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Minnesota Income Tax Increase Modification Could Encourage Tax Avoidance and Promote Poor Investment Decisions

By

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Introduction

Minnesota is one of 46 states that begin their fiscal year on July 1. However, it is the only state that may endure a government shutdown, due to a tax policy impasse between Governor Mark Dayton (DFL) and the legislature.

In his two-year $36 billion general fund budget plan, Dayton proposed to create a new top marginal rate of 10.95% for those making over $85,000 in income, with a temporary three-year additional surcharge of 3% on income over $500,000 (see Table 1).[1] Those states that have adopted such "millionaires'" taxes[2] on high-income earners in recent years have mostly let them expire; only Minnesota at the present time is actively considering adopting such a tax.[3]

Table 1: Minnesota Individual Income Tax Rates for Single Filers Under Current Law and Dayton Proposal

Bracket	Current Rate	Proposed Rate in Governor Dayton's Plan
>$0	5.35%	5.35%
>$23,100	7.05%	7.05%
>$75,891		7.85%
>$85,000	7.85%	10.95%
>$500,000		13.95%

Source: Tax Foundation compilation of Minnesota Department of Management & Budget information.

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[1] *See* Minnesota Management and Budget, "Minnesota Biennial Budget FY 2012-2013: State Taxes and Local Aids and Credits, Governor's Budget," http://www.mmb.state.mn.us/doc/budget/narratives/gov11/tax-policy.pdf.

[2] In this case, a tax on half-millionaires.

[3] *See, e.g.*, Steven Sloan, "States Are Rejecting Millionaire Taxes," *Business Week* (Jun. 9, 2011), http://www.businessweek.com/magazine/content/11_25/b4233035888791.htm; Josh Barro, "Temporary Tax Increases Actually Proving Temporary," *National Review* (Jun. 13, 2011), http://www.nationalreview.com/agenda/269499/temporary-tax-increases-actually-proving-temporary-josh-barro; Joseph Henchman, "State Tax Changes During 2010," *Tax Foundation Special Report No. 188* (Jan. 2011), http://www.taxfoundation.org/research/show/26963.html.

Minnesota officials estimate that the new top bracket will raise $1.89 billion for the two-year budget for Fiscal Years 2012 and 2013, and affect 5.5 percent of filers (about 138,000 out of 2.5 million).[4] The temporary surcharge on income over $500,000 would raise an additional $918.4 million, and affect 0.8% of filers.[5]

Those two proposals make up a large proportion of his proposed $3.31 billion in additional revenue. Dayton has also proposed a new 1% state property tax on the value of residences over $1 million, and a law requiring corporations with no property or employees in Minnesota to pay Minnesota corporate income tax. The latter proposal would likely encounter strong constitutional challenges, and would be unlikely to raise any revenue.[6] Together, the package would likely impact most or all Minnesota taxpayers.

The legislature passed a $34 billion general fund budget that did not include Dayton's tax increases, but Dayton vetoed nine of the ten appropriations bills in May. Since then a stalemate has occurred, with Dayton insisting on a $36 billion level funded with tax increases.

Exempting Small Businesses from Income Tax Would Likely Be Unworkable

In an effort to overcome the strong opposition that has materialized against his February tax proposal, Dayton has begun floating other revenue-increasing ideas, such as sales tax broadening or modifying his income tax proposal.

At a press conference in late May, Dayton stated that he would consider exempting small businesses from the income tax increase.[7] This could be understood one of two ways:

- Exempting small business income from "pass-through entities" (LLC, LLP, or S-corporation income) from the proposed 10.95% and 13.95% income tax rates, resulting in small business income being taxed at the 7.85% rate
- Exempting a taxpayer from the 10.95% and 13.95% income tax rates if that taxpayer has any small business income from pass-through entities (LLC, LLP, or S-corporation income) at all.

Under the first proposal, any income derived from pass-through entities would be excluded. In the second proposal, all income, *from any source*, would be excluded if any is derived from pass-through income. Both would introduce additional compliance costs and create large incentives for tax avoidance, and as such they represent bad tax policy.

The first proposal would create the incentive to push all existing income into a pass-through entity, such as an LLC or S-corporation. This could easily result in entirely new sorts of tax avoidance strategies, such as neighbors banding together to form an earnings association, or employees developing a partnership for direct payment from customers. Aside from the considerable cost of such distortions in economic behavior, the cost of compliance might easily outweigh any potential increase in revenue.

The second proposal might have lower compliance costs than the first proposal but would introduce a much greater incentive for tax avoidance. This is because every taxpayer in the top bracket would have the incentive to claim income from a pass-through entity. For example, a household that makes $500,000 per year (approximately the average annual income of filers making more than $200,000) could purchase a $1,000 stake in a pass-through entity. This action would lower the household's tax liability from $45,353 (using the proposed four-marginal-rate system) to $37,603 (same assumption). In short, spending

[4] *See* Minnesota Management and Budget, "Minnesota Biennial Budget FY 2012-2013: State Taxes and Local Aids and Credits, Governor's Budget," http://www.mmb.state.mn.us/doc/budget/narratives/gov11/tax-policy.pdf, at 7-8.

[5] *See id.*

[6] *See* Joseph Henchman, "'Amazon Tax' Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems," *Tax Foundation Special Report No. 176* (Mar. 2010), http://www.taxfoundation.org/research/show/25949.html.

[7] *See* Dave Mindeman, "Exempt Small Business: Game-Set-Match, Dayton!," *Progressive Political Blog* (May 27, 2011), http://www.mnpact.org/sblog/blog.php?id=2835.

$1,000 would reduce the household's taxes by $7,750. The tax avoidance that would result from this proposal would probably lead to no additional revenue being collected from the tax increase.

Either proposal would also risk promoting poor investment decisions in addition to creating incentives for tax shelters. With many taxpayers eager to put small amounts of money into small LLCs, LLPs, and S-corporations, entirely for tax reasons, the end result could be a "bubble" in pass-through entity investment without investor oversight.

Conclusion

While the Minnesota legislature is resistant to increasing taxes, Governor Dayton is insistent. His proposed new high-earner individual income tax rates flow against recent trends in other states, and his suggested exclusion of small business income would be difficult to implement, encourage tax avoidance, and risk promoting poor investment decisions.

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