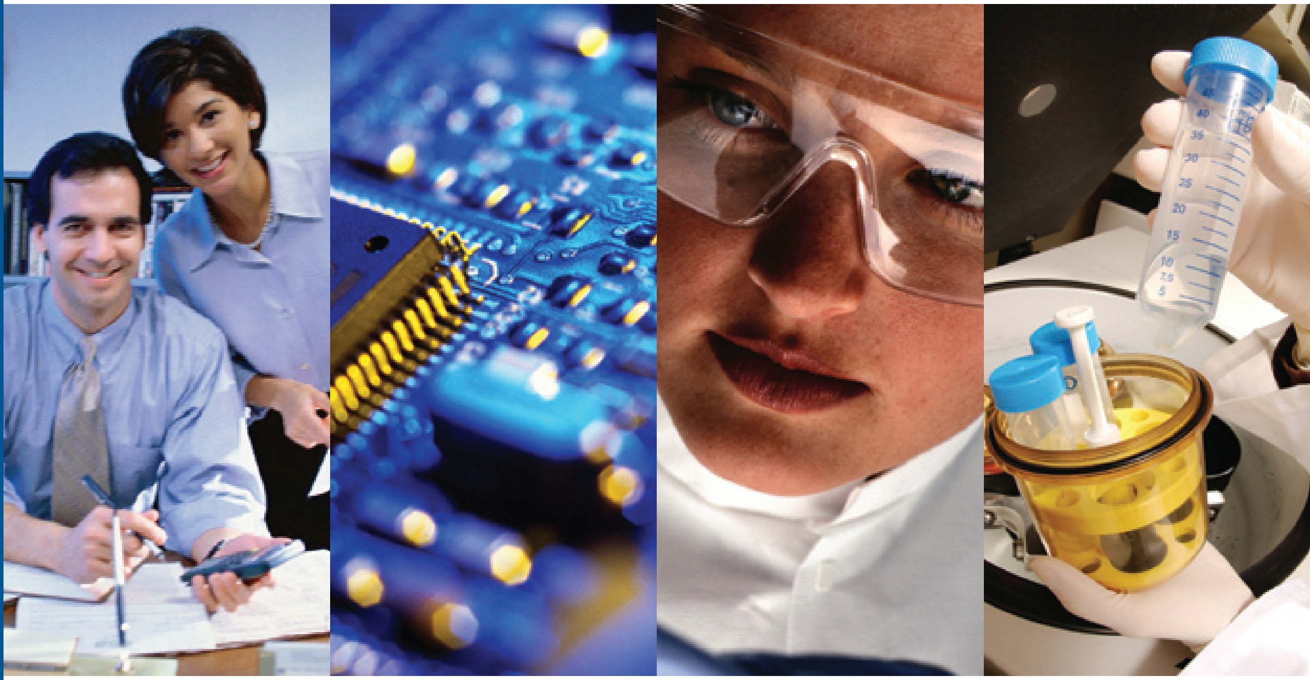
Minnesota's Millennium:

Launching a New Generation of Competitive Leadership and Economic Growth

2009 Report



The Governor's 21st Century
Tax Reform Commission

THE GOVERNOR'S 21ST CENTURY
TAX REFORM COMMISSION

COMMISSION MEMBERS

Michael M. Vekich, CPA (Chair)
Chair and President, Skyline Exhibits and Vekich Associates

Philip J. Albert
Vice President of Corporate Tax, Medtronic Inc.

David Beito
Chairman, President and CEO, Northern State Bank of Thief River Falls

William V. Belanger
Former State Senator

Danielle A. Buchberger, CPA
Eikill and Schilling Ltd.

David R. Carlsen
Chairman and CEO, UMI Company Inc.

Corey Haaland
Vice President and Treasurer, Target Corporation

Mark Haveman
Executive Director, Minnesota Taxpayers Association

Joy Lindsay
President, StarTec Investments, LLC

Wendell Maddox
President and CEO, ION Corporation

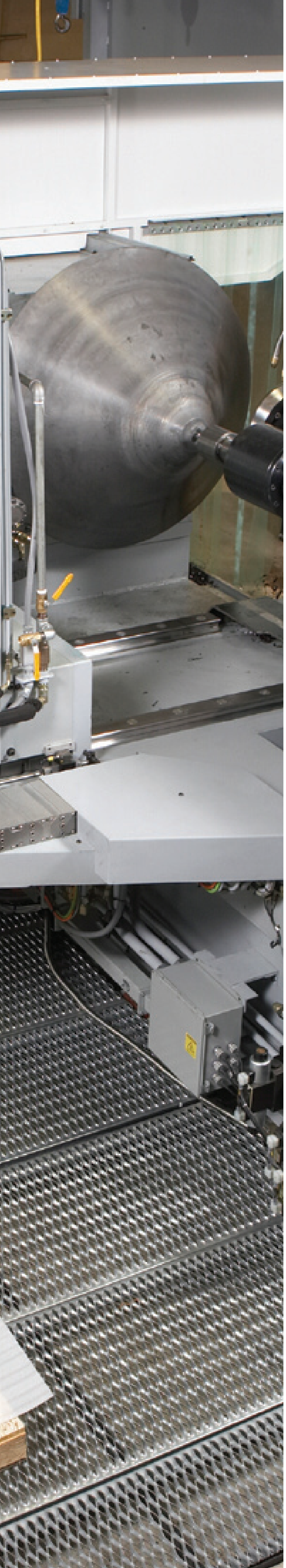
Gerald Morris
Director and Senior Tax Counsel, General Mills Inc.

Rebecca Paulsen, CPA
Vice President of State Taxes, U.S. Bank N.A.

Kate Rubin
President, Minnesota High Tech Association

John Spry, Ph.D.
Associate Professor, Department of Finance, Opus College of Business, University of St. Thomas

David L. Welliver, CPA
Wilkerson Associates



The Governor's 21st Century
Tax Reform Commission

February 13, 2009

Honorable Tim Pawlenty
Governor
Minnesota State Capitol
St. Paul, Minnesota 55155

Dear Governor Pawlenty:

I am pleased to present to you the findings and recommendations of the Governor's 21st Century Tax Reform Commission. This report reflects the outstanding work of our 15 commissioners and the many people who contributed their time and expertise through testimony, research and creative thinking.

The title of this report, "Minnesota's Millennium," reflects our view that Minnesota must modernize its approach to taxing business in order to lay a foundation for growth in the 21st century – and beyond. We believe our recommendations, if enacted, will transform Minnesota into a global engine of economic growth and job creation.

The Commissioners took to heart the charge of your Executive Order directing us to identify tax changes that would make Minnesota more competitive in a global economy.

Some will interpret our recommendations as merely a tax give-away for businesses. Such criticism is short-sighted. Minnesota's Millennium offers a pathway to growth in today's fast-changing economic landscape – with investments in the future of all Minnesotans. Our proposals will enable businesses of all sizes to unleash innovation and productivity, and in the process, create and sustain a new generation of high-quality jobs throughout the state, now and well into the future.

The Commission presents this report with confidence that the recommendations within will provide a substantial return on investment and spark a renewal of the quality of life that is so important to our state. The sooner Minnesota moves to gain a global competitive edge, the more quickly all Minnesotans can reap the benefits of job growth and economic expansion.

On behalf of the Commission, I thank you, Governor Pawlenty, for the opportunity to serve our state. We respectfully submit "Minnesota's Millennium," and we urge quick enactment of our recommendations and the investments they represent in our collective future.

Sincerely,

Michael Vekich
Chair

Table of Contents

Section 1

Executive Summary

"Difficulties mastered are opportunities won."

~Winston Churchill

Introduction

Economists are often criticized for tempering their views with the phrase "on the other hand." Frustrated by this tendency, President Harry S Truman is said to have demanded more one-armed economists!

But there is one point on which virtually all economists agree: The way out of the economic slump gripping Minnesota and the nation is to grow and sustain more well-paying jobs. Government spending may have its place but provides, at best, a short-term stimulus. Long-term economic renewal requires expanded business investments and payrolls that put more Minnesotans to work in jobs that create economic security, stability and wealth.

State business taxation is an important piece of this puzzle. It's becoming clear that state tax systems are not only failing to keep up with dramatic shifts in the U.S. and world economies, but are a drag on economic growth.

The Commission's recommendations provide a blueprint for policymakers who are serious about creating jobs, building wealth and providing sufficient resources to maintain the quality of life all Minnesotans have come to expect. Only businesses and private investments can create the wealth necessary to drive growth across the private, government and nonprofit sectors and maintain that quality of life for all workers and their families.

We are confident that, if enacted, these recommendations will move the state forward, even in these difficult times. On the proverbial "other hand," if policymakers fail to grasp the urgency of creating a more friendly business climate through tax reform, Minnesota will see further long-term economic and cultural declines. Right now, our economic future – and that of future generations – is in our hands.

Executive Summary

Summary

Before formulating final recommendations, the Commission heard from a wide range of tax-policy experts, business groups and other stakeholders. Their suggestions, presentations and opinions were viewed against a backdrop of traditional tax principles, academic research and real-world experience. Robust debate within the Commission yielded the following broad recommendations and specific proposals:

Reduce business tax burdens

- Repeal the state corporate income tax.
- Exempt 20% of active "pass-through" business income from taxation.
- Conform to federal tax write-off provisions for business-related assets.
- Replace the capital equipment sales tax refund with an upfront exemption.
- Extend the capital equipment exemption to businesses that produce services subject to sales tax.

Improve the transparency of business taxation

- Simplify the state property tax system.
- Require a biennial "benefits-received" report of Minnesota business taxation.

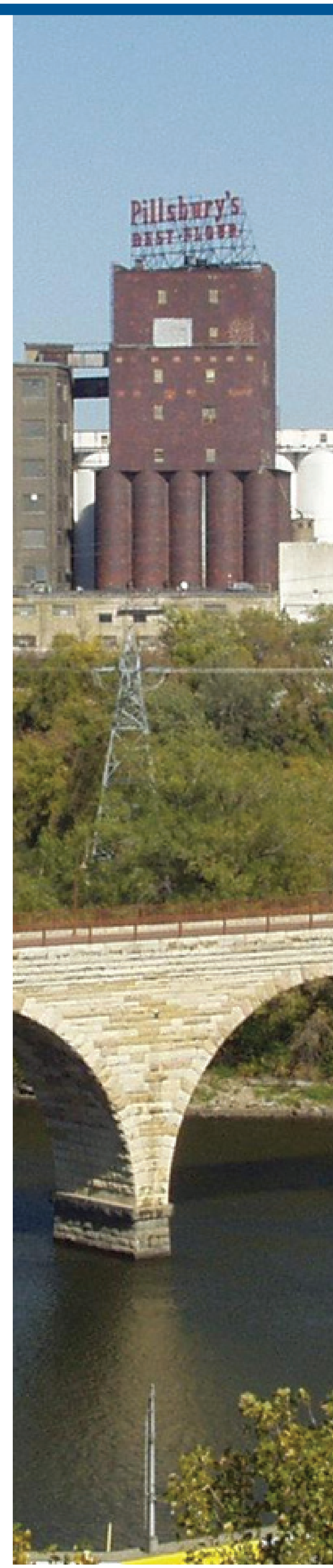
Promote investments in innovation, entrepreneurship and emerging/ high-tech companies

- Overhaul the R&D Tax Credit.
- Enact the Small Business Investment Act.
- Enact an Early-Stage Investment Tax Credit.
- Encourage low-income entrepreneurship and business creation loans.

Paying for reform

- Extend the sales tax base to a broader range of consumer products and consumer services.
- Increase the excise tax on cigarettes.

Members of the Commission brought a range of viewpoints and experiences to this task. As with virtually all things tax-related, it is difficult to achieve consensus on every aspect of the reforms in this report. That being said, the Commission has agreed to unanimously support this report in recognition of the need to respond to the economically challenging times in which all Minnesotans find themselves today.



A downloadable copy of this report, and other information relating to the Commission's work, can be found at our website,

http://www.taxes.state.mn.us/mntaxreform/index.shtml

Section 2

The Case for Reform

Guiding principles for reform

The Commission began its work in June of 2008 by establishing outcome-based guidelines for reform, which guided its thinking and overall approach. As outlined below, these principles incorporate traditional and widely accepted tax concepts – such as transparency, simplicity and fairness.

As a result of reform, Minnesota's business tax system should be:

1. **Inherently Competitive** – The fundamental design and structure of Minnesota's business tax system should reduce or eliminate the need for subsidies, exemptions, and related business tax expenditures.
2. **Tied to Benefits Received** – There should be a strong, direct relationship between the nature and level of business taxation in the state and the cost of benefits and services provided to businesses by state and local governments.
3. **Friendly to Economic Growth** – Minnesota's business tax system should encourage savings, capital investment, or capital formation.
4. **Administratively Inexpensive** – The administrative costs of oversight and compliance with state and local tax laws should be minimized for taxpayers and for state and local governments.
5. **Resistant to Political Change** – The basic design and structure should discourage legislative tinkering and improve the predictability of tax burdens for business planning purposes and revenues for state budgeting purposes.

For much of the last century, Minnesota's rich stocks of natural resources and human capital – enhanced by homegrown innovation and a strong emphasis on education – helped drive a booming economy based on manufacturing and (more recently) technology and services.

In recent years, the economic and competitive landscape has shifted, exacerbating underlying issues with Minnesota's aging business tax system. Our outdated tax system hinders growth in the 21st-century knowledge-based economy, with its increasingly global markets for investment capital and labor – as well as the goods and services they produce.

But with challenge comes opportunity. Minnesota boasts the foundation of a world-class education system, an industrious workforce recognized for its productivity, and a broad base of businesses – both large and small – that are built around creativity and innovation. [*See 'What Minnesota does right,' page 9*]

We can revitalize Minnesota by overhauling our outdated state business tax system to put these assets to work in the rapidly changing global marketplace. Bold, yet thoughtful, reform will encourage economic growth, generate new jobs and help create wealth for Minnesota workers, businesses, and investors.

Shifting landscape

Minnesota's approach to taxing businesses is antiquated. It reflects a time dramatically different from today's fast-moving, technology-driven and global economy. And Minnesota is paying a price in the competition for new jobs, economic growth and business investments.

This outdated tax structure gives Minnesota less traction in an economic landscape that is shifting on several fronts:

- **Globalization** – Investment capital and labor (like the goods and services they produce) are increasingly mobile. Because the deployment of economic resources is more responsive to cost differences, a state's business tax climate is more important than ever before.
- **Economic Composition** – Since the 1960s, the service-producing and retail sectors have expanded dramatically and now dominate the economy, while manufacturing has grown at a much slower pace.
- **Demographics** – Maintaining economic growth will be more challenging. The workforce in Minnesota, as in other states and nations, is rapidly aging. Aging reduces the ratio of workers to retirees, puts pressure on state spending and slows the growth in tax revenue.
- **Innovation and Technology** – Economic growth depends on increased productivity as fewer new workers enter the workforce. Growth in a knowledge-based economy requires innovation and rapid adoption of new technologies. Tax policy must promote these changes.
- **Economic Decline** – Minnesota's once-enviable growth has fallen off in recent years, and we now lag the U.S. average on key economic indicators.

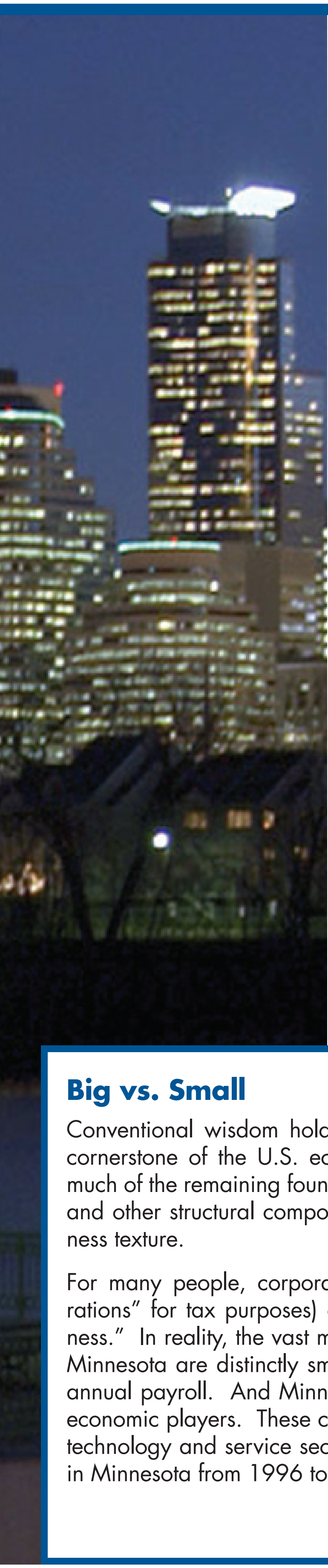
Globalization

Minnesota increasingly competes with other states – and other nations – for new jobs and business investments. Minnesota's workers face stiff competition from their lower-wage counterparts around the world, many of whom are highly skilled or educated.

With increasingly mobile capital, tax differences matter more than ever. Many economists point to corporate income taxes as "most harmful for growth."[1] As other states and nations reduce corporate taxes to compete more effectively,[2] Minnesota's high tax rates make the state less attractive to new or expanding companies. Since 2002, five states have reduced corporate tax rates (Kentucky, New York, North Dakota, Vermont, and West Virginia).[3] In addition, Ohio's replacement of its corporate income tax with a broad-based gross receipts tax will cut its business taxes by $1.4 billion annually.[4]

We can revitalize Minnesota by overhauling our outdated state business tax system to put these assets to work in the rapidly changing global marketplace.

Minnesota's statutory corporate income tax rate of 9.8% is among the highest in the nation. Since the U.S. has one of the highest corporate income tax rates among industrialized na-



tions, according to statistics from the OECD*, Minnesota's combined state/federal rate ranks among the highest in the world.[5]

Such high statutory income tax rates can greatly distort business perception when in fact many businesses here ultimately pay lower effective rates due to tax planning strategies, local incentives, and other factors. Business executives, entrepreneurs and investors throughout the world rely on rankings that are often based on statutory tax rates when making decisions about where to locate new or expanded operations.

Bold, yet thoughtful, reform will encourage economic growth, generate new jobs and help create wealth for Minnesota workers, businesses, and investors.

The corporate income tax represents the largest anti-competitive gap for any tax between Minnesota and overseas competitors, which can discourage foreign investment in the state. Other state business taxes are also high. Minnesota's high top personal income tax rate – applicable to non-corporate business income – high business property taxes and sales taxes on business inputs also discourage investment in Minnesota. A recent study concludes that Minnesota business taxes are more than twice as large as the public benefits received by business – a higher tax-to-benefit ratio than all but eight other states.[6] [*See 'Benefits-received,' page 14*]

These high business tax rates may explain why Minnesota companies are increasingly choosing to expand in other states or offshore as well as moving existing manufacturing and service activities. Most other states and nations offer lower tax rates – sometimes combined with valuable incentives. In many cases, they also represent important markets for the goods and services produced.

Becoming more competitive on business taxes will assure that Minnesota

**Organisation for Economic Co-operation and Development, an umbrella group through which 30 of the world's industrialized market democracies work together to promote economic growth.*

Big vs. Small

Conventional wisdom holds that small businesses are the cornerstone of the U.S. economy. But if that's true, then much of the remaining foundation – not to mention the walls and other structural components – has a distinctly big-business texture.

For many people, corporations (registered as "C Corporations" for tax purposes) are synonymous with "big business." In reality, the vast majority (96%) of corporations in Minnesota are distinctly small, with less than $5 million in annual payroll. And Minnesota's small businesses are big economic players. These companies – many of them in the technology and service sectors – created 44% of new jobs in Minnesota from 1996 to 2005.[70]

The state's medium and large businesses pack a sustained economic punch. In 2007, companies with more than $5 million in payroll comprised just 1.2% of Minnesota's total employers, but they paid more than 62.5% of total payrolls.[71] From 1996 to 2005, companies with more than 100 workers created 56% of new jobs in the state.[72]

Large companies employ more Minnesotans, but also indirectly boost the bottom line and drive growth as customers of the state's smaller firms. For example, General Mills and U.S. Bank each purchased about $1 billion last year in goods and services from small companies based in Minnesota.

A look beneath the surface of the big-versus-small debate reveals a more complex picture, but one thing is certain: Businesses of all sizes are crucial to spur new development, jobs and wealth creation.

grows or attracts new businesses that leverage the state's skilled workforce, quality infrastructure and natural, cultural or educational amenities.

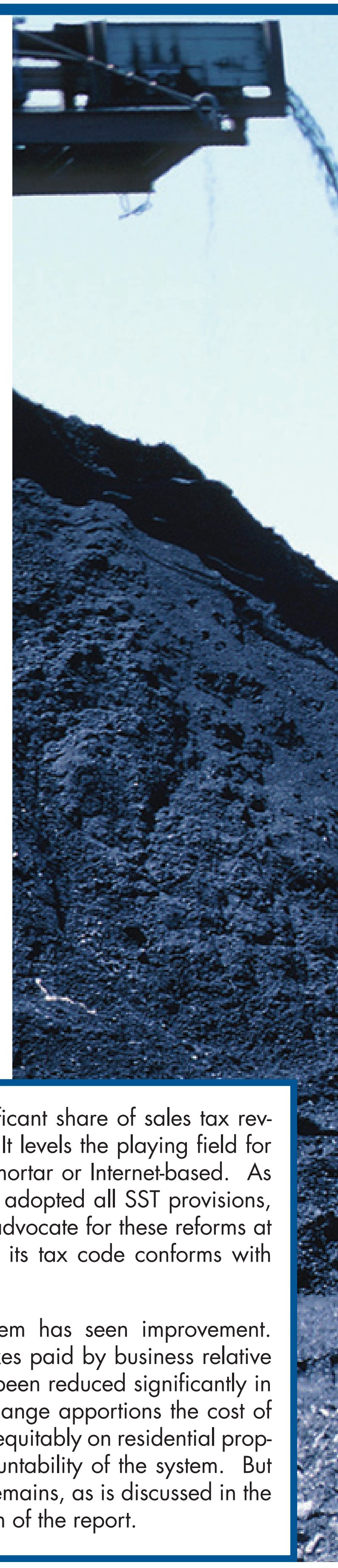
Economic Composition

Minnesota's economy, mirroring a national trend, has undergone a dramatic shift from consumption of goods to consumption of services since the 1960s. Manufacturing and natural resource production retain a sizable share of the gross state product, and they remain an important source of jobs and economic growth. But these sectors have not matched the explosive expansion of services, a trend that is expected to continue.

Mining, timber, agriculture and associated manufacturing have shrunk from 19% of the economy in 1963 to about 6.5% today.[7] Meanwhile, the service-producing sectors – including retail, banking and financial services, among others – have mushroomed. These sectors today account for 80% of Minnesota's $255 billion economy.[8] This economic transformation has narrowed the base of Minnesota's primary tax on consumption – the sales tax. Almost two-thirds of consumer goods and services are exempt from tax. Because the consumer tax base is so narrow, Minnesota is forced to increase its reliance on income and property taxes to fund government.

The corporate income tax represents the largest anti-competitive gap for any tax between Minnesota and overseas competitors, which can discourage foreign investment in the state.

In this rapidly-changing business environment, Minnesota has been a fertile breeding ground for innovation and entrepreneurship, producing a broad mix of business types and sizes. *[See 'Big vs. Small,' page 8]* Most of the state's 18 "Fortune 500" companies are homegrown, and many of them have roots going back to the 1960s or earlier. While medium or large companies still employ most Minnesotans, entrepreneurial startups and small businesses – many of them technology or service firms – have emerged as a major force in the state's 21st-century economy. Many of the entrepreneurs starting new businesses once worked for the state's larger companies.



What Minnesota does right

While reform is needed to help Minnesota compete in today's economy, several aspects of the business tax code should be preserved.

For the most part, Minnesota's sales and property taxes do not apply to manufacturing-related equipment, inventory or "tangible property," or to business-to-business services. This makes good policy sense and provides a solid foundation upon which to build a business tax system that fits the 21st-century economy.

Maintaining Minnesota's leading role in the Streamlined Sales and Use Tax Agreement (SST) is also key. The SST helps keep in-state retailers competitive with online merchants while capturing a significant share of sales tax revenue from Internet purchases. It levels the playing field for merchants, whether brick-and-mortar or Internet-based. As one of just 18 states that have adopted all SST provisions, Minnesota should continue to advocate for these reforms at a national level, to make sure its tax code conforms with updates to the SST agreement.

Minnesota's property tax system has seen improvement. The share of local property taxes paid by business relative to other types of property has been reduced significantly in the past two decades. This change apportions the cost of local spending decisions more equitably on residential property, which increases the accountability of the system. But a problematic differential still remains, as is discussed in the 'Imperatives for Growth' section of the report.

New business creation is a key factor in growing Minnesota's economy, employment and personal incomes. Business tax changes can encourage research and innovation, and increase access to capital for new startups, particularly those in the rapidly expanding high-technology sector. This will help ensure that Minnesota thrives in today's fast-moving and rapidly-changing economy.

Business tax changes can encourage research and innovation, and increase access to capital for new startups, particularly those in the rapidly expanding high-technology sector.

Demographics

The number of Minnesota workers reaching retirement age jumped 30% in 2008 as the first members of the Baby Boom generation turned 62. The number of workers turning 62 is expected to double by 2013, compared with 2006 levels. Meanwhile, the rate at which younger workers enter the workforce is leveling off, and the number of Minnesotans in the 18-25 age group will decrease in the next 15 years. Minnesota's labor force grew 1.5% annually during the 1990s, but annual growth will slow to 0.1% by the 2020s.[9]

As boomers age, leaving a slower-growing workforce in their wake, they will reshape Minnesota's revenue and spending as never before. Aging workers will likely pay sharply lower state income and sales taxes once they retire, even as their health-care needs increase.[10] *[See Figure 1 and Figure 2]* These demographic changes will increase pressure to raise business taxes to solve revenue shortfalls and finance spending growth as baby boomers retire. To grow, Minnesota must expand its tax base by attracting new or expanding businesses and the high-quality jobs they bring. It's crucial to fill the gap without resorting to anti-competitive tax increases.

Innovation and Technology

As similar demographic changes unfold across the nation and around the globe, Minnesota will increasingly compete for workers as well as dollars. Immigration will barely keep the state workforce from shrinking outright, according to projections from the Minnesota State Demographer. *[See Figure 3]* As a result, boosting worker productivity – through innovation, new technology, research and education – will become the principal means to grow the state economy.

Minnesota is losing its historic lead in the education and academic research that drive innovation and technological development. While 91% of Minnesota's adult workers today have at least a high school diploma, high school graduation rates have decreased dramatically, to just 85% in 2006.[11] Minnesota's ranking for academic R&D per capita has declined from 20th in the nation in 1972 to 40th in 2004.[12]

Part of the decline in academic R&D stems from a federal emphasis on defense research – where other states, particularly on the coasts, have an edge because of their large concentration of military and defense contractors. But generous R&D tax credits and other efforts have helped some states make inroads into areas where Minnesota has traditionally been strong, such as a recent initiative to boost biomedical research in California.[13]

Restoring Minnesota to its historic role as a leader in innovation will expand the state's tax base and create well-paying jobs. A transformed tax system that encourages R&D at all levels and nurtures emerging companies

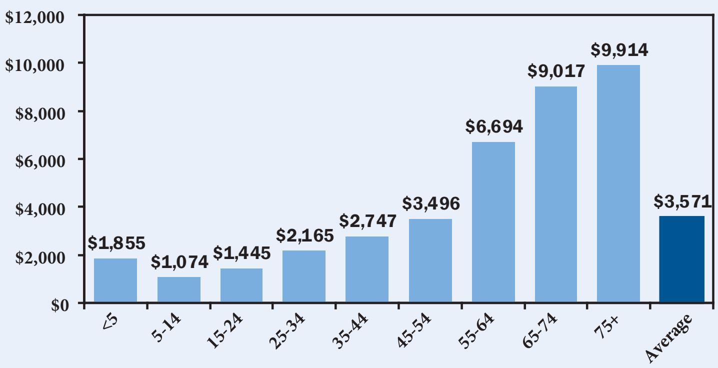
Figure 1: State Taxes Paid by a Married Couple Before and After Retirement

Income	Income Tax	Sales Tax	Total	Change	Pct
Before retirement					
$35,000	$1,236	$782	$2,018		
$65,000	$3,387	$1,295	$4,682		
After retirement					
$25,000	$0	$559	$559	-$1,459	-72%
$45,000	$1,091	$896	$1,987	-$2,695	-58%

Source: Minnesota State Economist

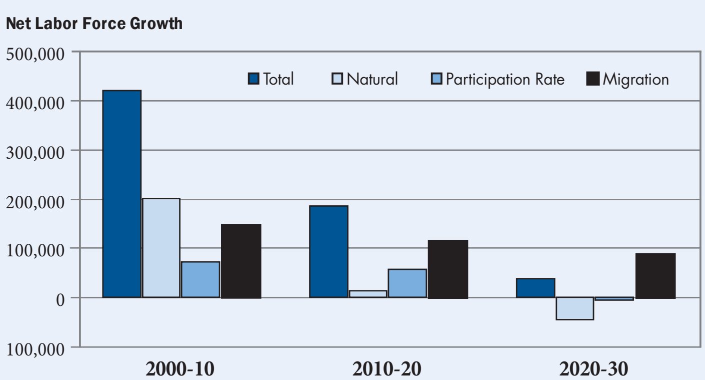
Figure 2: Health-Care Spending Spikes After 55

U.S. Health-Care Spending By Age, 2004



Source: Agency for HealthCare Research and Quality, Medical Expenditure Panel Survey, data for per capita spending by age group in the Midwest. Excludes spending for long-term care institutions.

Figure 3: Migration Increases in Importance as Labor Force Growth Slows



Source: Minnesota State Demographer (projection revised 2007)

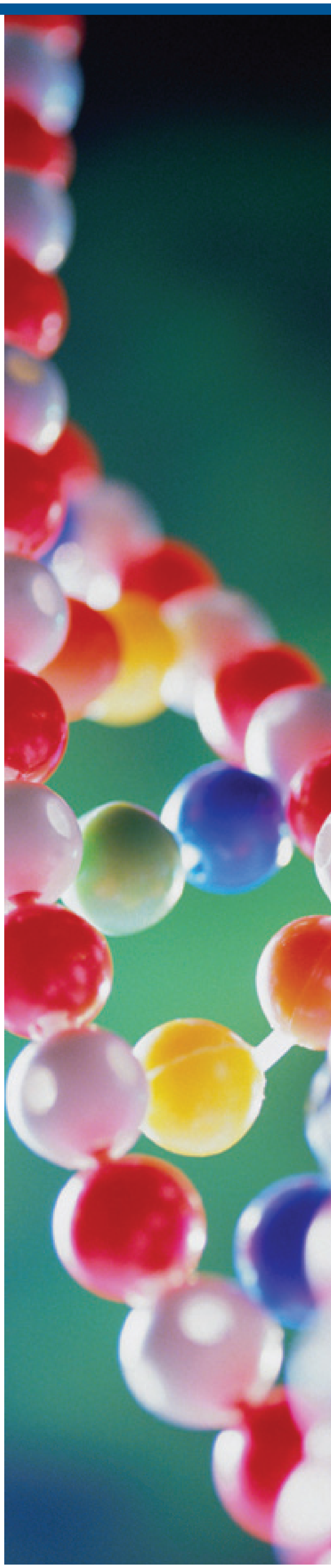
will spur growth by high-tech companies that build up – and are built on – Minnesota's world-class educational system and intellectual legacy.

Economic Decline

For most of the late-20th century, Minnesota's economic growth outpaced the U.S. average. Nation-leading graduation and employment rates drove a growing economy. Increasing incomes propelled Minnesota to high national rankings across a range of social and economic factors, including:

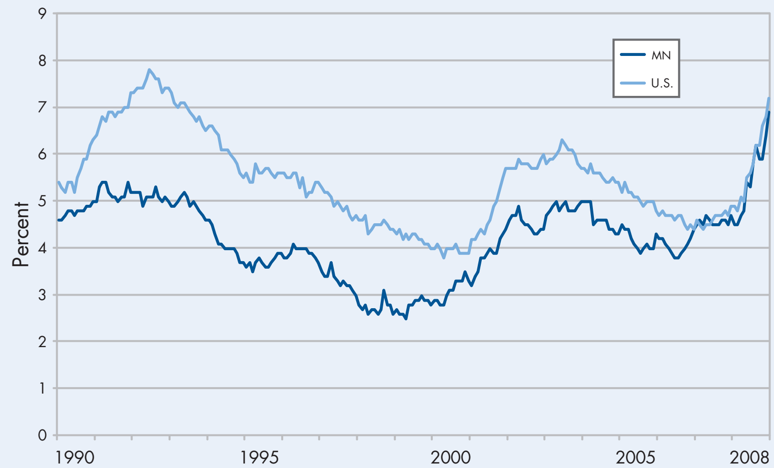
- 2nd-highest percentage of 16-to-64-year-olds in the workforce (76.9%).
- 8th-lowest poverty rate (9.8%).
- Highest percentage of workers with at least a high school diploma (90.7%).
- 2nd-highest rank for state "healthiness" by the United Health Foundation (2007).[14]

For several decades at the end of the century, Minnesota's payroll employment grew faster than the U.S. average and Minnesota's unemployment rate stayed about 1% below



that of the nation. The income of Minnesotans also grew faster than the national average.[15] From 1959 to 1999, average personal income grew 6.7% per year in Minnesota (2.6% above inflation), outperforming most states on a per capita basis. Minnesota's per capita income moved from 6% below the national average (ranked 27th) to 7.5% above (ranked 11th) during this period.[16]

***Figure 4:* Minnesota Unemployment Rate Compared to U.S. Rate (1990 - 2008)**



Source: U.S. Bureau of Labor Statistics, 1990-2008

Economic shifts have shaken Minnesota's economy in recent years. From 2004 to 2007, Minnesota fell behind the national economy:

- Personal income growth per capita was 13.5%, lagging the U.S. average of 16.6% and ranking 47th among all states.
- State GDP growth slipped to 2.6%, less than half the U.S. average of 5.4%, ranking 42nd in the nation.
- Job growth slowed drastically, as Minnesota ranked 30th among states from 2000 to 2007.[17]
- In 2007, for the first time in decades, Minnesota's unemployment rate exceeded the U.S. average.

A transformed tax system that encourages R&D at all levels and nurtures emerging companies will spur growth by high-tech companies that build up – and are built on – Minnesota's world-class educational system and intellectual legacy.

After staying consistently one to two percentage points below the national average, the state unemployment rate has not significantly differed from the U.S. average during the last two years.[18] [*See Figure 4*]

Three Dimensions of Tax Reform

The changing economic landscape has major implications for Minnesota's tax system and its ability to help – or hinder – economic growth and investment in the state. Meaningful business tax reform should take into account the ***structure*** of state and local business taxes, the ***level*** of business taxation in the state, and the ***use*** of state and local business tax revenues.

Tax Structure – In today's global market, it is more important than ever to avoid placing significant tax burdens on mobile capital and labor. The increasing shift from manufacturing to services in Minnesota's economy illustrates why we should strive for a tax structure that is not only competitive, but also resilient to the oft-changing fortunes of various industries or economic sectors. The goal should be a supportive tax environment in which all sizes and types of businesses can thrive, rather than a system geared toward specific sectors or business types. The increasing dominance of services highlights the need to shift Minnesota's sales tax toward a broader-based form of consumption tax.

Level of Business Taxation – States adjust business tax rates to stay competitive with other states in their region and across the nation. Globalization raises the stakes, forcing states to also consider how they stack up against other nations.

Use of State and Local Business Tax Receipts – Under the benefits-received principle, an important goal of business tax reform is to align business tax receipts to the greatest extent possible with productivity-enhancing investments in the state's economic future. [*See 'Benefits-received' page 14*] As noted earlier in the report, Minnesota does not compare favorably to most other states.Businesses here pay more than twice as much in taxes as they receive in benefits, based on analysis by the Federal Reserve Bank of Chicago.[19]

The need to increase productivity and Minnesota's recent under-performance in economic growth and new job growth highlight the importance of using business tax revenues wisely to continue to invest in the productive capacity of the state. ■

> ***"Anytime is a good time to fix a bad policy. Business taxes are inefficient. Period."***
>
> **Art Rolnick,**
> Senior vice president and research director, Federal Reserve Bank of Minneapolis

Section 3

Imperatives for Growth

Benefits-received: The right way to tax business

Since business taxes are ultimately passed along to individuals, economists recognize that the primary – some would say only – reason for taxing businesses is to pay for the benefits they receive from government services and infrastructure. These benefits include public assets like the education and legal systems, state universities and research institutions, worker training programs, and public roads and highways.

Under this "benefits-received" principle, the ideal system would balance the taxes businesses pay with the benefits they receive. While perfection is unlikely, the ratio of taxes to benefits is one way to measure how one state's business taxes compare with other states. By this standard, Minnesota's taxes are among the least balanced in the U.S.: Businesses pay more than twice as much in taxes as they receive in public benefits, the nation's 8th-worst tax-to-benefit ratio.

In 2005, state and local governments in Minnesota collected $8.9 billion in business taxes, but businesses received only $4.3 billion in government services in return. The resulting ratio of 2.06 is 15.7% above the U.S. average, according to research by the Federal Reserve Bank of Chicago.[73] In fact, based on the 2005 numbers, Minnesota's tax-to-benefits ratio would still be 4.6% above the national average even if the state corporate income tax were eliminated.

The dire economic circumstances in which we find ourselves in 2009 present the perfect opportunity for meaningful and effective tax reform. Lowering tax costs for businesses in Minnesota helps them create new jobs and grow our state's economy.

The taxes businesses pay should not exceed the costs incurred by government on their behalf. [*See 'Benefits-received,' above*] The Commission's recommendations are based on this benefits-received principle and hold that individuals – who ultimately bear the brunt of business taxes – should be informed as to the true tax burden they bear. With these imperatives in mind, the Commission urges the adoption of the following reforms.

Reduce business tax burdens

The Commission concludes that tax relief should be an integral part of Minnesota's business tax reform strategy, and has identified the following five areas of priority:

- Repeal the state corporate income tax.
- Exempt 20% of "pass-through" business income from taxation.
- Conform to federal tax write-off provisions for business-related assets.
- Replace the capital equipment sales tax refund with an upfront exemption.
- Extend the capital equipment exemption to businesses that provide services subject to sales tax.

Roads best not taken

Several states have reformed their business taxes in recent years, often replacing a corporate income tax with some other form of entity-level business taxation. These reforms have generally aimed to improve each state's competitiveness and increase revenue stability, while ensuring adequate revenue to fund services.

These states have taken one of three general approaches to reform: gross receipts taxation, gross margin taxation or value-added taxation. The Commission heard expert testimony and considered the experiences of other states with these alternative approaches – in various structural forms – before settling on its final recommendations.

Taxes based on receipts are widely acknowledged to violate tax policy principles of transparency, fairness, economic neutrality and competitiveness. A tax that violates fundamental principles of tax policy, like a gross receipts tax, directly impacts average people by frustrating job creation and economic development.[74]

A **gross receipts tax (GRT)** applies to every sales transaction at every stage of business activity. It has appeal partly because of the large potential volume of taxes that can be collected at low tax rates. While the GRT may bring greater stability to the business tax system, the Commission does not endorse it for Minnesota because it scores so poorly on transparency and fairness. A GRT results in substantial tax pyramiding: Additional tax burdens are added at each step of business activity, which brings higher prices for consumers, with correspondingly higher sales taxes on the end purchase. In addition, the apparent simplicity of this approach is often undermined by the introduction of the same types of credits, exemptions and exclusions that make the corporate income tax so problematic, and the difficulty in defining and identifying "receipts".[75]

Gross receipts taxes are stealth taxes that affect individuals in several unseen ways: 1) as sellers, by taxing their receipts, while not taxing receipts of some competitors and thus making their products less competitive; 2) as purchasers, by imposing hidden taxes and thus making the products they purchase more expensive; and 3) as workers, by depressing investment and thus reducing wages and employment opportunities.[76]

A **gross margins tax (GMT)** or **"modified gross receipts tax"** corrects for a major problem of GRT by taxing companies on their revenues less their cost of goods sold. Like the GRT it can introduce greater stability to business taxation by applying to a much broader range of business enterprises – not just those that report a profit – with lower tax rates. However, tax liabilities can be substantial even if a business has no income. The experiences of states that have embarked on this approach (such as Texas) suggest that implementing such a tax is also rife with administrative complexities. Because a state is developing a tax system independent of the federal income tax, states must resolve a wide variety of definitional, rule making and administrative issues for which there is no established body of law on how to resolve them.

A **value-added tax (VAT)**, sometimes known as a "Business Activities Tax" (BAT), amounts to a tax on all the goods and services consumed by the economy. The VAT can take a variety of structural forms but in general they tend to promote greater tax stability by taxing all businesses while being relatively simple to collect and administer. However, when considering state competitiveness, the level of taxation is as important as the structure of the tax. Experts who have examined value added taxation have concluded it may not create significant disincentives for business use of capital and labor or harm competitiveness "as long as the tax is no higher than needed to pay for public services provided to business."[77] For example New Hampshire's "Business Enterprise Tax" – recognized by tax experts as one of the best VAT approaches – is viable because there is no state sales tax, no personal income tax and New Hampshire's effective state tax rate on business property is relatively low.[78] In contrast, Minnesota collects an estimated $2.1 billion from business through the state sales tax, and has an effective state property tax rate more than triple that of New Hampshire.

Minnesota businesses already pay more than enough to cover the cost of public services they receive through the existing state property tax, personal income tax and sales tax. Thus the Commission does not recommend that Minnesota adopt a VAT, a GRT or any other entity-level replacement for its corporate income tax.

Repeal the state corporate income tax.

Taxes on business profits penalize success and stifle capital formation while discouraging savings, investment, new jobs and economic growth. Competitive, growth and policy problems are endemic to this inefficient, regressive and economically harmful tax.[20]

Taxes on business profits penalize success and stifle capital formation while discouraging savings, investment, new jobs and economic growth. Competitive, growth and policy problems are endemic to this inefficient, regressive and economically harmful tax.

Currently, Minnesota's combined state and federal statutory rate (41.1%) is the 3rd-highest corporate tax rate in the world; surpassed only by Pennsylvania and Iowa, and compares to the average tax rate among OECD members of 26.2%. Research has shown that high statutory income tax rates do matter. They incentivize tax planning and other efforts to avoid tax burden, thus reducing both revenues and the size of the state tax base.[21]

In recognition of this problem, some states are reducing or eliminating their own state corporate income taxes. Some are replacing them with other forms of business taxation. [*See "Roads best not taken," page 15*] Eliminating the corporate income tax would substantially improve Minnesota's competitive standing within the U.S. We would become one of just four states with no tax on corporate income and no replacement entity taxes.

Minnesota's corporate income tax carries high compliance and administrative costs for businesses and government. But it accounts for a relatively small portion of the state budget – about $1 billion (7%) in FY 2008 – and of total Minnesota business taxes (12%).[22] The corporate income tax specifically targets certain businesses – known as "C Corporations" under the tax code – that are most likely to seek investors to support new or rapidly expanding operations.

Numerous economic studies demonstrate that high corporate income taxes drive away investment capital. Research has shown that each 1% increase in the corporate tax rate reduces foreign direct investment by 1%.[23] Other research has shown that high corporate tax rates will have a detrimental effect on aggregate investment, entrepreneurial activity and state gross domestic product.[24]

Like other forms of business taxation the corporate income tax is a regressive tax that lacks transparency since its burden is ultimately passed onto people – primarily employees of companies that pay the tax, and consumers who purchase the goods and services they produce. The economic model used in the *Minnesota Tax Incidence Study* predicts that over 90% of any net reduction in corporate tax payments would go to Minnesota consumers in the form of lower prices or to Minnesota workers as higher wages and benefits.[25]

The corporate income tax features other major policy-related problems that justify its elimination.

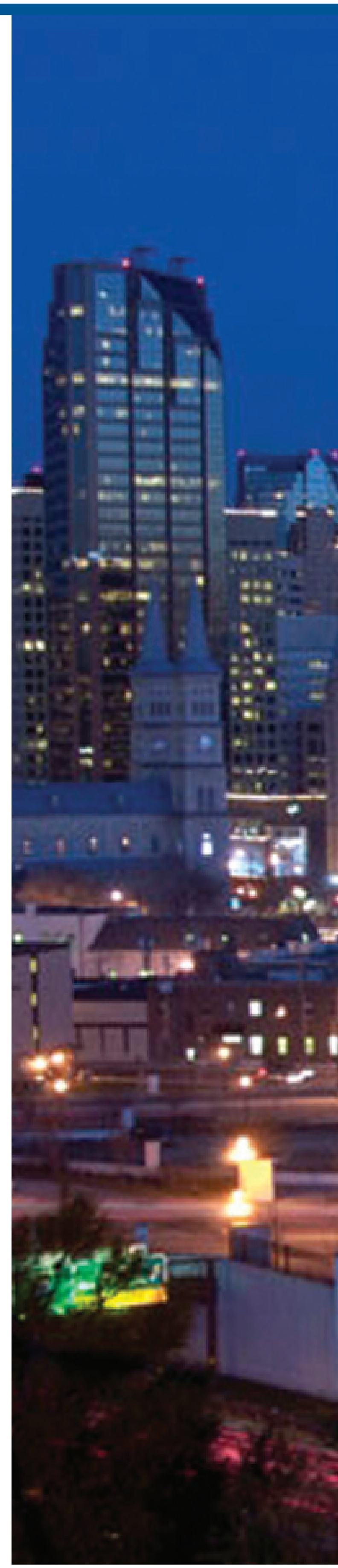
- *It's broken and cannot be fixed* – State corporate income taxes were designed to function in an environment in which interstate – and international – tax competition was not nearly as intense as it is today. As a result of competitive pressures, state corporate income taxes are filled with credits, exclusions, deductions, exemptions and an abundance of planning opportunities to minimize tax liability. A high rate yielding a relatively low level of revenue is a hallmark of a bad tax. However, as long as the tax remains intact, no state – including Minnesota – can afford the competitive fallout from eliminating these favorable provisions unilaterally. Even unapologetic believers in the theoretical merits of taxing business profits have concluded that the practical, political and administrative obstacles to creating a viable state corporate income tax are not easily overcome. Needed reforms are well beyond the ability of individual states. As a result, numerous tax experts have called for its elimination.[26]

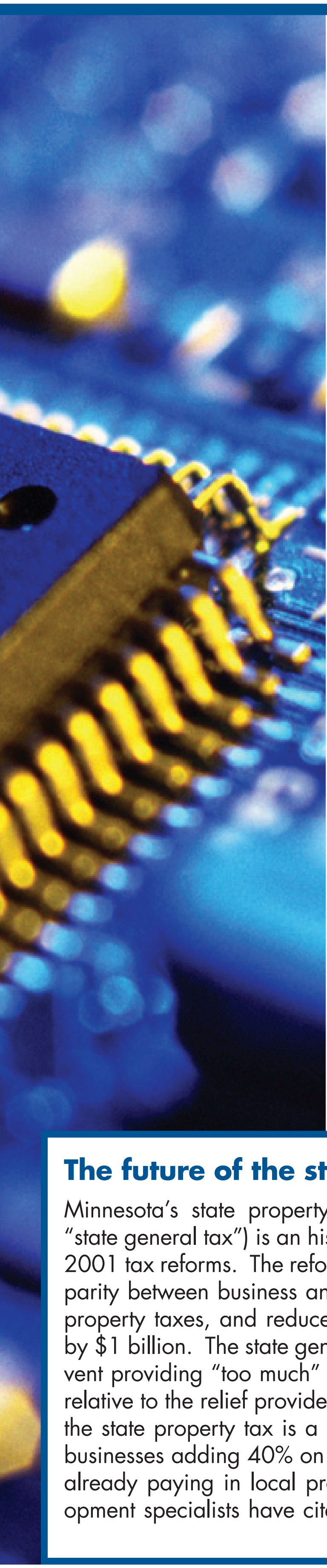
Like other forms of business taxation the corporate income tax is a regressive tax that lacks transparency since its burden is ultimately passed onto people – primarily employees of companies that pay the tax, and consumers who purchase the goods and services they produce.

- *It's highly volatile* – The corporate income tax is the most unstable and unpredictable revenue source for state government. Since 2000, year-over-year receipts from this tax have varied wildly, increasing up to 47% in one year, only to decrease by as much as 27% in another.[27] Recently, Minnesota Management and Budget forecasted that corporate tax revenues will drop by $408 million – or 22.5% – in the next two-year budget period.[28] The Minnesota Budget Trends Commission, in its recently released report, had this to say about the corporate income tax:

> *Minnesota's corporate [income] tax base, which constitutes 7 percent of general fund tax revenue and boasts the highest trend growth rate, is the most volatile of the three major revenue sources, extremely sensitive to economic cycles and thus subject to substantial uncertainty. In fact, the volatility of Minnesota's corporate [income] tax base is almost four times greater than the volatility of the individual income tax base and nearly six times greater than the volatility of the general sales tax base.*[29]

- *It's expensive to administer and comply with* – According to the Minnesota Department of Revenue the tax is the most expensive to administer relative to revenue collected and costs more than twice as much as the individual income tax.[30] However, this is just a small part of the administrative burden the tax places on both business and government. There are substantial legal and judicial costs as well as significant compliance and administrative costs for the private sector.[31] Compliance costs are particularly burdensome for small and medium-sized corporations. According to a review of the entire corporate tax system by Prof. Joel Slemrod of the University of Michigan, "the compliance costs dwarf the administrative costs, and certainly tax policy





needs to address these costs even if they do not show up in government budgets."[32] It is a waste of economic energy in both the public and private sectors.

Minnesota was one of the first states to seek a competitive advantage by tweaking its corporate income tax structure.[33] Similar attempts today are quickly bypassed by changes in other states, resulting in a national "race to the bottom." Minnesota can regain national leadership on the corporate tax front – rather than participating in a race with no end – by eliminating the inefficient and economically harmful corporate income tax.

Exempt 20% of active "pass-through" business income from taxation.

Many businesses in Minnesota – especially smaller ones – organize and operate as "S Corporations," partnerships or limited liability companies (LLCs). None of these entities pay taxes on net income.[34] Instead, net income is allocated and distributed (or "passed through") to shareholders, partners or members who then include the income or loss in their individual income tax returns.[35]

The current economic downturn underscores the importance of maintaining and growing jobs in Minnesota. Entrepreneurship and small businesses are key drivers to job maintenance/creation, provided they have the requisite investment capital or access to reasonably priced credit. If investment capital and/or access to credit become scarce, taxes can become a particularly strong factor in the equation when considering whether to retain or add employees.

In order to provide S Corporations, partnerships and LLCs with the means and incentive for retaining and adding jobs in Minnesota, the Commission recommends the adoption of a 20% exclusion on income allocated to shareholders, partners and members. Specifically, the exclusion would be limited to individual shareholders, partners and members whose respective S Corporation, partnership or LLC has ongoing business operations with employees and tangible property in Minnesota.[36]

Minnesota's maximum individual tax rate of 7.85% is currently 11th-highest in the U.S. Excluding 20% of pass-through income would enhance Minnesota's competitiveness with

The future of the state property tax

Minnesota's state property tax (otherwise known as the "state general tax") is an historical artifact resulting from the 2001 tax reforms. The reforms significantly reduced the disparity between business and other property types for local property taxes, and reduced school property tax revenues by $1 billion. The state general tax levy was created to prevent providing "too much" property tax relief to businesses relative to the relief provided to other types of property. Yet the state property tax is a significant burden to Minnesota businesses adding 40% on average to what businesses are already paying in local property taxes.[79] Economic development specialists have cited property taxes as one of the more influential considerations in business location and expansion decisions.

A strong case can be made that the state general tax could be significantly reduced or eliminated based on the benefits-received principle. However, state budget realities make this unlikely in the near-term, especially in light of other Commission recommendations.

The Commission recommends any future efforts to improve Minnesota competitiveness with respect to property taxes be directed at the state general tax. Targeting this tax has an additional practical benefit since it can be addressed without impacting the property taxes of other types of property owners.

other states by dropping the highest marginal rate on these earnings to 6.28%, or 23rd-highest in the nation.

Research indicates that higher marginal tax rates on pass-through business income increase the cost of capital and discourage additional investment and hiring by entrepreneurs. Even when new investment or hiring occurs, higher tax rates decrease the amount of capital investment, the number of new jobs and total wages paid by these businesses.[37] For example, a 5% increase in marginal tax rates resulted in a 10.4% reduction in the number of entrepreneurs making new capital investments, and reduced the amount of any such investments by 9.9%.[38]

Conform to federal tax write-off provisions for business-related assets.

Section 179 of the federal tax code allows small businesses to fully deduct (or "expense") the depreciation costs of some assets (or "tangible property") in the year of purchase, subject to an annual cap, rather than spreading those deductions over several years.[39] Congressional changes since 2002 gradually increased the expensing limits up to $250,000 for 2008 taxes.[40] Minnesota still caps these expenses at the original $25,000 per year.

Minnesota can regain national leadership on the corporate tax front – rather than participating in a race with no end – by eliminating the inefficient and economically harmful corporate income tax.

Until such time as the corporate income tax is completely eliminated, increasing the state expensing limits to match the current federal standard will help Minnesota's small businesses add to or upgrade their existing equipment. The ability to expense equipment purchases under Section 179 encourages small businesses to invest in upgrading or expanding their operations by reducing the cost.[41] These investments also spur additional economic activity in the state when Minnesota manufacturers or sellers are the source of those purchases.

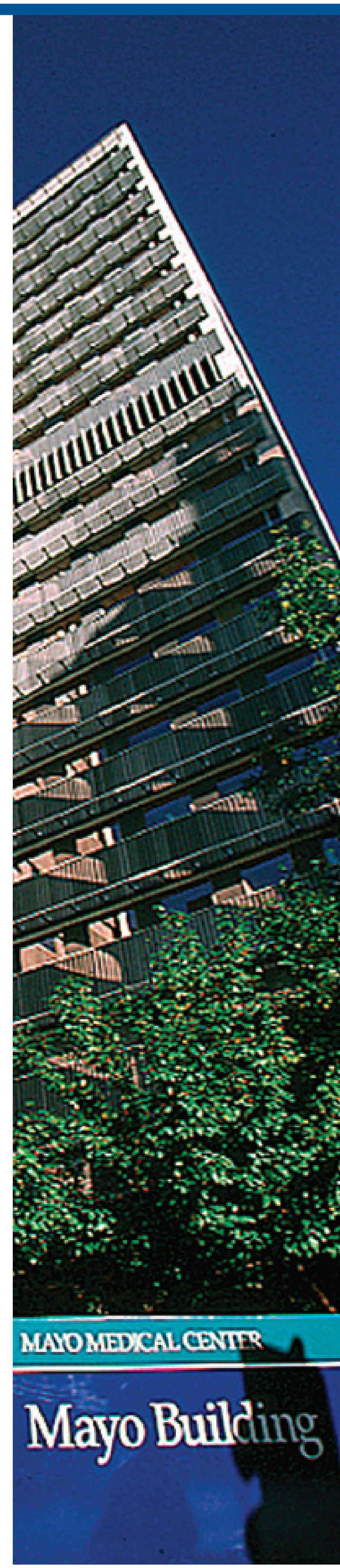
Conforming with the federal standard now and in the future also simplifies compliance for small businesses that would no longer have to comply with two sets of Section 179 expensing rules.

Replace capital equipment sales tax refund with up-front exemption.

Under legislation passed in 1992, to encourage capital investment in the state and reduce the pyramiding that occurs when inputs are subject to tax, Minnesota businesses are not taxed for buying or leasing equipment used for manufacturing, fabricating, mining or refining.

But the businesses must pay the sales tax at the time of purchase and then apply for a refund. The state refunds about $220 million each year, but the process is cumbersome, and businesses fail to claim about 5% of eligible refunds. This delay is particularly harmful to small or startup businesses, where cash-flow is a crucial concern. Some businesses hire consultants to track and file for the refund on their behalf, which represents an additional business cost.

Changing to an up-front sales tax exemption on capital equipment purchases would simplify compliance and regulation.[42]



Extend the capital equipment exemption to companies that produce services subject to sales tax.

Service companies are currently required to pay state sales tax on capital equipment purchases, even companies that provide services which are subject to the state sales tax (known as "1987 services" because that is the year they became taxable).[43]

Encouraging service companies to invest in capital equipment in Minnesota, while reducing the pyramiding of the sales tax on these purchases, is as desirable an objective for these businesses as it is for the businesses that currently qualify for the exemption.

Extending the capital equipment exemption to include purchases by companies that provide services subject to state sales tax would make the tax code more consistent. As with current rules for manufacturers, the exemption would cover purchases of capital equipment used to directly provide a service but would not include ancillary business equipment or supplies. This exemption should be extended to any service provider covered under future expansion of the sales tax base, if applicable.

Improve the Transparency of Business Taxation

The Commission concludes that greater transparency in business taxation and spending should be an integral part of Minnesota's business tax reform strategy, and has identified the following two areas of priority:

- Simplify the state property tax system.
- Require a biennial "benefits-received" report of Minnesota business taxation.

Minnesota's tax system is too complex, which makes administration for businesses and tax officials difficult and expensive. Such complexity also makes the tax system less visible for taxpayers, obscuring the link between tax revenues and how they are spent. This transparency is important to encourage voluntary compliance with the tax system, and is necessary if taxpayers and elected officials are to have an accurate reflection of reality on which to base personal, business or political decisions.

Simplify the state property tax system.

- Consolidate the property tax classification system.
- Eliminate Minnesota's high "advertised" property tax rates.
- Follow through with the scheduled repeal of Minnesota's Limited Market Value law.

Property taxes account for more than one-third of the total tax burden for U.S. businesses – more than any other single tax – which makes them a key factor in decisions about where to build or expand.[44] The high rates and complexity of Minnesota's property tax system often eliminates it from consideration early in the decisionmaking process.[45] [*See Appendix C for a sample property tax calculation for a business property.*] Greater transparency will allow for accurate comparisons by businesses and site selection consultants, highlighting where Minnesota's competitiveness has improved and where work remains to be done.

Consolidate Minnesota's property tax classification system.

Minnesota has 51 property classes and tiers, which unnecessarily complicates the system for both taxpayers and government officials. Simplification would make the whole system more understandable for all taxpayers, reduce the administrative burden for business and government, and make it easier to compare Minnesota property taxes with other states.

Simplification could be accomplished by consolidating classes with similar uses and rates together under four broad classes:

1. Agricultural;
2. Residential (including residential rental property);
3. Low-value commercial and industrial; and
4. High-value commercial and industrial.

Some property owners could experience large rate and liability changes, both positive and negative, as with any class consolidation. But such changes would be minimized if no class has a significant change in class rate. For example, the various residential classes currently have class rates that range from 0.75% to 1.25%; they could all be combined into a single residential class rate of 1%.

> ***Encouraging service companies to invest in capital equipment in Minnesota, while reducing the pyramiding of the sales tax on these purchases, is as desirable an objective for these businesses as it is for the businesses that currently qualify for the exemption.***

Eliminate Minnesota's high "advertised" property tax rates.

Since 1988, Minnesota's property tax system has been unique among the states in that the taxable portion of property valuations is calculated using relatively low "classification rates" (1% or 2%, for example). These low classification rates effectively shrink local property tax bases (by 98% or 99%, for example).

These dramatic base reductions drive local property tax rates to the uncommonly high levels needed to meet local revenue goals. The current statewide average local property tax rate (or "tax capacity rate," in the current system) is 94.7%.

To potential investors in other parts of the nation or world, our unique system is likely to appear unnecessarily complex, and our tax rates confiscatory. On paper, Minnesota's rates are many times higher than those of other states even though actual property tax burdens may be comparable.

There is no compelling reason to retain our current "tax capacity" system. Our high advertised property tax rates can easily be converted to the lower "mill rates" used in most other states, without losing revenue or shifting taxes across properties or property classes. [*See Appendix D for an example of how this can be accomplished.*]

Follow through with the scheduled repeal of Minnesota's Limited Market Value law (LMV).

LMV shifts taxes from rapidly growing properties to slower-growth properties. In 2008 the LMV law increased property taxes on 93% of the state's 1.4 million residential homesteads (a total increase of $60 million).[46] If the law expires as scheduled after payable year 2009, most business properties, apartments and residential homesteads will receive tax relief. It is our recommendation that the Legislature allow the repeal of the limited market value law as scheduled to better align Minnesota property taxes with actual property values.

Require a biennial benefits-received report of Minnesota business taxation.

In an ideal system, businesses should not pay more in taxes than the services and benefits they receive from state and local governments. Minnesota business taxes currently exceed services and benefits by more than 2-to-1 [*see 'Benefits-received,' page 14*]. The most direct way to create a proper balance is by lowering the tax burden on business, which the Commission believes should be a top priority.

Another way to improve Minnesota's business tax-to-benefit ratio is to better align business tax revenues with spending that will improve the state's economic and competitive standing. Greater transparency in how tax revenues are actually used is particularly important for business taxes – since those burdens are ultimately passed on to people, and the economic rationale for taxing business is so dependent on benefits-received.

Therefore the Commission recommends that the departments of Revenue and Minnesota Management and Budget develop a biennial benefits-received study to examine and report on the relationship of business taxes paid to business benefits received in the state. This study will serve as a valuable complement to the existing Minnesota Tax Incidence Study and Price of Government Report to track trends and identify circumstances when changes to either the levels of business taxation or state spending priorities may be necessary.

Promote investments in innovation, entrepreneurship and emerging/high-tech companies

The Commission concludes that encouraging investments in the state's emerging and/or innovation-based companies should be an integral part of Minnesota's business tax reform strategy, and has identified the following four areas of priority:

- Overhaul the R&D Tax Credit.
- Enact the Small Business Investment Act.
- Enact an Early-Stage Investment Tax Credit.
- Encourage low-income entrepreneurship and business creation loans.

Imperatives for Growth

Elimination of the Minnesota corporate income tax is an essential step to create an attractive business climate while also implementing sound tax policy. Admittedly, special deductions and tax incentives are not consistent with good tax policy. However, the reality is that other countries – as well as other states – continue to engage in an "arms race" with each other, competing for investment capital and job creation. Minnesota cannot "unilaterally disarm" without making the state fundamentally uncompetitive – especially if political and/or fiscal factors prevent the elimination of the corporate income tax in its entirety. Minnesota must create a climate that is conducive to research and development activity and small business expansion.

The recommendations below specifically (*1*) encourage research and development ("R&D") activity in Minnesota for all businesses regardless of size and type, and (*2*) improve access to capital for small and startup businesses in Minnesota. These policies promote innovation, capital formation and job growth in a wide range of industries and business sizes. They will help make Minnesota a driving force in the 21st century's fast-moving, increasingly global and technology-driven economy.

Overhaul the R&D Tax Credit.

- Extend the R&D Tax Credit to pass-through businesses (S Corporations, partnerships and limited liability companies).
- Increase the rate to 10%.
- Make the R&D credit refundable so it can benefit businesses that have no taxable income, or affiliates of corporations that are members of a unitary combined group.

Studies show that an R&D tax credit is an effective means of stimulating private-sector R&D activity. Minnesota's current R&D tax credit is currently available only to C Corporations,[47] and ranks poorly when compared to similar credits offered by many other states.

To potential investors in other parts of the nation or world, our unique system is likely to appear unnecessaily complex, and our tax rates confiscatory. On paper, Minnesota's rates are many times higher than those of other states even though actual property tax burdens may be comparable.

Allowing the state R&D credit to be utilized by the shareholders, partners and members of pass-through entities accommodates the standard business practice of conducting R&D activity in an LLC, partnership or S Corporation (especially common for small, startup businesses). Increasing the rate will encourage businesses of all types and sizes – most notably the large multi-national corporations that may be tempted to move R&D activity to a foreign country – to instead conduct and even expand R&D activity in Minnesota. Finally, converting the R&D credit to a refundable credit enables a business to currently utilize the credit even though it does not yet have taxable income, since net operating losses are particularly common for small startup businesses. In situations where the business earning the R&D credit is a member of

a unitary combined group, converting to a refundable credit effectively enables profitable affiliates to currently utilize the credit.

Overhauling the current R&D tax credit will spur additional private-sector research spending, which is crucial to growing technology jobs and companies in Minnesota. The majority of private R&D spending nationwide (70%) goes to pay worker salaries.[48] A published study found that a 10% increase in R&D tax credits correlates to a nearly 10% increase in long-term business research spending.[49]

Greater transparency in how tax revenues are actually used is particularly important for business taxes.

Minnesota companies spent roughly $6 billion on R&D annually in 2004 and 2005.[50] There are more than 128,000 technology workers in Minnesota, and they earn an average wage that is 69% higher than workers in other sectors.[51] Extending the R&D tax credit to pass-through businesses and making it refundable will be an especially strong incentive for small technology businesses to continue and expand R&D activity in the state.

Minnesota became the first state to offer an R&D tax credit in 1982, one year after the credit was established for U.S. federal taxes. That pioneering role helped establish the state as a leading promoter of technology businesses and the jobs they bring.[52] However, most states now offer some form of R&D tax incentive, and Minnesota's tiered 5%/2.5% credit ranks among the lowest in the nation.[53]

A 2006 research paper indicates that R&D credits tend to become more generous with time, with several states approaching or exceeding the 20% federal credit.[54,55]

Enact the Small Business Investment Act.

The Commission recommends the enactment of the Small Business Investment Act (SBIA) whereby Minnesota small businesses can access venture capital from a managed fund of up to $200 million that would be formed with cash contributions from insurance companies. In exchange for its contribution, an insurance company receives a credit against its state insurance premium tax equal to 80% of its contribution. The credit would be applied over a four-year period beginning four years after the contribution. A fund manager, licensed by the state, would make investments in selected small businesses and then provide the business with financial consulting. The program could be structured such that the investments would be targeted to economically stressed areas (e.g., rural Minnesota or low income communities) and the state could share in the returns.

SBIA is patterned on similar programs in other states[56] and is an alternative to banks and other conventional sources of capital – which is critically important when credit is either unavailable or extremely expensive. The economic impact would be felt almost immediately as small businesses taking part in the program hire employees and/or invest in new facilities and equipment. Minnesota would incur no costs for four years.[57]

According to projections presented to the Commission, the increased state revenue from SBIA-generated economic activity could substantially reduce or offset the annual $40 million cost of the tax credits.[58]

Companies backed by venture capital represent an important growth vehicle in the U.S. economy, but Minnesota is lagging behind many other states. While venture capital investments can fluctuate sharply from year-to-year, from 2000 to 2007 Minnesota received only 1.24% of total U.S. venture capital dollars invested and only 1.09% of seed and early-stage venture capital investments.[59] The SBIA taps into a large source of investment capital from insurance companies that otherwise would not have been invested in the state.

Even when new investment or hiring occurs, higher tax rates decrease the amount of capital investment, the number of new jobs and total wages paid by these businesses.

Enact an Early-Stage Investment Tax Credit.

The program would provide a 30% tax credit to investors in early-stage companies with high growth potential, often called "angel investors." Total tax credits available under the program would be capped at $15 million each year.

Angel investors are alternative sources of capital for promising high-technology entrepreneurs and nascent businesses, accounting for up to 90% of early-stage equity not obtained from friends or family.[60] These investors provide relatively modest amounts of capital (usually $100,000 or less) to local or regional companies that are not yet able to secure capital from other sources.

Many of these small, high-tech companies are highly mobile, and other states are providing incentives to attract them. In all, more than 20 states offer tax credits that aim to attract or retain investment capital, including the nearby states of Wisconsin (25%), Iowa (20%), Indiana (20%) and North Dakota (45%).[61] After Wisconsin implemented its angel investment tax credit in 2005, the state saw a 54% increase in angel investments from 2005 to 2006, and an additional increase of 43% from 2006 to 2007.[62]

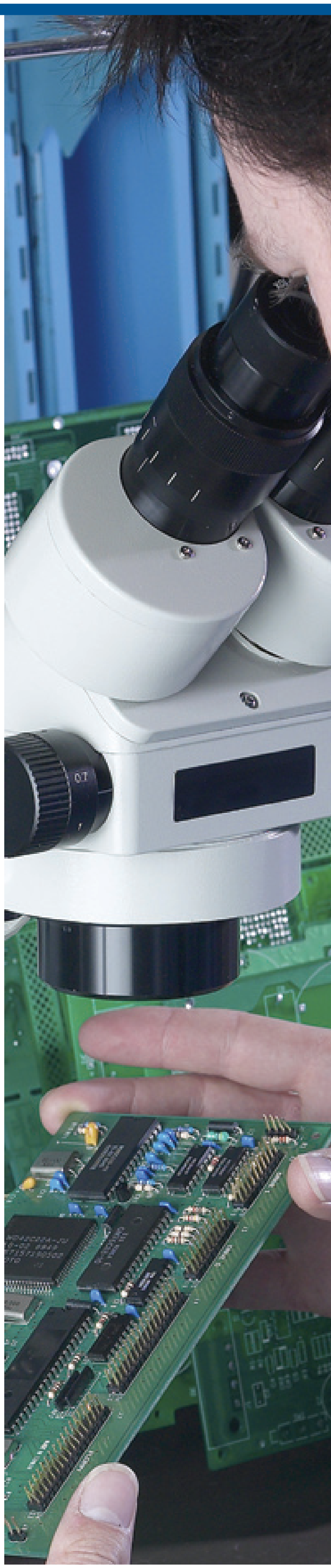
Business acumen, resources and network opportunities that angel investors provide are also crucial to startup companies. Because venture capital is ordinarily placed with businesses that are at least moderately developed, angel investments are increasingly important to help infant businesses reach the point where venture capital funding becomes available.

Encourage low-income entrepreneurship and business creation loans.

- Establish Small Enterprise Loan Guarantee Program (SELGP).
- Expand the current Family Assets for Independence in Minnesota initiative (FAIM).

Microenterprise development and entrepreneurship among low-income and immigrant households are necessary for a healthy state economy. Supporting such efforts is an important complement to existing state and federal income support and economic assistance programs.

Both of these programs are designed to provide "gap-financing" in geographic areas with high poverty rates and high unemployment rates. The SELGP program would be used to guarantee loans to low income house-



holds for the purpose of starting a business. The program would be administered by Community Development Financial Institutions who target economic development hot zones. The FAIM program would provide 3-to-1 matching funds for savings up to $480 per year to be used for purchase of a first home, pursuit of higher education or capitalization of a small business.

By providing access to investment capital and business coaching, these programs help create jobs while increasing income levels and economic self-sufficiency.

For a relatively small state investment, these programs can have a substantial impact in revitalizing and stabilizing low-income and immigrant communities.

These programs target economically distressed areas where would-be or existing entrepreneurs need capital to establish or expand their businesses and more-traditional sources of capital are not available.

Paying for reform

The Commission concludes that aligning the state tax system with personal consumption should be an integral part of Minnesota's business tax reform strategy, and has identified the following two areas of priority:

- Extend the sales tax base to a broader range of consumer products and consumer services.
- Increase the excise tax on cigarettes.

To thrive in today's highly competitive global economy, Minnesota needs to encourage saving and investing. Economists and tax policy experts universally agree that taxation of personal consumption – not income or investment – is conducive to increased saving and investing. Expanding the state sales tax base and increasing the cigarette excise tax will strengthen the consumption focus of the state tax system while covering the costs of reforms that are recommended by the Commission.

Taxes on income and investment such as the corporate income tax or capital gains tax are inefficient and volatile sources of revenue – and increasingly so in an age of mobile capital. Income taxes tend to penalize success, which discourages incremental savings and business investment, which in turn stifles job creation and economic growth.

Consumption taxes, such as the sales tax, are generally preferable because they are less volatile, cheaper to administer, and encourage saving and investing. Presently, the state sales tax in Minnesota has numerous exemptions – including many consumer products and nearly all consumer services. The exemption of consumer services from sales taxation is particularly inefficient considering that services have increased substantially as a percentage of total personal consumption – from 51% to 67% over the last 35 years. The exemptions substantially narrow the sales tax base, which makes the sales tax a less dependable source of revenue and a source of frustration – and expense – for the businesses that collect the sales tax on behalf of the state.

Extend the sales tax base to a broader range of consumer products and consumer services.

Expanding the sales tax base to most products and services purchased directly by individual consumers will achieve the benefits associated with a consumption tax. The Commission is not recommending specific consumer goods or consumer services to be taxed. As a general guideline, however, it would be best to avoid extending the sales tax to (*1*) products that carry significant regressivity concerns, such as food or residential heating fuels, without a corresponding income tax credit targeted at lower-income taxpayers, (*2*) or to those items already exposed to excise or wholesale taxes, such as motor fuels or prescription drugs.

Purchases of goods and services by businesses should generally be exempt from sales tax – as in the case of capital equipment – to the extent the goods and services represent business inputs that contribute to the final good or service. Products and services primarily purchased by consumers, such as car repair or office supplies, would remain subject to sales tax. Tax pyramiding occurs when the sales tax on business inputs at various stages of production is passed along to the customer, increasing both the purchase price and (on taxable sales) the amount of sales tax paid at purchase. If a significant number of inputs are subject to sales tax, the effects of this inflation can be substantial. This not only raises costs for consumers and businesses, but also represents a competitive issue for companies that consider overall tax levels when deciding where to locate their operations.

To thrive in today's highly competitive global economy, Minnesota needs to encourage saving and investing. Economists and tax policy experts universally agree that taxation of personal consumption – not income or investment – is conducive to increased saving and investing.

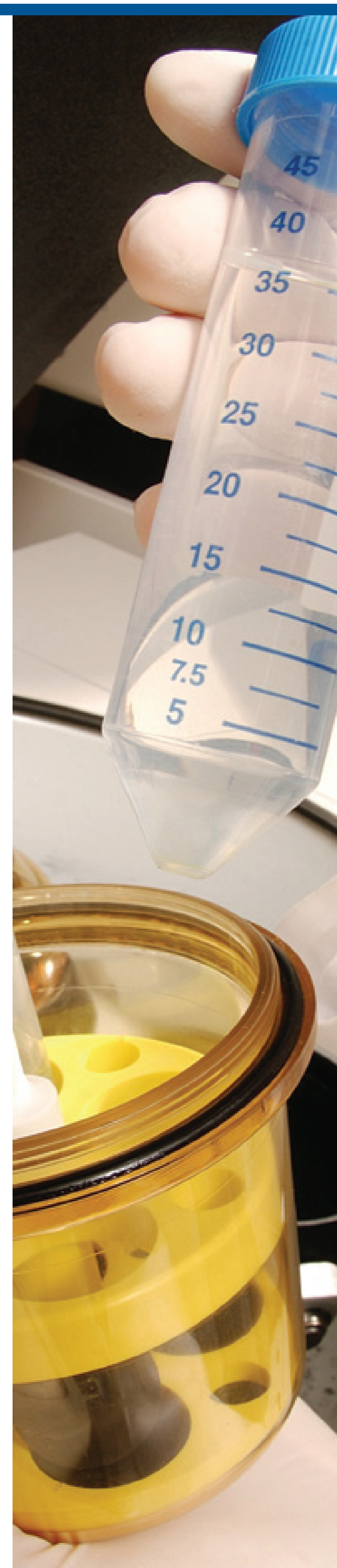
Increase the excise tax on cigarettes.

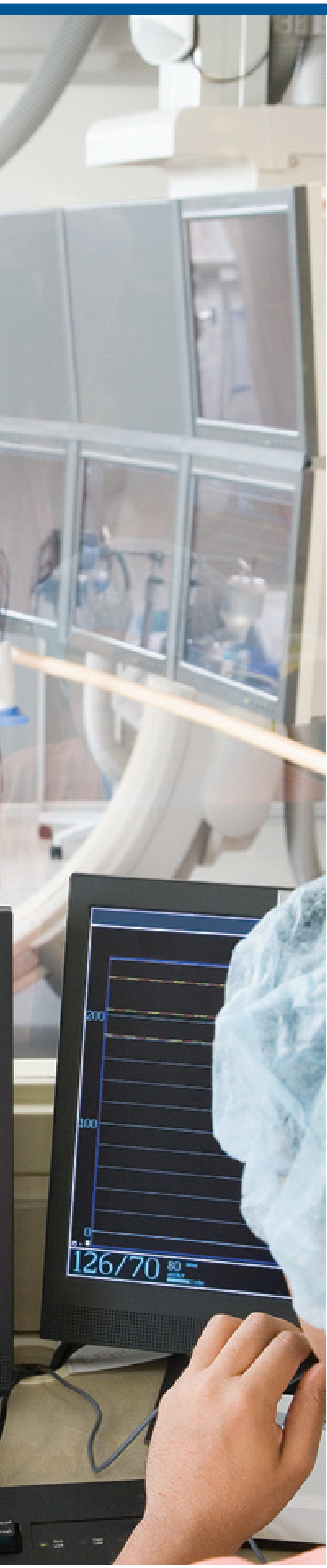
Increasing the excise tax on cigarettes will discourage smoking – especially among teenage children – while also helping to offset the costs of other reforms proposed by the Commission.

The Minnesota Department of Revenue estimates that increasing the cigarette excise tax by $1 per pack would bring in $148.7 million in additional revenue in 2010, while a 50-cent per pack increase would net $95.7 million.

Research shows that increasing the tax on cigarettes results in fewer smokers.[63] This is not only a desirable social goal, but will ultimately result in lower health-care costs for the state and for businesses that provide health care to their employees.

After Minnesota imposed a 75-cent Health Impact Fee in 2005 on every package of cigarettes sold in the state, cigarette sales declined more than 16% over the next year. Even with this decline, the state collected more than $160.7 million in new revenues.[64] In a recent survey, more than 25% of current smokers said the fee and result-





ing higher price had encouraged them to try to quit.[65]

Research by the Minnesota Department of Health calculates that cutting the number of smokers in the state by 2% could save about $350 million annually in smoking-related health-care costs.[66] If Minnesota could reduce its smoking rate by 2% per year from 2009 to 2013, the cumulative savings would exceed $3.6 billion.[67]

The additional revenue from a higher cigarette excise tax could help cover the costs of business tax reforms, or could be used more directly to lower health insurance costs to small and medium employers. For example, the proceeds from this increase could be dedicated to replace or reduce the assessments on health insurance and HMO premiums that helps fund the state's high-risk insurance pool.[68] Small and medium employers, along with the self-employed and individual policyholders, bear the brunt of these assessments. This increases their health insurance costs while contributing to a high overall tax burden that keeps some of them from being able to afford employee health coverage at all.[69] ■

Conclusion

The Governor's 21st Century Tax Reform Commission was asked to recommend reforms to modernize Minnesota's antiquated tax system in ways that promote economic growth, business investments and new job creation.

The reforms in this report build upon Minnesota's history of innovation, productivity and entrepreneurial spirit. They represent a much-needed investment in the future of all Minnesotans.

We believe that enactment of these recommendations will help generate new high-quality jobs, lay a foundation for future growth and sustain Minnesota's quality of life well into the future.

Acknowledgements

The Commission would like to thank the many people who contributed their time and expertise through testimony, research, creative thinking and other support.

Section 5

APPENDICES

Appendix A – Commission Members

Michael M. Vekich, CPA (Chair), Chair and President, Skyline Exhibits and Vekich Associates

Philip J. Albert, Vice President of Corporate Tax, Medtronic Inc.

David Beito, Chairman, President and CEO, Northern State Bank of Thief River Falls

William V. Belanger, former State Senator

Danielle A. Buchberger, CPA, Eikill and Schilling Ltd.

David R. Carlsen, Chairman and CEO, UMI Company Inc.

Corey Haaland, Vice President and Treasurer, Target Corporation

Mark Haveman, Executive Director, Minnesota Taxpayers Association

Joy Lindsay, President, StarTec Investments, LLC

Wendell Maddox, President and CEO, ION Corporation

Gerald Morris, Director and Senior Tax Counsel, General Mills Inc.

Rebecca Paulsen, CPA, Vice President of State Taxes, U.S. Bank N.A.

Kate Rubin, President, Minnesota High Tech Association

John Spry, Ph.D., Associate Professor, Department of Finance, Opus College of Business, University of St. Thomas

David L. Welliver, CPA, Wilkerson Associates

Appendix B –
Gov. Tim Pawlenty's charter/addendum for the Governor's 21st Century Tax Reform Commission

Executive Order 08-06 – Providing for the Governor's 21st Century Tax Reform Commission

I, TIM PAWLENTY, Governor of the State of Minnesota, by virtue of the authority vested in me by the Constitution and applicable statutes, do hereby issue this executive order:

WHEREAS, Minnesota's goal is to be the best place in America to live, work and raise a family; and

WHEREAS, Minnesota's long-term prosperity requires that businesses and entrepreneurs invest, remain and grow in the state; and

WHEREAS, Minnesota's current tax system reflects the economy and demographics of the 1960s and could be improved to better support business development and investment, job growth, income generation, entrepreneurial activity, research activities and exports; and

WHEREAS, Minnesotans will benefit from an improved tax system that is simple, more predictable, and that supports a strong economy and job climate.

NOW, THEREFORE, I hereby order the creation of the Governor's 21st Century Tax Reform Commission ("Commission").

1. The Commission will be comprised of up to 15 members appointed by the Governor:

   a. Membership on the Commission will include individuals with knowledge and experience in how state tax systems affect business location, job creation and capital investments.

   b. Membership will also include representatives of the following types of businesses and individuals:

      i. large and small businesses;

      ii. businesses from key Minnesota industries;

      iii. C-corporations, S-corporations, partnerships, and sole proprietors;

      iv. suppliers of investment capital; and

      v. individuals with special experience or knowledge in taxation and the economy.

   c. The Governor will designate a chair.

   d. Commission members will serve a two-year term, or until the Commission is disbanded at the request of the Governor.

   e. Commission members will serve on a voluntary basis and are not eligible for per-diem or payment of expenses.

   f. The Commissioner of Revenue and any designees will provide administrative and staff support to the Commission.

2. The Commission's responsibilities include providing advice and recommendations to the Governor on reforming the state's tax laws with the goal of making long-term improvements in the revenue system that reflect changes in business practices, demographics, and the economy that have occurred in Minnesota and in other states.

a. The Commission will recommend tax law changes that improve Minnesota's ability to successfully compete with other states and nations for jobs and business investments, and that promote the long-term economic prosperity of the State and its citizens.

b. The combined impact of the Commission's recommendations should be revenue-neutral.

c. The Commission's recommendations should reflect principles of sound tax policy including equity, simplicity, competitiveness, efficiency, stability, and ease of compliance and administration.

d. The Commission will provide the Governor with a report of its recommendation by December 1, 2008.

3. The Commission will meet as soon as practicable following the completion of the open appointment process.

IN TESTIMONY WHEREOF, I have set my hand this 29th day of February, 2008.

Executive Order 08-16 – Providing for the Governor's 21st Century Tax Reform Commission

I, TIM PAWLENTY, Governor of the State of Minnesota, by virtue of the authority vested in me by the Constitution and applicable statutes, do hereby issue this executive order:

WHEREAS, on February 29, 2008, I issued Executive Order 08-06 establishing the 21st Century Tax Reform Commission ("Commission"); and

WHEREAS, since completion of the open appointments process in April 2008, the Commission has been meeting regularly and the members devoting significant personal time to complete the Commission's analysis and recommendations; and

WHEREAS, the original order called for the Commission to issue a report and recommendations by December 1, 2008; and

WHEREAS, Minnesota and the rest of the country have experienced significant changes to the economic conditions this Fall; and

WHEREAS, the Commission should consider the changes to the economy, November forecast and the Governor's proposed budget in preparing its report and recommendations.

NOW, THEREFORE, I hereby order:

1. The Commission should review and consider as part of its analysis the changes to the Minnesota and national economy, the November state forecast and the Governor's proposed state budget.

2. Executive Order 08-06 is amended to provide that the Commission issue its report and recommendations to the Governor no later than February 15, 2009.

Pursuant to Minnesota Statutes 2006, Section 4.035, Subdivision 2, this Executive Order will be effective fifteen (15) days after publication in the State Register and filing with the Secretary of State.

IN TESTIMONY WHEREOF, I have set my hand this 7th day of November, 2008.

Appendix C – Sample Property Tax Calculation

Calculation for a hypothetical commercial/industrial property*

1. Determine the property's taxable market value.	$1,000,000
2. Determine the class rate based on property type.	Commercial/Industrial: First $150,000 in value 1.5% Remaining value 2.0%
3. Multiply taxable market value by class rate to obtain the *net tax capacity*.	$150,000 x 1.5% = $ 2,250 $850,000 x 2.0% = $17,000 Total: $19,250
4. Determine the total local tax rate by summing the tax rates of all jurisdictions authorized to levy property taxes upon the property (i.e., jurisdictions whose boundaries include the property).	County 50% City/town 35 School district 25 Special districts 5 Total: 115%
5. Multiply net tax capacity by total tax rate to determine the net tax capacity-based portion of the gross tax.	$19,250 X 115% = $22,138
6. Determine the total market value tax rate by summing the market value tax rate for all taxing jurisdictions authorized to levy property taxes upon the property.	County 0.0% City/town 0.0 School district 0.1 Special districts 0.0 Total 0.1%
7. Multiply taxable market value by total market value tax rate to determine the market value-based portion of the gross tax.	$1,000,000 X 0.1% = $1,000
8. Add the net tax capacity-based gross tax to market value-based gross tax to obtain the total gross tax.	$22,138 + $1,000 = $23,138
9. Applicable credits.	$0
10. Subtract the credit from the gross tax to obtain the net tax.	$23,138 - $0 = $23,138

**Note: This example does not include any additional calculations needed for business properties affected by special programs, such as the Twin Cities Metropolitan Area Fiscal Disparities Program or the Iron Range Fiscal Disparities Program.*

Appendix D – Converting from Tax Capacity to Mill Rates

Minnesota's classification rates can be scaled up by any proportion to create smaller tax rates expressed as more common "mill rates."

BEFORE *(Tax Capacity System)*				**AFTER** *(Mill Rate System)*			
	Home	**C/I**	**Other**		**Home**	**C/I**	**Other**
Market Value	$200,000	$150,000	$200,000	**Market Value**	$200,000	$150,000	$200,000
Class Rate	0.01	0.015	0.013	**Assessment Ratio**[1]	0.5	0.75	0.65
Tax Capacity	$2,000	$2,250	$2,600	**Taxable value**	$100,000	$112,500	$130,000
Tax Cap. Rate[2]	0.947	0.947	0.947	**Mill Rate**[2]	0.01894	0.01894	0.01894
Tax[3]	**$1,894**	**$2,131**	**$2,462**	**Tax**	**$1,894**	**$2,131**	**$2,462**

[1]In the above example, the three class rates, 0.01, 0.015, and 0.013 are increased fifty-fold to yield assessment ratios of 50%, 75%, and 65%.

[2]The result is a reduction of "advertised tax rates" from a tax capacity rate of 94.7% to a mill rate of 18.94 mills (.01894).

[3]The shaded lines show no change in tax liabilities as a result of the conversion.

Endnotes

1. Johansson, Asa, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, *Tax and Economic Growth: Economics Department Working Paper No. 620*, Organisation for Economic Co-operation and Development (July 11, 2008), pp. 2.

2. Cline, Robert, *Recent State Business Tax Reforms*, Presentation to The Governor's 21st Century Tax Reform Commission (Sept. 5, 2008) [http://www.taxes.state.mn.us/mntaxreform/presentations/TRC_Cline_Reforms_090508.pdf].

3. Tax Foundation, *State Corporate Income Tax Rates 2000-2009* [http://www.taxfoundation.org/research/show/230.html].

4. Cline, *Recent State Tax Reforms*.

5. National tax rates are provided by the Organisation for Economic Co-operation and Development (OECD) [http://www.oecd.org/dataoecd/26/56/33717459.xls]. The U.S. has the second highest national rate. State rates are reported by the Federation of Tax Administrators [http://www.taxadmin.org/fta/rate/corp_inc.html]. The combined state plus local rate exceeds all other countries and all other states except Iowa and Pennsylvania. The reported rate takes into account the deductibility of state tax on federal tax returns, so it is less than the simple addition of federal and state tax rates (35% and 9.8% respectively).

6. Phillips, Andrew, Robert Cline, and Thomas Neubig, *Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007*, Council on State Taxation/Ernst & Young (February 2008) [http://www.statetax.org/WorkArea/showcontent.aspx?id=69656].

7. Stinson, Tom, and Tom Gillaspy, *Minnesota's Economics and Demographics: Looking to 2030 and Beyond*, Presentation to The Governor's 21st Century Tax Reform Commission (July 25, 2008) [http://www.taxes.state.mn.us/mntaxreform/presentations/EconomyDemographics_072508.ppt].

8. Isaacson, Bob, *Minnesota's Economy: Change and Competitiveness*, Presentation to The Governor's 21st Century Tax Reform Commission (June 20, 2008) [http://www.taxes.state.mn.us/mntaxreform/presentations/DOR_Business_Tax_0608_distribution.pdf].

9. Stinson and Gillaspy, *Minnesota's Economics and Demographics*.

10. Stinson and Gillaspy, *Minnesota's Economics and Demographics*.

11. Stinson and Gillaspy, *Minnesota's Economics and Demographics*.

12. Pardey, Philip G., Steven Dehmer, and Jason Beddow, *Long Gone Lake Wobegon? The State of Investments in University of Minnesota Research*, University of Minnesota, International Science and Technology Practice and Policy Paper No. 44083 (May 2007) [http://ageconsearch.umn.edu/bitstream/44083/2/Wobegon.pdf].

13. Pardey, Dehmer, and Beddow, *Long Gone Lake Wobegon?*

14. Stinson and Gillaspy, *Minnesota's Economics and Demographics*.

15. Stinson and Gillaspy, *Minnesota's Economics and Demographics*.

16. Rankings based on state-by-state per capita income data provided by U.S. Bureau of Economic Analysis [http://www.bea.gov/regional/spi/]. Inflation rate was calculated using historical CPI data provided by U.S. Bureau of Labor Statistics [http://www.bls.gov/cpi/home.htm].

17. Stinson and Gillaspy, *Minnesota's Economics and Demographics*.

18. U.S. Bureau of Labor Statistics, 1979-2008 [http://www.bls.gov/lau/home.htm].

19. Mattoon, Richard H., and William A. Testa, *How Closely Do Business Taxes Conform to the Benefits Principle?*, Presentation at the Future State Business Tax Reforms: Perspectives from the Business Government and Academic Communities conference, Federal Reserve Bank of Chicago (Sept. 17, 2007). See also Phillips, Cline, and Neubig, *Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007*.

20. The Congressional Budget Office finds, "The domestic distortions that the corporate income tax induces are large compared with the revenues that the tax generates."

    "At a purely domestic level, the corporate income tax has the potential to distort economic incentives and generate inefficiency in at least six ways. First, because it is imposed on income from capital, it biases individuals' decisions about how much to save and can therefore influence overall capital investment and economic growth. Second, because the corporate income tax is imposed only on some kinds of business profits (in the United States, typically those of corporations that have many shareholders) and not on others (such as the profits of partnerships and sole proprietorships), it affects the ways in which businesses are organized and creates biases in investment and production toward those types of business structures that are not subject to the corporate income tax. Third, it creates a bias in corporate financing toward the use of debt—because the tax is imposed on income from equity-financed investment and not on the return to debt-financed investment. Fourth, because the law treats a corporation as a separate taxable

Endnotes

entity from which shareholders subsequently realize income in the form of either dividends or capital gains, the relatively beneficial tax treatment of capital gains under the individual income tax creates a bias toward them and against the payment of dividends. Fifth, because the United States levies corporate income tax on the basis of schedules for depreciation that do not correspond to economic depreciation, it taxes different kinds of assets and industries at different effective rates, creating a bias in investment and production toward the more lightly taxed assets and sectors. Finally, the corporate income tax may distort the allocation of resources by making corporations' compliance with taxation costly and by creating additional opportunities for tax planning." Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons* (November 2005), pp. ix, 1, and 2.

21. Bruce, Donald, John Deskins, and William Fox, *On the Relative Distortions of State Sales and Corporate Income Taxes*, Paper presented at National Tax Association Annual Conference (June 2008) [http://web.utk.edu/~dbruce/bruce.deskins.fox.distortions.pdf].

22. Phillips, Cline, and Neubig, *Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007*.

23. Agostini, Claudio A. "The Impact of State Corporate Taxes on FDI Location," *Public Finance Review,* 35 (2007), pp. 335.

24. Djankov, Sineon, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer, "The Effect of Corporate Taxes on Investment and Entrepreneurship," *National Bureau of Economic Research Working Paper 13756* (January 2008) [http://www.nber.org/papers/w13756.pdf].

25. These results differ from estimates shown in the *Tax Incidence Study*. As noted in that study: "The incidence of a *change* in business taxes would be different from those presented in this study. Compared to the results in this study, economic theory suggests that the long-run incidence of a *change* in Minnesota business taxes would fall less on nonresidents, less on Minnesota owners of capital, more on Minnesota consumers, and more on Minnesota labor." Minnesota Department of Revenue, *2007 Minnesota Tax Incidence Study* (March 2007), pp. 84. Because state taxes are deductible in calculating federal liability, the net reduction in corporate tax payments is the reduction after netting out the increase in federal tax.

    Some leading economists argue that the share of Minnesota's tax shifted forward to consumers is even larger. They argue that a state corporate income tax apportioned 100% based on the Minnesota share of its total sales will *all* be shifted forward in higher prices. If this is true, then the corporate income tax in effect imposes a hidden sales tax at arbitrary rates on everything businesses sell in the state, including products popularly thought to be tax-free such as food and prescription drugs. McLure, Charles, "The State Corporate Income Tax: A Lamb in Wolves' Clothing", *The Economics of Taxation,* Brookings Institute (1980). Atkins, Chris, *A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems*, Tax Foundation Background Paper 49 (October 2005).

26. Brunori, David, "Stop Taxing Corporate Income," *State Tax Notes* (July 1, 2002). Also see Martin Sullivan, "State Corporate Tax Leakage: $14.5 billion in 2006," *State Tax Notes* (Nov. 26, 2007) and Charles McLure, "How – and How Not – To Tax Business," *State Tax Notes* (April 4, 2005).

27. Minnesota Management and Budget, *Price of Government* (2000-2008) [http://www.mmb.state.mn.us/budget-pog].

28. The agency projects that corporate income tax revenues in the 2010-11 budget biennium will drop to $1.404 million, down from $1.812 million in the 2008-09 budget biennium. Minnesota Management and Budget, *Minnesota Financial Report and Budget Forecast*, (November 2008) [http://www.mmb.state.mn.us/doc/fu/08/complete-nov08.pdf].

29. Minnesota Budget Trends Study Commission, *Commission Report to the Legislature* (Jan. 12, 2009) [http://www.mmb.state.mn.us/doc/budget/trends/report-09.pdf], pp. 19.

30. According to Minnesota Department of Revenue statistics, it costs $0.015 to administer the corporate income tax per dollar of revenue raised. The next-highest administrative cost is the sales and use tax at $0.009, followed by the individual income tax at $0.007.

31. Seventeen percent of Minnesota Supreme Court decisions containing the world "tax" between 2003 and 2008 involved the corporate income tax, according to an electronic search performed by Prof. John Spry of the University of St. Thomas.

32. Slemrod, Joel, *The (Compliance) Cost of Taxing Business*, AEI Conference Transcript (June 2, 2006) [http://www.aei.org/events/filter.all,eventID.1348/transcript.asp].

33. For example, Minnesota enacted a 70% weighted sales apportionment option for calculating corporate tax for manufacturers in 1939 (later extended to all companies in 1953). This

decreased the corporate tax liability stemming from payroll or property holdings in Minnesota while placing a greater emphasis on the sales of products or services in the state, an early attempt to make Minnesota a more desirable place for company headquarters or other business operations. Most other states didn't follow suit until the 1990s.

34. An "S Corporation" is a business that is organized as a corporation under state law; however, it is registered and maintained under Subchapter S of the Internal Revenue Code. As such, an S Corporation does not pay income tax at the entity level and income/loss is passed through to the shareholder(s). A limited liability company ("LLC") likewise is organized as a corporation under state law; however, it is treated as a partnership for federal income tax purposes. Most states also treat an LLC as a partnership for state income tax purposes.

35. "C Corporations" are businesses organized as corporations under state law; however, they are registered and maintained under Subchapter C of the Internal Revenue Code. Accordingly, C Corporations do report and pay tax on net income at the entity level. Additionally, the shareholders of C Corporations must also pay tax on income distributed to them as dividends.

36. In order to qualify for this exclusion, the principal business activity of an S Corporation, partnership, or LLC must involve active business operations (e.g., manufacturing, construction, provision, and/or sale of tangible goods, property or services). The principal business cannot be passive (e.g. asset holding) or investment in nature.

37. Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, *Entrepreneurs, Income Taxes, and Investment: Working Paper No. 6374*, National Bureau of Economic Research (January 1998). Cited in "Treasury Conference on Business Taxation and Global Competitiveness," U.S. Department of Treasury (July 23, 2007).

38. Carroll et al, *Income Taxes and Entrepreneurs' Use of Labor: Working Paper No. 6578*, National Bureau of Economic Research (May 1998) and *Journal of Labor Economics*, Vol. 18, No. 2 (2000), pp 324-351. Cited in "Treasury Conference on Business Taxation and Global Competitiveness," U.S. Department of Treasury (July 23, 2007).

39. Section 179 benefits mostly small businesses because the expensing benefit is gradually phased out when purchases of eligible property for the year exceed a certain amount; for tax year 2008, that limit is $800,000. Tangible property that qualifies for expensing includes machinery and equipment, furniture and fixtures, most storage facilities and single-purpose agricultural or horticultural buildings.

40. The annual cap has gradually risen, from $100,000 in 2003, up to $250,000 for tax year 2008. The limit is scheduled to gradually decline again, to $25,000 in 2011, unless modified again by Congress.

41. Equipment tax write-offs under Section 179 reduce income taxes for small businesses. Eliminating the state Corporate Franchise Tax, as recommended by the Commission, would eventually make this change a non-factor for small businesses registered as corporations. But Section 179 write-offs would remain an important incentive for small corporations until full the corporate income tax is fully eliminated, and for "pass-through" businesses going forward.

42. The Department of Revenue Research Division estimates the shift would cost $140 million spread over the first three years, and $10 million a year thereafter due to increased participation in the program.

43. The services made taxable in 1987 are: parking; motor vehicle cleaning and maintenance (not repair); pet grooming; laundry and dry cleaning; building and residential cleaning, maintenance, and exterminating; detective agencies, security, burglar and fire alarm, and armored car services; and lawn, garden, tree, and shrub services.

44. Nationally, U.S. businesses paid $202.5 billion in property taxes for FY 2007, accounting for 35.1% of the total business tax burden. Next were sales taxes on materials, equipment and other business inputs at $132.3 billion (22.9%) and corporate income taxes at $58.7 billion (10.2%). The proportions were similar in Minnesota, where businesses paid $3.5 billion in property taxes, accounting for 35% of total business taxes – $10 billion in FY 2007; next were sales taxes at $2 billion (20%), followed by the corporate franchise tax at $1.2 billion (12%). Phillips, Cline, and Neubig, *Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007*.

45. Isaacson, *Minnesota's Economy*.

46. Minnesota Department of Revenue, *2007 Limited Market Value Report* (March 2008) [http://www.taxes.state.mn.us/taxes/legal_policy/research_reports/content/2008_lmv_final.pdf]. The law had been scheduled to expire several times, most recently after 2007 but was extended by two years by the Legislature.

Endnotes

47. A "C Corporation" is a business that is (1) organized and operated as a corporation under state law and (2) registered and maintained as a tax paying entity per Subchapter C of the Internal Revenue Code. An "S Corporation" is also a business that is organized as a corporation under state law; however, it is registered and maintained under Subchapter S of the Internal Revenue Code. As such, an S Corporation does not pay income tax at the entity level and income/loss is passed to the shareholder(s).

48. Ernst & Young, *Supporting Innovation and Economic Growth: The Broad Impact of the R&D Credit in 2005* (April 2008), pp. 7. Prepared on behalf of the R&D Credit Coalition.

49. Bloom, Nick, Rachel Griffith, and John Van Reenen, "Do R&D tax credits work? Evidence from a panel of countries 1979-1997," *Journal of Public Economics* 85 (2002), pp. 1-31.

50. In 2004, Minnesota companies spent $6.0 billion on R&D. American Electronics Association, *Cyberstates 2008: A Complete State-by-State Overview of the High-Technology Industry* (2008). In 2005, Minnesota companies spent $6.05 billion on R&D. Ernst & Young, *Supporting Innovation and Economic Growth*.

51. In 2006, there were 128,525 high-tech workers in Minnesota, earning an average wage of $71,559, while the state's average private sector wage was $42,324. American Electronics Association, *Cyberstates 2008*.

52. "[T]the initiation of a state R&D tax credit has significant and positive effects on the number of the state's high-technology establishments relative to its population or total business establishments." Wu, Yonghong, "State R&D Tax Credits and High-Technology Establishments," *Economic Development Quarterly* Vol. 22, No. 2, (2008), pp. 136-148.

53. In 2006, a total of 32 states offered an R&D tax credit, with effective rates ranging from 2.5% to 20%. Minnesota's rate of 2.5% above $2 million ranked 22nd among those states. Wilson, Daniel J., *Beggar thy Neighbor? The In-State, Out-of-State, and Aggregate Effects of R&D Tax Credits*, Federal Reserve Bank of San Francisco (August 2007), Table 1.

54. The federal R&D tax credit, currently authorized through Dec. 31, 2009, has a statutory rate of 20%, but since the credit itself counts as income (if the taxpayer does not elect the reduced credit per Sec. 280C of the Internal Revenue Code), an effective rate of 13.5%. In 2006, 10 states had credits with statutory rates of 10% or greater; the effective rates in California (13.7%), Hawaii (20%) and Rhode Island (16.9%) exceeded the federal effective rate. Wilson, *Beggar Thy Neighbor?*

55. More recently, North Dakota enacted enhanced R&D tax credit provisions that provide a credit against corporate income tax which is equal to 25% on the first $100,000 of qualified expenditures and depending on the year and whether the taxpayer has claimed R&D credits in North Dakota prior to 2007, up to 20% on expenditures above $100,000. Additionally, R&D credits earned by pass-through entities can be claimed by the respective shareholder, member, or partner. *N.D. Cent. Code* § 57-38-30.5 (2007).

56. Certified Capital Company, or "CAPCO" programs have been implemented in 10 states, including Wisconsin, Missouri, Texas, New York and Alabama.

57. If MSBI became effective at the recommended level in 2010, for example, $200 million of investment capital would become available for investment immediately. But the state cost of $160 million in tax credits would not be payable until 2014, and would be spread over four years ($40 million a year from 2014 to 2017).

58. The projections from a Regional Dynamics "REDYN" economic model indicate that even a smaller-scale $100 million SBIA program (with the state providing $80 million in tax credits) could produce up to roughly 5,800 new jobs in Minnesota and additional revenue of $328 million over 10 years. Leonard Street and Deinard, *The Minnesota Small Business Investment Act*, Presentation to The Governor's 21st Century Tax Reform Commission, Oct. 3, 2008.

59. PricewaterhouseCoopers/National Venture Capital Association, *Moneytree Report*, 2000-2007 [https://www.pwcmoneytree.com/MTPublic/ns/index.jsp]. Based on data provided by Thomson Financial.

60. Preston, Susan L., *Angel Investment Groups, Networks, and Funds: A Guidebook to Developing the Right Angel Organization for Your Community*, Ewing Marion Kauffman Foundation (September 2004). Hudson, Marianne, "Why Entrepreneurs Need Angels—and How Angels Are Improving," *Kauffman Thoughtbook 2005*, Ewing Marion Kauffman Foundation (2005), pp. 156–160.

61. National Governors Association Center for Best Practices, *Issue Brief: State Strategies to Promote Angel Investment for Economic Growth* (April 2008).

Endnotes

62. Ward, Dr. David J., *Risk Capital Report for Wisconsin 2006*, Wisconsin Angel Network (June 2007) [http://www.wisconsinangelnetwork.com/uploads/ReportingMetrics/RiskCapital2006-Report.pdf]. *2008 Risk Capital Report: Wisconsin*, Wisconsin Angel Network (June 2008) [http://www.wisconsinangelnetwork.com/uploads/2008WRCR.pdf].

63. From January 2005 to December 2006, there were a total of 18 cigarette tax increases in the U.S., all of which resulted in fewer cigarettes being sold, with declines ranging from 1.4% to 42%. Minnesota's 75-cent "health impact fee," effective August 2005, decreased cigarette sales by 16.1% over the next year. Campaign for Tobacco-Free Kids, *Raising State Cigarette Taxes Always Increases State Revenues [and Always Reduces Smoking]* (Aug. 5, 2008).

64. Campaign for Tobacco-Free Kids, *Raising State Cigarette Taxes*.

65. In the 2007 Minnesota Adult Tobacco Survey , 26.3% of current smokers said they attempted to quit smoking after the Health Impact Fee was imposed in August 2005. ClearWay Minnesota SM, Blue Cross and Blue Shield of Minnesota, and Minnesota Department of Health, *Creating a Healthier Minnesota: Progress in Reducing Tobacco Use* (Sept. 20, 2008) [http://www.health.state.mn.us/divs/chs/tobacco/matscomptech07.pdf].

66. The study, prepared for the Health Care Transformation Task Force, estimated that reducing the smoking rate in Minnesota from its current level of 17.7% to 9.3% by 2013 would save $1.7 billion in smoking-related health-care costs in 2013. If Minnesota reduced its smoking rate by 2% per year from 2009 to 2013, the cumulative cost savings would exceed $3.6 billion. Minnesota Department of Health, *Potential Health Care Cost Savings from Reducing Overweight/Obesity and Smoking* (Nov. 14, 2007) [http://www.health.state.mn.us/divs/hpsc/hep/transform/novdocuments/obesityandsmoking111507.pdf].

67. Minnesota Department of Health, *Potential Health Care Cost Savings*.

68. The Minnesota Comprehensive Health Association provides health-care coverage for people who are unable to buy insurance due to pre-existing conditions or other factors. MCHA is partially funded though an assessment on health-care policies sold by private insurers, HMOs, Blue Cross Blue Shield and "preferred provider organizations." Companies that manage their own health-care plans, or "self-insure," are not subject to this surcharge. Minnesota Taxpayers Association, *Health Care Taxes in Minnesota: An Analysis* (2001).

69. Most small or medium businesses cannot afford to self-insure, which means the impact of the MCHA surcharge falls heavily on them, making it more expensive for them to provide health coverage for their employees. National Association of State Comprehensive Health Insurance Plan, *State High Risk Pools Hold Value in the Era of Health Reform* (2007).

70. U.S. Census, *Business Dynamic Statistics 1977-2005* [http://www.ces.census.gov/index.php/bds]

71. Based on Department of Revenue filing data for tax year 2007.

72. U.S. Census, *Business Dynamic Statistics 1977-2005*.

73. Oakland, William H., and William A. Testa, "State-Local Business Taxation and the Benefits Principle," Economic Perspectives (January 2006), pp. 2-19 [http://www.chicagofed.org/publications/economicperspectives/1996/epjan96a.pdf]. Cited in Phillips, Cline, and Neubig, *Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007*.

74. Council On State Taxation, ("COST") *Gross Receipts Taxes Policy Position* [http://www.statetax.org/uploadedFiles/About_COST/Policy_Statement/GrossReceiptsTaxes.pdf].

75. For example, the state of Washington's "Business and Occupation Tax" statute lists 71 exemptions, 21 deductions and 21 credits. Wash. RCW /S/ 82.04 (2009).

76. COST, *Gross Receipts Taxes Policy Position*.

77. Arnold, Stan, and William F.J. Ardinger, "Top Ten Reasons Why New Hampshire's BET May Provide an Answer to State Tax Reform," *State Tax Notes* (Nov. 29, 2004).

78. McLure, Charles, "How – and How Not – To Tax Business," *State Tax Notes* (April 4, 2005).

79. In 2008, commercial, industrial, and utility properties paid $695 million in state property taxes on top of $1.757 billion in local property taxes, according to Department of Revenue property tax data.

The Governor's 21[st] Century
Tax Reform Commission