The Governor's 21st Century Tax Reform Commission believes that Minnesota must modernize its approach to taxing business in order to compete in a radically different – and ever-changing – world.

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.

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 want to create jobs, build wealth and provide sufficient resources to maintain the quality of life all Minnesotans have come to expect:

- **Reduce business tax burdens**
- **Improve the transparency of business taxation**
- **Promote investments in innovation, entrepreneurship and emerging/high-tech companies**
- **Pay for reform while aligning the tax system with consumption**

"Anytime is a good time to fix a bad policy. Business taxes are inefficient. Period."

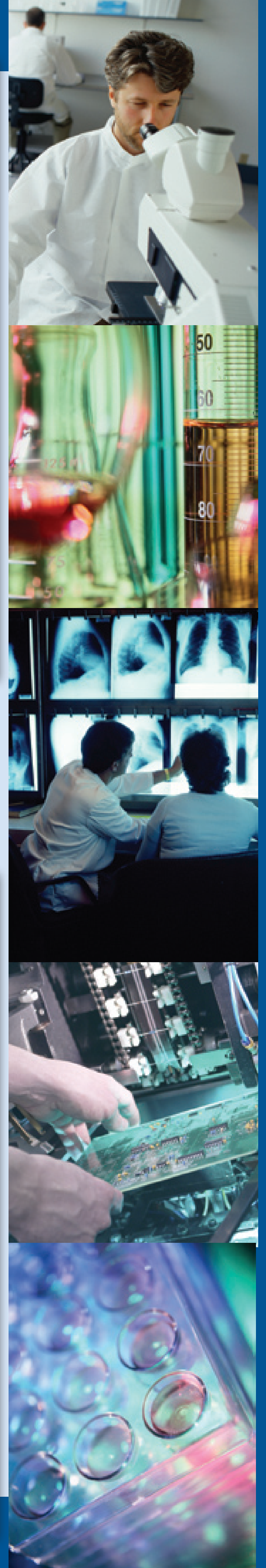
Art Rolnick,
Federal Reserve Bank of Minneapolis

Guiding Principles for Reform

The Commission began its work by establishing outcome-based guidelines for reform to guide its thinking and overall approach. 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 design and structure of Minnesota's business tax system should reduce the need for subsidies, exemptions and related business tax expenditures.
2. **Tied to the benefits received** – There should be a strong, direct correlation between the taxes paid by businesses and the costs incurred by government on their behalf.
3. **Friendly to economic growth** – Minnesota's business tax system should encourage savings, capital investment or capital formation.
4. **Inexpensive to administer** – 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.



The Governor's 21st Century
Tax Reform Commission

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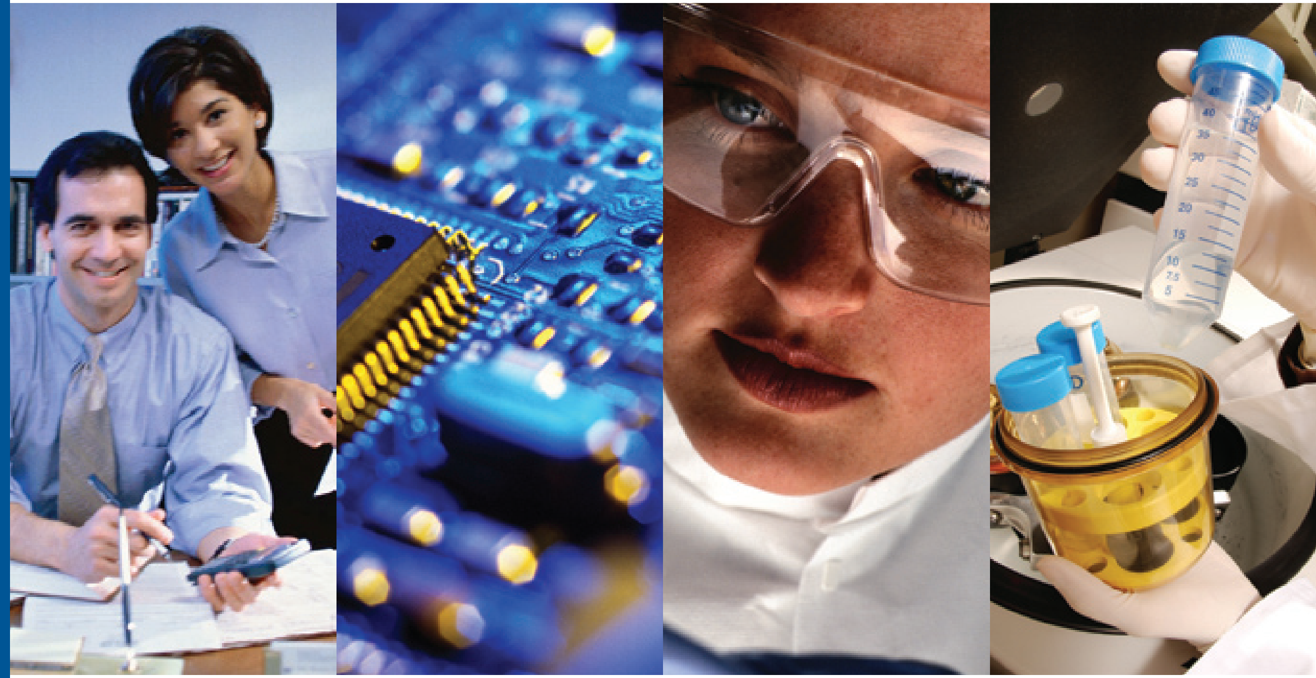
Minnesota's Millennium:

Launching a New Generation of Competitive Leadership and Economic Growth

2009 Report Summary

"The [Governor's 21st Tax Reform] 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."

Excerpt from Governor Tim Pawlenty's Executive Order, signed February 29, 2008.



The Governor's 21st Century
Tax Reform Commission

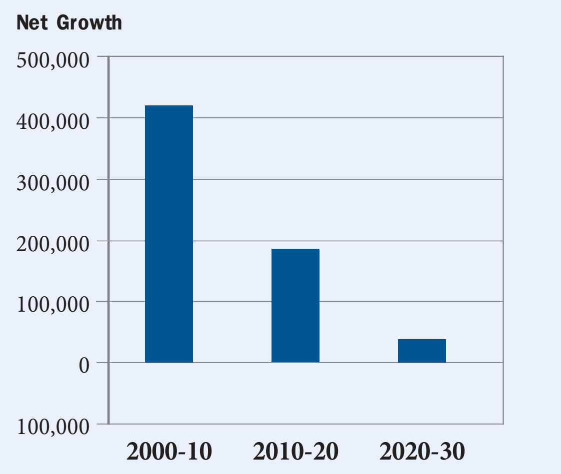
Shifting Landscape

Minnesota's approach to taxing businesses reflects a time dramatically different from today's fast-moving, technology-driven and global economy. 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** – The workforce in Minnesota, as in other states and nations, is rapidly aging. This 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 the rate of workforce expansion slows. Growth in a knowledge-based economy requires innovation and rapid adoption of new technologies.
- **Economic Decline** – Minnesota's once-enviable growth has fallen off in recent years. We now lag the U.S. average on key economic indicators.

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 seven other states.*

Labor Force Growth



Source: Minnesota State Demographer (projection revised 2007)

Reduce Business Tax Burdens

Lowering tax costs for businesses in Minnesota helps them create new jobs and grow our state's economy.

Repeal the state corporate income tax.

The corporate income tax represents the largest anti-competitive gap for any tax between Minnesota and overseas competitors. The Commission recommends its elimination for three reasons:

- *It's broken and can't be fixed* – In today's competitive environment, the corporate tax is riddled with credits, exclusions, deductions, exemptions and other opportunities to minimize tax liability.
- *It's highly volatile* – The corporate tax is the most unstable and unpredictable revenue source for state government.
- *It's expensive to administer and even more expensive to comply with* – The corporate tax is the most expensive to administer relative to revenue collected – but those costs are dwarfed by the compliance costs for businesses.

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

Entrepreneurship and small businesses are key drivers to job creation. Taxes are a strong factor when considering whether to retain or add employees.

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

Until the corporate income tax is completely eliminated, increasing state expensing limits to match Section 179 of the federal tax code helps help small businesses add to or upgrade their existing equipment.

Replace the capital equipment sales tax refund with an upfront exemption.

The current sales tax refund on equipment for manufacturing, mining or refining is a cumbersome process – and harmful to small businesses and startups concerned with cash-flow.

Extend the capital equipment exemption to businesses that provide services subject to sales tax.

Encouraging investment in capital equipment by Minnesota service companies is just as important as it is for manufacturers and other businesses that currently receive the sales tax exemption.

Improve the Transparency of Business Taxation

Our tax system is too complex, which makes it less visible to taxpayers, and difficult and expensive to administer.

Simplify the state property tax system.

- *Consolidate the property tax classification system* – Reduce the current 51 classes and tiers to 4 broad classes: agricultural, residential, low-value commercial/industrial and high-value C/I.
- *Eliminate Minnesota's high "advertised" property tax rates* – Property tax rates under Minnesota's unique "tax capacity" system are several times higher than other states – on paper – even when actual property tax burdens may be comparable.
- *Follow through with the scheduled repeal of Minnesota's Limited Market Value law* – Letting this law expire as scheduled after 2009 provides tax relief to most business properties, apartments and residential homesteads and better-aligns state property taxes with actual market values.

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

Greater transparency in how tax revenues are actually used is particularly important for business taxes – since those burdens are ultimately passed on to consumers and the economic rationale for taxing business is so dependent on benefits-received.

*Based on research by the Federal Reserve Bank of Chicago

**Based on combined statistics from the Federation of Tax Administrators and the Organisation for Economic Co-operation and Development

Promote Investments in Innovation, Entrepreneurship and Emerging/High-Tech Companies

While special deductions and tax incentives are generally inconsistent with good tax policy, we cannot ignore reality. Minnesota cannot "unilaterally disarm" from the current "arms race" among other states (and nations) seeking investment capital and job creation. We must promote a climate that is conducive to research and development activity and small business expansion.

Overhaul the R&D Tax Credit.

Increase the rate to 10%, extend it to pass-through businesses and make it refundable to encourage companies of all types and sizes to locate, continue or expand their research and development activities in Minnesota.

Enact the Small Business Investment Act.

Give Minnesota small businesses access to venture capital from a managed fund of up to $200 million in cash contributions from insurance companies, which receive a delayed 80% tax credit on their contributions.

Enact an Early-Stage Investment Tax Credit.

Provide a 30% tax credit to "angel investors" in early-stage companies with high growth potential, subject to a $15 million annual program cap.

Encourage low-income entrepreneurship and business creation loans.

Establish a Small Enterprise Loan Guarantee Program and expand the Family Assets for Independence in Minnesota initiative to provide more "gap financing" in geographic areas with high poverty and unemployment rates.

Pay for Reform While Aligning the Tax System with Consumption

Economists and tax policy experts universally agree that taxing consumption – rather than income or investment – promotes savings and investing.

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

Strengthen the consumption focus of Minnesota's tax system to reflect today's economy and to pay for other needed reforms.

Increase the cigarette excise tax.

Increase the excise tax on cigarettes to discourage smoking – especially among teenage children – and to help pay for other needed reforms.

University of Minnesota Research and Development

	Rank 1972	Rank 2004
Academic R&D per capita	20	40
Academic R&D per dollar of GSP	20	43

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).

Minnesota's combined state and federal statutory rate is the 3rd-highest corporate tax rate in the world.**

Some argue that statutory rates are meaningless because many businesses pay lower effective rates as a result of tax planning strategies, local incentives and the like.

However, 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.