Tax Expenditure Budget

FY 2022-2025

Tax Research Division
Minnesota Department of Revenue

Presentation to the Tax Expenditure Review Commission

July 14, 2022

The report will be posted to the Department of Revenue website at:
https://www.revenue.state.mn.us/tax-expenditure-reports

Legislative Mandate

18th Minnesota Tax Expenditure Budget

(Minn. Stat. 270c.11)

- First report delivered in 1985
- Now due November 1 of even-numbered years
- Major project—Includes estimates for 316 separate items across 15 taxes

Outline

- “Tax Expenditure” as a Concept
- Defining the Reference Tax Base
- Using the Tax Expenditure Budget
- Differences between the Tax Expenditure Budget and revenue estimates
- Looking Ahead

Tax Expenditures are statutory provisions which reduce the amount of revenue that otherwise would be generated by granting special and selective tax relief to a subset of taxpayers

"Tax Expenditure" as a Concept

- If the only goal were to raise revenue, then it would be best to have a broad income tax base & low rates.
- But state policy makers want to:
  - encourage home ownership → Mortgage Interest Deduction
  - help pay for child care → Child Care Credit
  - recognize/reward combat veterans → Combat Credit
  - increase business start-ups → Angel Investment Credit
  - help beginning farmers buy land &/or farm assets → Beginning Farmer Credit
- Could design a direct expenditure program to meet each of these goals.

Defining a Tax Expenditure

It’s a tax expenditure [in the TEB] only if:

1. Tax applies statewide
2. Provides preferential treatment
3. Has a revenue impact
4. Is not subject to an alternative tax
5. Is not counted as a direct expenditure
6. Legislature has authority to impose tax
7. It is included in the definition of the tax base

Defining the Reference Tax Base

Reference Tax Base is defined in chapter introductions

- Income Taxes: *Income from all sources less expenses that are reasonable & necessary to generate that income*
  - deduction allowed only for “true” depreciation
  - personal & dependent exemptions & standard deduction assumed part of basic tax structure
  - graduated rates & different tax brackets by filing status assumed part of basic tax structure
  - for corporate tax, equal-weight apportionment & throwback rule

Defining the Reference Tax Base

- Sales tax: *All final purchases of tangible goods or services.*
  - Business purchases of *capital equipment* are in the base
  - Not defined as a "consumption tax"
- Property tax: *Market value of real property*
  - Property tax base determines the distribution of taxes rather than the overall amount

Number of Tax Expenditures by Tax:

• **Individual Income Tax**	**104**
• Corporate Franchise Tax	32
• Estate Tax	6
• **General Sales & Use Tax**	**92**
• Motor Vehicle Sales Tax	18
• Excise Taxes (motor fuels, alcohol. tobacco)	16
• Mortgage & Deed Taxes	8
• Gambling Taxes	6
• Insurance Taxes	10
• Property Taxes	12
• Motor Vehicle Registration Tax	10
• Air-Flight Property & Registration Taxes	2
TOTAL	**316**

1.6 Home Mortgage Interest

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Legal Citation

Minnesota Statutes, Sections 290.0122, Subd. 2, 5 and 290.0132, Subd. 19(b)

Description of Current Law

A taxpayer may take an itemized deduction for interest paid on debt secured by a principal or second residence. Mortgage interest is deductible on up to $750,000 of debt used to buy or improve a principal or second residence. If the debt is used for any other purpose, the limitation is $100,000 of debt. If more than one home is involved, the limitations apply to the total amount. This deduction is one of several deductions subject to the limitation of itemized deductions for higher-income taxpayers.

History

Home mortgage interest was deductible without limitation until restrictions were enacted in 1987. In 2018, the federal limitation was temporarily decreased from $1 million to $750,000 in debt. In 2019, Minnesota established its own itemized deduction for home mortgage interest with a limit of $750,000.

Number Affected

An estimated 138,000 returns will claim this deduction in tax year 2021.

Dollar Impact

Fiscal Year	2022	2023	2024	2025
State General Fund	$78,400,000	$83,200,000	$91,800,000	$107,000,000

Using the Tax Expenditure Budget

TEB can give guidance on the impact of past policy choices.

Three Cautions:

1. Repeal of some tax expenditures would increase complexity
2. Repeal of some tax expenditures would cause compliance challenges
3. Some tax expenditures interact so can't add estimates together

Using the Tax Expenditure Budget

1) Repeal of some tax expenditures would significantly increase complexity.

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

Using the Tax Expenditure Budget

2) Repeal of some tax expenditures would create compliance problems.

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

Using the Tax Expenditure Budget

3) Interactions among Tax Expenditures

- Repealing multiple itemized deductions raises less than the sum of the estimates shown separately

Simple sum (items 1.63-1.68)	$258 mill.
Adjust for interactions:	-87 mill.
Tax expenditure for all combined:	$171 mill.

Tax Expenditure Estimates differ from Revenue Estimates

Unlike revenue estimates, tax expenditure estimates:

- Ignore interactions among provisions
- Ignore any impact on other taxes
  - Example: vehicle registration tax changes can have an impact on income tax collections
- Do not adjust for "effective dates"
  - Example: timing provisions like tax deferrals or phase-in of new policy
- Are updated only every two year

Looking Ahead

- Next report in November 2024, to facilitate consideration of tax expenditures as part of biennial budget process
- New content in next report:
  - Purpose statements as defined by TERC
  - Estimated rate change reduction if provision is repealed
  - Incidence analyses of ‘significant’ income and sales tax expenditures

QUESTIONS?

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