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Minnesota, It's Your Turn Now

The future of Minnesota's individual income tax will be front and center in the 2018 legislative session. A look at a few of the issues lawmakers will be grappling with.

Passage of the Tax Cuts and Jobs Act (TCJA) in December accomplished many things besides restructuring federal taxation. It proved that politicians' outrage over abuses of the legislative process have the half-life of carbon-10 once they gain majority status.[1] It breathed new life into the debate about the federal debt. And it moved the phrase "federal conformity" from the insular world of tax wonks onto the front pages of newspapers around the country.

Minnesota is certainly not alone in having to chart a response in 2018. But for both substantive and political reasons, the state faces one of the more complex tax policy development challenges to be found anywhere in the nation. We take a closer look at three high profile topics pertaining to individual income taxation that will be central to the debate about Minnesota's response over the coming months.

Just How Big an Issue is SALT Deductibility for Minnesota?

The three big individual itemized deductions targeted as potential "pay-fors" of federal reform were charitable contributions, mortgage interest payments, and state/local tax payments, or "SALT". The first two, as one tax expert colorfully stated, "are protected by an impenetrable brick wall of raw political power and moral rectitude."[2] That left SALT – more politically vulnerable in part because its benefits are disproportionately skewed toward so-called "blue states" with higher state and local taxes – like Minnesota.

According to the latest IRS *Statistics of Income* data, a little over one in three income tax filers (about 950,000 Minnesota households) claimed the deduction for state and local taxes on their 2015 federal tax returns, with an average deduction of $12,954. The provision is relatively important to Minnesotans – in 2015 the total SALT deduction was equal to 6.3% of total adjusted gross income, 10th highest in the nation. Yet filers in other states have been much bigger beneficiaries of this policy. For some perspective, in 2015 the average claimant's SALT deduction in California, Connecticut, and New York was 42%, 52%, and 71% higher than Minnesota's respectively. It's not surprising that some of the biggest pushback from congressional Republicans on early versions of the reform came from these states.

Preliminary modeling done by the Tax Policy Center and others on the elimination of SALT deductibility – in isolation – projected sizeable tax increases for a lot of Minnesota households. But the final TCJA had many moving parts including a significant increase in the standard deduction, which reduces the number of filers choosing to itemize their deductions. That alone renders the SALT issue moot for what is likely to be a substantial number of "former itemizers". The new federal rate structure further offsets potential tax increases, and the final negotiated $10,000 cap on SALT deductibility takes some of the sting for any households that will continue to itemize. And for households with children, the increase in the child tax credit ($400 refundable; $1,000 nonrefundable) also helped address any increases in tax burdens.

Put it all together, and it explains why our earlier modeling concluded an "average Minnesota filer" across all filing types and income levels was likely to see some level of federal income tax relief.[3] Some households will undoubtedly experience higher 2018 burdens but it's difficult to envision a critical mass of taxpayers heading to voting booths armed with torches and pitchforks because of the new limitations on their state and local tax deductions. Indeed, as taxpayers check their 2018 paycheck stubs, popularity for the tax bill has grown.[4]

The primary impacts of the SALT deduction changes are longer term in nature affecting state and local government finance and state competitiveness. Simply put the TCJA generally – and the SALT limitations specifically – accentuates state income tax and effective tax rate differentials.

To illustrate, consider the accompanying table comparing total federal and state individual income tax burdens for a Minnesota filer with those for a similar filer in four states without an income tax. We chose to

1 We'll save you the googling: 20 seconds

2 "Economic Analysis: Repeal of SALT Deduction – Politics over Policy," Martin Sullivan State Tax Notes July 17, 2017

3 "Impacts of the TCJA on Minnesota Individual Income Filers, MCFE, January 2018

4 "Poll Finds Upturn in Sentiment on Tax Overhaul and Economy", New York Times, January 16, 2018

Minnesota Center for Fiscal Excellence

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Aaron Twait, *Research Director*
Mark Haveman, *Executive Director*
Linda Edstrom, *Executive Secretary*

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Fiscal Focus
c/o Minnesota Center for Fiscal Excellence
85 East Seventh Place, Suite 250
St. Paul, Minnesota 55101

Phone: (651) 224-7477 or (800) 322-8297
Fax: (651) 224-1209

E-mail: question@fiscalexcellence.org
Web Site: www.fiscalexcellence.org

model a high income married joint filer to capture "senior executive talent" – the type of taxpayer (and payrolls) Minnesota would obviously like to see more of.

The left-most set of numbers (actual) reflects the status quo and shows that total individual income tax collections (federal and state) are $12,000 - $13,000 higher in Minnesota than in states without an income tax. The middle set of numbers assumes Minnesota fully conforms to the TCJA with no changes in rates or brackets to offset the higher income base. The total income tax burden for this Minnesota filer declines, but savings at the federal level are offset by higher state taxes. The net impact is $4,000 of tax relief compared to $6,000 in the rest of the states with no state income tax offset. As a result, Minnesota's comparative income tax disadvantage increases by about one-third (12 to 13 percentage points).

The right-most numbers now assume that Minnesota lawmakers are able to hold this filer completely harmless from any state income tax increase as a result of the TCJA. As the results show, that hold harmless provision only slightly mitigates the growth in Minnesota's comparative disadvantage. That's because the larger TCJA-related federal tax savings – which affects all filers across the country – makes the existence of Minnesota's current state income tax more economically relevant.

Of course, comparisons to states with no income taxes represent an extreme; relative impacts compared to states with an individual income tax would be more muted. And to what extent an approximately $1,200 increase in Minnesota's already existing "comparative disadvantage" would have real world consequences with respect to residency and job-siting decisions is debatable – especially in an overall net income tax cut environment. But this example illustrates why state income tax policy responses to the TCJA do entail risk.

It's a risk that seems to be recognized by the Dayton administration. Its criticism of SALT limitations was couched as concern over the welfare of Minnesota taxpayers. However, it almost assuredly reflected the recognition that the tax prices of Minnesota government really do matter and that the biggest impact of the reduction of federal subsidies via SALT limitations will be to make these tax prices become much more noticeable among high earners, the state's recent "go to" source for revenue. It will be interesting to see if tax influenced residence decisions, migration, and competitiveness concerns gain more attention this year or if confidence in the superior value proposition Minnesota's public goods and services offer remains as unshakable as ever.

If the state is going to violate core tax principles of neutrality and equity, we should at least do it intelligently.

To FAGI or Not to FAGI?

One of the immediate issues facing lawmakers this year concerns the starting point for determining Minnesota taxable income. When Minnesota adopted federal taxable income (FTI) as its starting point 30 years ago it did so out of ease of compliance for taxpayers and tax administrators. Today, because of the TCJA's overhaul of the standard deduction, itemized deductions, and exemptions, the merits of continuing to use FTI deserve to be called into question.

The chief advantage of retaining FTI as the starting point for determining Minnesota taxable income continues to be the administrative and compliance benefits it offers. The primary concern with the changes – that FTI no longer provides any sensitivity to family size – does not automatically disqualify its continued use. Minnesota could address the issue by creating its own dependent exemption, deduction, or credit. However, the revenues raised from federal base expansions are insufficient to offset the state's cost of conforming to the higher standard deduction and replacing the dependent exemptions making revenue neutral conformity impossible without tapping business tax base expansions as a source of revenue. Plus, family size adjustment is just one of several tweaks to FTI lawmakers may deem important in responding to federal reform. At some point it simply makes more sense to build the house you want to live in than go through the trouble and hassle of retrofitting an existing one to fit your needs.

The most common alternative starting point is federal adjusted gross income (FAGI), which is used by 31 of the 41 states (including the District of Columbia) with a broad-based income tax. The primary benefit of returning to FAGI as a starting point is that it would enable Minnesota to develop its own desired package of standard deductions, itemized deductions and family size adjustments. Tax experts, however, have identified several other good tax policy reasons why a transition back to FAGI has considerable merit:

- A state standard deduction offers the opportunity to rationalize or eliminate income subtractions in the state tax code which have proliferated in past Minnesota legislative sessions.

Total Federal and State Income Tax Burdens – Minnesota and Selected States, $250,000 Married-Joint Filer, Actual and Alternate Scenarios*

State	Actual			With Full TCJA Conformity			With TCJA, No Change in State Taxes		
	Total Tax	MN vs State		Total Tax	MN vs State		Total Tax	MN vs State	
		$	%		$	%		$	%
Minnesota	$52,169	NA	NA	$48,170	NA	NA	$47,224	NA	NA
Florida	$38,989	$13,180	34%	$32,887	$15,283	46%	$32,887	$14,337	44%
South Dakota	$40,324	$11,845	29%	$33,951	$14,219	42%	$33,951	$13,273	39%
Texas	$39,489	$12,680	32%	$33,347	$14,823	44%	$33,347	$13,877	42%
Washington	$39,448	$12,721	32%	$33,322	$14,848	45%	$33,322	$13,902	42%

*Calculations based on taxpayer profiles from tax year 2014 – most recent data available

- It offers an avenue for rationalizing charitable contribution rules, which currently provide different incentives based on the income tax brackets taxpayers find themselves in. Replacing itemized deductions and the non-itemizer subtraction with a well designed credit would advance the cause of tax fairness.

- Adopting a Minnesota-specific standard deduction and itemized deduction rules would avoid future budget balancing turmoil resulting from the expiration of the federal changes at the end of 2025. Since MMB forecasts are based on current law, it will have to build that expiration into its revenue projections. Having our own permanent standard and itemized deduction rules would eliminate the uncertainty surrounding this future expiration and the headaches accompanying the nature and timing of federal extender bills which will almost certainly be a distinguishing feature of the 2026 tax system.

The primary disadvantage of this change is that it would ***require*** the state to develop an agreed-upon package of standard deductions, itemized deductions and family size adjustments in a short session, in an election year, in an environment where bad blood and distrust have been defining features of the policymaking landscape. Under normal circumstances delivering on this agenda would be a challenging task; under current legislative dynamics it appears herculean.

The 20% Pass Through Deduction

In a sea of base expansions, the TCJA's 20% deduction for owners of certain pass through businesses stands out as a major contraction of the income tax base. Aside from being one of the strangest forms of industrial policy favoritism the federal government has ever cooked up, the state price tag for full conformity (preliminarily estimated at about $1 billion over four years) makes it difficult to adopt these provisions and pursue income tax rate reductions in response to tax base expansions. Then there are the considerable administrative issues and incentives surrounding its implementation. Or as Deputy Assistant Treasury Secretary Dana Trier bluntly commented at a recent meeting of the American Bar Association "this is going to be a feast for tax planning."

For these and many other reasons the provision scores poorly on the general principles of good tax policy. But could conforming to this tax provision make Minnesota a more attractive location for business investment or increased business activity? If the state is going to violate core tax principles of neutrality and equity, we should at least do it intelligently in a way that yields economic returns. A new publication from Minnesota House Research (*Evaluating How to Cut Business Taxes*) provides a framework for us to judge how well or poorly this provision would accomplish this task (see accompanying table).

House Research's Competitiveness Factor	20% Pass Through Provision
Provide the benefit to mobile firms and not location-bound ones tied to local customers or suppliers	Does not distinguish as such but is likely more targeted than general reduction in individual income tax rates.
Provide the benefit to new versus old capital –firms that are increasing their capital investment and business activity	The exemption applies equally to capital already in place and new investment
Provide the benefit to "high value added" businesses — those that pay more in taxes than they receive in benefits	Not targeted to businesses with high profits or highly paid employees
Provide the benefit to company investments that are durable and enduring	Not tied to capital or any other durable investments but applies to income from general business activities
Reduce negative headline features - high "advertised" tax rates	Does nothing to change the most visible feature of the income tax – the tax rate – but rather makes that objective more difficult to achieve

The fundamental problem behind this idea is that it's practically impossible to meaningfully distinguish between wage income and business income. As author and tax scholar Daniel Shaviro notes, "Business income IS wage income insofar as it reflects the labor of the business owner. Anything else that we want the owner to do, such as reinvesting or whatever, can be addressed via rules aimed at that particular activity." [5] That would include conforming to the federal treatment of capital investment expensing, which would be a much better use of any dollars made available for reducing business tax burdens since such investments are linked to the long-term economic interests of the state.

Inaction is not an option

These three issues are a sample of the topics the tax committees will be discussing this year. Our accompanying article in this issue highlights the extraordinary fiscal and legal complexity associated with how to respond to the TCJA's changes to the corporate income tax regime. If one contextual issue is working in our favor, it is that our decisions will likely not be made under the overhang of a budget deficit. That's a luxury not afforded to about half the states.

As the 2018 session approaches, there is really only one option that should be completely off the table – doing nothing. The administrative implications for taxpayers and the state of continuing to operate off the old tax code are too great to ignore. Even though the current political environment is ripe for having discussions about how to respond to the TCJA infected with all manner of partisan politics, it's imperative that lawmakers find a path forward. ■

[5] "There is No Reason Why" Daniel Shaviro blog *Start Making Sense*, December 9, 2017

How Sweeping Federal Tax Reform May Create Benefits (and Headaches) for Minnesota Businesses

Guest contributors Christopher Martin, Senior Manager and Sarah Durst, Senior Associate of Grant Thornton's Minneapolis SALT practice examine the extraordinarily complicated issues surrounding Minnesota's response to federal corporate income tax reform and offer "dos and don'ts" for lawmakers to consider.[6]

Minnesota has just finished hosting the biggest, most exciting sporting event in the world. Not only did Super Bowl LII have an economic impact, it likely changed some perceptions that existed about the state. Now an even more important event

[6] The authors wish to recognize and offer special thanks to Dale Busacker for lending his insights and expertise to make this article possible.

Christopher Martin
Senior Manager
Grant Thornton

Sarah Durst
Senior Associate
Grant Thornton

concerning the state's future will be taking place in St. Paul this spring. And the outcome of this event, much more than the Super Bowl, will impact both Minnesota's economy and perceptions about our state's business climate.

On December 22, 2017, the President signed H.R. 1, commonly known as the "Tax Cuts and Jobs Act of 2017" ("Act"), into law, creating significant changes to federal tax provisions affecting C corporations, pass-through entities ("PTEs"), and individuals. Minnesota does not conform yet to the changes in the Act.[7] Absent federal tax reform, Minnesota's 2018 tax legislation likely would have been minor or nonexistent. But with federal tax reform now in place, legislators and the Governor have a unique opportunity to decide how to position Minnesota's tax system for the next generation.

This change would drop Minnesota's rate to 18th highest in the country, well below California's 8.84% tax rate and comparable to neighboring Wisconsin's 7.9% rate.

In our short-circuited pursuit of a homefield Super Bowl, Minnesota experienced a "miracle" with the Vikings' exciting come-from-ahead-then-from-behind playoff victory. Can we come up with another "miracle" by reforming the state's tax system to take into account the new environment that businesses, employees, and shareholders will face as a result of federal tax reform? Let's examine how federal tax reform will ultimately affect Minnesota's C-corporations, and what the Legislature might do in response, with the goal of a more cohesive, comprehensive, fair, and less-complicated corporate income tax system. Because the corporate provisions should be viewed in their entirety, due to the interplay among the modifications, we have included considerations after each change to indicate which issues state legislators should keep in mind.

Corporate Tax Rates

Under the Act, the federal corporate income tax rate will be reduced permanently to 21% for tax years beginning after December 31, 2017.[8] Minnesota's current tax rate is nearly half of the new federal corporate income tax rate. At 9.8%,[9] Minnesota has one of the highest state corporate income tax rates in the United States,[10] bested only by Iowa (12%)[11] and Pennsylvania (9.99%).[12]

As Minnesota's corporate rate is one of the highest in the nation, Minnesota taxes could have a more significant impact on the decision to do business or expand in the state as state taxes become a larger portion of a business's effective tax rate due to a smaller federal deduction for state taxes paid. As evidenced by the recent news of hundreds of companies (including several based in Minnesota) announcing expansions in the U.S., giving bonuses and raises to its hourly and salaried employees, and bringing dollars back from overseas--business leaders do take taxes into account when making decisions.

While Minnesota's statutory rate is high, the amount of revenue the corporate income tax generates is relatively small compared to sales tax and individual income tax collections. According to the November 2017 budget forecast by Minnesota Management and Budget, corporate income taxes will bring in only 5.5% of the state's revenues over the next biennium.[13] In comparison, the sales and use tax will bring in over four times as much revenue. Individual income taxes will bring in nearly 10 times as much revenue. Yet how Minnesota will conform to the federal corporate income tax changes will no doubt consume a great deal of the Legislature's time this spring, just as it consumes the resources of corporate tax departments, lawyers, accountants, lobbyists, Minnesota Department of Revenue ("Department") auditors, etc. to prepare, audit and defend returns filed – all resources that could be better deployed elsewhere.

One need not go as far as the 2009 Governor's Commission on Tax Reform's recommendation to abolish the corporate income tax, but given that a central theme in the recent federal tax reform was a dramatic reduction in the federal tax rate for corporations, a significant complementary reduction in the Minnesota corporate tax rate by the Legislature could serve to improve the attractiveness of the state's business environment without hampering the overall budget. For example, the Department estimates decreasing Minnesota's corporate tax rate by 2% would reduce revenue by approximately $212 million per year, a small amount relative to the overall budget, but which could be offset by revenue increases from other changes.[14] This change would drop Minnesota's rate to 18th highest in the country, well below California's 8.84% tax rate and comparable to neighboring Wisconsin's 7.9% rate. At the same time, the imposition of a graduated corporate tax rate, similar to the individual rate, could be considered as a means to give smaller C corporations a break at their lower income levels. The level of the corporate tax rate is an important issue and will be discussed throughout this article as

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7 Minnesota has adopted static conformity, meaning the state conforms to the Internal Revenue Code as of a specific date under MINN. STAT. § 290.01, subd. 19(3) & subd. 31. Minnesota statutes currently conform to the IRC as of December 16, 2016. Id.

8 H.R. 1, Title I, Subtitle C, Part 1, § 13001.

9 MINN. STAT. § 290.06, subd. 1.

10 Note: Minnesota imposes a Corporate Franchise Tax so that it can take advantage of a federal law and tax interest income from U.S. Treasury bonds. The Franchise Tax, however, is calculated similar to an income tax and will be referred to as an income tax throughout the article.

11 Iowa Code § 422.33.1.d. Note: Since Iowa allows a 50% federal taxes paid deduction, its effective corporate tax rate is historically closer to 10%.

12 72 Penn. Stat. § 7402(b).

13 Minnesota Management & Budget, *Budget & Economic Forecast*, page 5 (Nov. 2017), available at *https://mn.gov/mmb-stat/000/az/forecast/2017/november-forecast/complete.pdf*.

14 Minnesota Department of Revenue Tax Research Division, *Budget Options – Annual Impacts* (December 22, 2017).

the rate interacts with the various federal changes the Legislature must address.

Issue to Consider: Seriously contemplate lowering corporate tax rates, in line with the recent reduction in the federal corporate tax rate, as a means to make Minnesota's corporate tax system more competitive with other states.

Net Operating Loss Limitations

Net operating losses ("NOLs") allow a taxpayer to offset its federal taxable income using losses generated from future or previous tax years in order to smooth out the taxes paid. One of the provisions in the Act limits the use of NOLs to 80% of the taxpayer's taxable income, without regard to the deduction.[15] Previously, a taxpayer was only allowed to offset 90% of its income if it was subject to the corporate AMT. The new provisions also eliminate the federal carryback provisions, but do allow the NOLs to be carried forward indefinitely. While NOLs may be used up over time, they will never be able to completely offset taxable income in a particular year.[16]

Like many states, Minnesota's method of tracking and utilizing NOLs differs from federal law. Minnesota has not followed the federal treatment of generating NOLs on a consolidated group basis, but rather tracks NOLs on a separate company basis within the unitary combined group, allowing a 15-year carryforward period.[17] However, Minnesota does reference the federal NOL treatment of IRC § 172.[18] Assuming Minnesota adjusts its conformity date of the IRC to December 22, 2017, or later, there is the open question of whether that change automatically translates into Minnesota adopting the limitation changes that occurred in IRC § 172. If the state only conforms to the updated IRC, however, it appears the carryforward would remain at 15 years, which would be an unfortunate oversight. Care must be taken when updating Minnesota's NOL provisions that all consequences are considered.

The purpose of the NOL attribute (whether for federal or state) is to allow businesses to smooth out their income tax liabilities by allowing the use of losses generated in down years to offset income in profitable years without any arbitrary limitation. For example, after experiencing several years of big losses, perhaps due to a recession, limiting the NOL deduction would put businesses at a disadvantage by requiring them to pay tax on a larger portion of their income in the very first year they are profitable. Such an outcome could occur at the same time when businesses are coming out of a slump and want to reinvest in their equipment or workforce.

Two Issues to Consider: Whether to decouple from the treatment in the Act and determine that the state NOL should not be limited, to ensure that the purpose of the NOL attribute is retained. In the alternative, whether to limit the state NOL in line with the Act's unlimited carryforward, such a limitation should only be enacted in combination with other reforms considered in this article.

Dividends Received Deduction Equalized and Expanded

Prior to federal tax reform, the federal dividends received deduction ("DRD") was 80% for dividends from 20% or more owned corporations and 70% for dividends from less than 20% owned corporations.[19] These federal deductions have been lowered to 65% and 50% for domestic dividends, respectively.[20] Due to the fact that the corporate tax rate has decreased from 35% to 21%, the effective tax rate on dividends received remains relatively the same.

Minnesota currently follows DRD treatment as in effect prior to federal tax reform.[21] If Minnesota were to adopt the updated DRD percentages under federal tax reform (65%/50%), then the state should simultaneously reduce the corporate tax rate to match. Since DRD and NOLs are both used as subtractions to compute taxable income (but the DRD cannot be carried forward), the Legislature should clarify that taxpayers can choose to use a DRD first to reduce taxable income in order to preserve NOLs to be used in future years. It should be noted that the Department's preliminary fiscal estimates for the impact of the Act do not reference the DRD percentage changes, presumably because Minnesota has a law specifying its own DRD percentage and because the reduced federal percentages were indeed linked to the lower federal tax rate.[22]

In addition, the federal regime now allows a 100% DRD of foreign earnings that are brought back to the U.S. beginning in 2018. Assuming Minnesota remains a water's-edge state that would exempt foreign income from state taxation, the potential taxation of 20% of the foreign earnings returned to the U.S. as a dividend seems inconsistent.

Issues to Consider: Seriously contemplate matching any corporate tax rate decrease with a DRD reduction. Additionally, Minnesota taxpayers may be better served if the Legislature waits for federal guidance on these international changes rather than beginning to tax foreign income for state purposes that is no longer being taxed federally.

Alternative Minimum Tax Repealed

The Act repealed the federal corporate Alternative Minimum Tax ("AMT"), a regime historically designed to require corporations to pay a minimum amount of tax on its income. Although the federal AMT ceases to exist, taxpayers may continue to use AMT credit carryovers, and may provide for certain AMT credits to be refundable.

Minnesota is one of just seven states that applies an AMT on corporations.[26] Minnesota's AMT requires corporations that meet certain requirements[27] to compute its tax under AMT using a broader tax base while applying a lower tax rate.[28] To the extent this AMT exceeds the tax calculated using

[15] H.R. 1, Title I, Subtitle C, Part 1 § 13302(a)-(b).

[16] For NOLs generated prior to January 1, 2018, NOLs will be able to be utilized at its full 100%, so taxpayers will be required to track losses generated before and after this date.

[17] MINN. STAT. § 290.095.

[18] Id.

[19] IRC § 243(a).

[20] H.R. 1, Title I, Subtitle C § 13002(a)(2).

[21] MINN. STAT. § 290.21, subd. 4.

[22] Minnesota Department of Revenue, *Tax Research Division, Federal Update: The Tax Cuts and Jobs Act of 2017 As Enacted* (Jan. 8, 2018), available at *http://www.revenue.state.mn.us/research_stats/Documents/Federal%20Update%20Tax%20Cuts%20and%20Jobs%20Act%202017_5.pdf*.

[23] H.R. 1, Title I, Subtitle D, Part I, Subpart A § 14101.

[24] H.R. 1, Title I, Subtitle B § 12001.

[25] H.R. 1, Title I, Subtitle B § 12002.

[26] MINN. STAT. § 290.0921; see also, ALASKA STAT. § 43.20.021(f); CAL. REV. & TAX CODE § 23455(d); FLA. STAT. § 220.11(3); IOWA CODE § 422.33(4); ME. REV. STAT. ANN. tit. 36, § 5203-C; N.J. STAT. ANN. § 54:10A-5a.

[27] MINN. STAT. § 290.0921, subd. 3a.

[28] MINN. STAT. § 290.0921, subd. 3.

the standard method, the corporation must pay the additional amount.

Minnesota's AMT calculation would not necessarily be impacted by the repeal of the federal AMT. Currently corporations must determine their state AMT filing requirement, regardless of whether they are subject to the federal AMT.[29] However, various adjustments, such as tax-exempt interest income, depletion, adjusted current earnings, and certain dividends, used in calculating federal AMT are also utilized in calculating Minnesota AMT.[30]

With the federal repeal of AMT and the various federal modifications located throughout the IRC, the Minnesota AMT calculation will likely be more complicated, confusing and burdensome (Is that even possible?) to taxpayers, if it remains. Practitioners are currently required to prepare additional forms calculating AMT, AMT credits, and AMT NOLs, which also requires additional time and resources for the Department to audit.

Issues to Consider: Seriously consider repealing the corporate AMT with allowance of a carryover of credits or refunds to taxpayers in order to reduce complexity, and particularly if NOL usage is limited.

Full Business Expensing & Limit on Interest Expense Deductibility

The Act provides an increase in business expensing, typically called bonus depreciation, and Sec. 179 expensing, allowing corporations to depreciate 100% of the cost of used or new property placed into service after September 27, 2017.[31]

With respect to bonus depreciation, Minnesota has not conformed to the federal treatment, and requires corporate taxpayers to add back 80% of the bonus depreciation, but then allows the deduction over a five-year period.[32] Fully conforming to these provisions for both pass-through entities and corporations would reduce state revenues by approximately $560 million during the FY18-19 biennium.[33] For many businesses, the disparate treatment at the state level simply creates a timing difference for the deduction and may not be material. For other businesses, the time value of money of being able to deduct the full cost of property placed in service in the first year versus over six years is a very real concern.

The Act also disallows any deduction of business interest expense in excess of 30% of adjusted taxable income with certain exceptions.[34] The restriction on interest expense is intended to be a complementary provision to the adoption of full expensing. Congress wanted to encourage companies to invest in their operations but also to limit their ability to deduct both the cost of the property and interest expense on debt borrowed to purchase the property. Since these provisions are linked, if Minnesota chooses to continue to decouple from bonus depreciation, then the prudent thing would be to decouple from the interest expense limitation as well. Because Minnesota requires a balanced budget, lawmakers often partially conform to federal changes in order to bring in the requisite tax revenue or decrease tax expenditures. However, in this case, a hybrid approach of requiring a lower addback percentage for bonus depreciation but allowing a higher interest expense limit for Minnesota purposes would add complexity to the tax system.

Conforming to the federal limitation on interest expense deduction would also be difficult because of the uncertainties involved when the federal consolidated group and the Minnesota combined unitary group composition differ. At the federal level, the taxpayer is the entire consolidated group. If a member of the federal group were to have substantial interest expense or substantial interest income, but not be included in the Minnesota return, this would raise an additional calculation and complexity to determine what, if any, interest expense limit would be shown on the Minnesota return.

Two issues to consider: The provisions of full expensing and interest expense limitation should be viewed in tandem. Consider whether Minnesota's policy of decoupling from bonus depreciation should be continued, in which case the restrictions on interest expense deductibility should not be adopted either. Alternatively, consider whether to adopt full bonus depreciation expensing, in which case the limitations on interest expense deductibility could be considered, along with guidance on how such limitations would apply to a Minnesota combined unitary group.

International Provisions

Corporations that have foreign income and/or operations will likely see significant changes to their taxes as part of federal tax reform. To make things more difficult for businesses, states will likely differ on their treatment of the federal provisions creating a complicated, new subset of corporate tax.

Tax on Deemed Repatriation of Foreign Earnings ("Transition Tax")

One of the biggest impacts for businesses with foreign income will be from taxation of deemed repatriation of foreign earnings and profit ("E&P") as the U.S. moves to a quasi-territorial system of taxation. If a U.S. shareholder owns at least 10% of a foreign corporation, the U.S. taxpayer is now required to recognize its share of accumulated deferred foreign E&P as Subpart F income to be taxed.[35] This deemed repatriation takes effect for the 2017 tax year. However, the corporation can elect to pay the federal tax due as a result of the deemed repatriation over an eight-year period.

Should Minnesota choose to tax a portion of this foreign income, several issues arise. If the foreign income is taxed, one could argue that apportionment relief should be given, in the form of foreign sales added to the sales factor denominator. Another question is whether the foreign business that generated the repatriated income (potentially many years ago) is unitary, or integrated, with the domestic combined group filing in Minnesota. If the foreign activity is not integrated, then the income may be excluded as nonbusiness income. For example, a construction company may hold Brazilian oil and gas investments that are managed separately and have no connection to their business activity in the U.S. Minnesota would be prohibited from taxing the income the Brazilian entity earned over time if it was not

29 *See generally*, MINN. STAT. § 290.0921.

30 *See*, MINN. STAT. § 290.0921, subd. 3 (adjusting Minnesota "alternative minimum taxable income" utilizing various provisions of IRC § 56, *Adjustments in computing alternative minimum taxable income*).

31 H.R. 1, Title I, Subtitle C, Part III, Subpart A § 13201, amending IRC § 168.

32 MINN. STAT. § 290.0132, subd. 14.

33 Minnesota Department of Revenue, Tax Research Division, *Federal Update: Full Conformity to Bonus Depreciation and Federal Update: Full Conformity to Section 179 Expensing, Tax Cuts and Jobs Act of 2017 As Enacted (Jan. 10, 2018).*

34 H.R. 1, Title I, Subtitle C, Part IV § 13301, amending IRC § 163(j).

35 H.R. 1, Title I, Subtitle D, Part I, Subpart A § 14103, amending IRC § 965.

integrated with domestic operations. Nonbusiness income issues are by nature fact-intensive exercises, convoluted for taxpayers to navigate and for the Department to audit. Given the dollars at stake, however, it may be material for companies to analyze these legal and constitutional issues.

Under the Act, repatriated earnings that are cash and cash equivalents are subject to a lower federal deduction to reach an effective tax rate of 15.5%, while earnings attributable to non-cash investments receive a higher deduction in order to be taxed at 8%. Minnesota's law currently does not provide for bifurcation of these liquid and illiquid earnings resulting in one tax rate being applied to both. Taxing liquid earnings (cash) and illiquid earnings (property, plant and equipment) at different rates would allow taxpayers to better plan cash flow in order to bring the earnings back to the U.S. in order to make the tax payments.

Another issue is timing. Companies will begin filing their 2017 tax returns this spring (and at the very least, pay the remainder of their 2017 estimated income taxes), likely before the Legislature has a chance to decide on a course of action. Even if companies extend their filings, this is an issue that cannot wait until next year. Even if the income is taxable, Minnesota still has not adopted the 8-year federal election in which to pay the tax. Without a statutory clarification, taxpayers may be stuck paying the full tax bill on their 2017 return.

Issue to Consider: Whether to adopt taxation of deemed repatriated foreign earnings at reduced rates and with nuanced changes keeping Minnesota's budget, tax structure, business environment, and taxpayers in mind.

GILTI and FDII

The Act created a new Code section (951A), which imposes a tax on global intangible low-taxed income ("GILTI") from a foreign subsidiary of a U.S. parent.[36] The purpose of this provision is to require businesses to pay a certain amount of tax on foreign income that cannot be avoided by placing intangible assets in countries where the company does not have significant investments in tangible property. A lower effective tax rate is achieved on GILTI income by allowing a 50% deduction after its calculation. It should be noted that GILTI is income included in the gross income calculation for federal tax purposes, regardless of whether the income is distributed as a dividend from the foreign subsidiary to the U.S. parent. However, there is tremendous uncertainty as to how GILTI would be treated by Minnesota (or any other state for that matter) for purposes of the corporate income tax base and sales factor. Such treatment could vary according to whether the amount is deemed to be Subpart F income, classified as a dividend, or eligible for a deduction as foreign source income or as a DRD.

Based on Minnesota's long-standing position that its taxation of corporations stops at the water's-edge of the U.S., serious reservations must be addressed before Minnesota were to wade off-shore and begin taxing foreign activity. Many of the same issues we addressed above are relevant here. Is the foreign activity that generated GILTI unitary with the Minnesota combined group?[37] If not, there may be serious constitutional and legal concerns with Minnesota taxing that income. Would sales of the foreign subsidiary be included in the Minnesota sales factor? Since GILTI is netted among income and loss entities in the federal consolidated group and calculated as a single amount, how would a company unravel and modify its calculation if one or more entities were not included in the Minnesota combined group? A larger federal deduction is allowed for GILTI, resulting in a lower effective rate than the standard 21% rate. If Minnesota were to tax GILTI, would it follow suit and apply a larger deduction to this foreign income?

The Act also creates a deduction for Foreign-Derived Intangible Income ("FDII") of domestic corporations.[38] (Don't worry, if you are feeling guilty for not understanding GILTI, FDII is about fifty percent less complicated.) FDII is income from the sale of property (including leasing and licensing) for foreign use or services provided to persons outside the U.S. The Act carves out FDII income, which would currently be taxed on federal and state returns, and allows U.S. corporations to take an additional deduction after net FDII, which is the excess of FDII less income computed from a "routine return" based on 10% of tangible assets. It is important to keep in mind that FDII is not foreign income, but domestic income derived from foreign sources and is already included in the tax base.

Similar to the current IC-DISC entity, which was retained as part of the Act, FDII focuses on export activities but covers broader incentives for U.S. corporations to retain intangible property domestically and to sell goods and services overseas. Currently Minnesota does not conform to the Sec. 199 Domestic Production Activities Deduction (DPAD) that was repealed under the Act or the IC-DISC provisions, but requires an addback of deductions from both provisions. Since the FDII deduction is not limited to a particular state, one may ask why Minnesota would want to encourage and incentivize a business from producing a good or service in California and selling it overseas. Because GILTI and FDII could be viewed as interconnected, maintaining consistent tax policy may result in Minnesota decoupling from both of these provisions, similar to how the state treated DPAD and IC-DISC's.

Another concern with Minnesota adopting GILTI and FDII provisions is that they are only available for C corporations at the federal level but not S corporations. If Minnesota were to tax this income and provide incentives, the Legislature must then decide whether S corporations should be treated differently and potentially put at a competitive disadvantage.

Adopting many of these complicated international business provisions would push Minnesota into a new realm of taxation.[39] Minnesota, like nearly 40 other states, has historically taxed companies on their domestic, water's-edge activity, understanding that difficulties abound when states begin taxing companies' foreign operations. There are several practical reasons few states choose to tax worldwide income. Before pushing to adopt a worldwide taxation regime, the Minnesota Department of Revenue should pause to ask whether its auditors are equipped to understand the foreign provisions, learn about each company's foreign operations, and then appropriately

[36] H.R. 1, Title I, Subtitle D, Subpart B, Chapter 1 § 14201, creating IRC § 951A.

[37] In other words, does the U.S. Constitution under its due process and commerce clause provisions allow Minnesota the power to tax this income?

[38] H.R. 1, Title I, Subtitle D, Subpart B, Chapter 1, § 14202, creating IRC § 250.

[39] It is important to note that the IRS and the Dept. of Treasury are still drafting regulations to provide guidance on the foreign provisions of the Act. This guidance may not be available later this spring when the Minnesota Legislature is in session, giving even more reason for Minnesota to move cautiously before adopting foreign provisions in total.

audit the companies' foreign books. This is a tall task and one that would likely require the Department to hire additional audit, appeals and technical resources that could take away from other pressing endeavors.

Issue to consider: Given the current lack of federal guidance, Minnesota should seriously consider decoupling from the GILTI and FDII regimes in order to preserve Minnesota's water's-edge tax system and to minimize compliance and audit burdens, until it is known how the federal treatment will impact Minnesota.

Conclusion

As the Minnesota Legislature, the Department, and the Governor work as a team to create the sweeping state tax changes that are needed to address federal reform, the burdens and benefits it places on businesses should not be forgotten. Several of the goals of federal tax reform were to increase investment in the U.S., encourage companies to purchase property, and return tax dollars to businesses to allow them to increase wages and their workforce, which businesses have pledged to do. It would be unfortunate if Minnesota sees federal tax reform solely as an opportunity to impose increased state taxes on businesses by conforming to federal changes without lowering rates and considering the interplay of the modifications in totality.[40] Instead, the Legislature has the opportunity to reduce the corporate tax rate, repeal corporate AMT, take into account the interplay between full expensing and interest expense limits, and carefully evaluate the impact of adopting foreign provisions. To accomplish all of this, St. Paul may need a miracle of its own, but if they can do it, it will be remembered as more beneficial to Minnesotans than any last-second touchdown or Super Bowl party. ■

[40] Note: There is a potential judicial decision on the horizon that could also result in higher state sales tax collections. If the Supreme Court were to overturn Quill Corp. v. North Dakota, 504 U.S. 298 (1992), and declare it constitutional for states to impose sales tax on companies lacking physical presence in their state, then it may provide an additional state revenue source. South Dakota v. Wayfair, Inc., 901 N.W.2d 754 (S.D. 2017), cert. granted, U.S. No. 17-494, Jan. 12, 2018, has been granted certiorari and will be heard by the U.S. Supreme Court this spring, with a decision expected relatively soon thereafter.

"Once More Unto the Breach, Dear Friends"

The political battle to get a signed pension bill has taken on the characteristics of a Shakespearean play.

In 2016, despite passing through both the House and Senate with only four "nay" votes, Governor Dayton vetoed the omnibus pension bill. Under the bill, retirees would have had their cost of living increases reduced. But school district officials were adamant they simply could not afford their portion of the shared sacrifice – the proposed contribution increases for FY 2017 – and insisted the state cover the cost with increased school aid. That commitment never materialized in the non-budget year. So contribution increases were not included for TRA which meant – out of "fairness" of course – contribution increases for any of the state plans had to be tabled for the time being. Even though everyone acknowledged employer and employee contribution increases would absolutely have to be part of the 2017 omnibus pension bill, retirees were upset at the perceived gross injustice of being a first mover, communicated that to the Governor, and down it went.

The TCJA is by far the best thing to have happened to public pensions in a very long time.

In 2017, state aid materialized for school districts (and others) in the Governor's budget, and, as expected, the omnibus pension bill provided for employer and employee contribution increases. However, the legislature handcuffed the pension bill to the very controversial local government preemption provisions creating a "take it or leave it" scenario. Unsurprisingly, the governor decided "taking" the preemption measures would be far more distasteful than "leaving" changes to the state's pension plans, which brought out the Governor's veto pen once again.

Now in 2018 pension stakeholders once again are gathering in Minnesota's Harfleur, otherwise known as Room 1150 of the Senate Office Building, girding themselves for yet another difficult push to get a pension bill enacted into law.

Time is Money: The Opportunity Costs of Delay

Market performance over the last year combined with the implications of the federal Tax Cuts and Jobs Act (TCJA) loom large over these legislative failures. On the progressive community's rogue list of biggest tax reform beneficiaries, one very prominent group never gets mentioned: public sector employees. Public pension stakeholders may not have wanted that tax reform, but likely deep down in places not talked about at parties, they admitted they needed that tax reform. In anticipation of the signing of the TCJA, companies announced over $70 billion in stock buybacks over just 10 days last December. Since January 1 companies have announced another $88.6 billion in stock buybacks – more than double the amount reported during the same period last year. Ironically, the fiscal irresponsibility of the federal government is proving to be a salve for the fiscal irresponsibility of state governments. The TCJA is by far the best thing to have happened to public pensions in a very long time.

According to the most recent data from the Federal Reserve, public defined benefit pension plans in the U.S. hold $4.16 trillion in assets heavily weighted toward equities and alternative investments like private equity and real estate – the type of investments necessary to try to get 8% per year in a 3.0% 30-year treasury environment. The asset mix for Minnesota's defined benefit plans is 80% public equity and alternatives representing $54.6 billion of its investment portfolio.[41] A typical blog headline we came across regarding the TCJA read, "Republicans Chose Corporate Shareholders Over Working Families." In the Venn diagram of public sector pensions, those circles are one and the same.

It's important to recognize the opportunity costs these vetoed bills represent. According to the Legislative Commission on Pensions and Retirement (LCPR), the veto of the haircut in retiree cost of living increases

[41] Minnesota State Board of Investment Comprehensive Performance Report, Quarter Ending December 31, 2017

cost $125 million just in FY 18 alone. There is also the opportunity cost of lost contribution increases which the LCPR pegs at $40 million for FY 2018. Using fiscal year-to-date S&P returns as a proxy, the lost earnings on that $165 million represents roughly $15-20 million in additional assets in just over 7 months. Add in the opportunity cost of the 2016 veto in which retained cost of living adjustments over a full year would have benefitted from SBI's 15.1% return in FY 2017 as well as current year to date returns and that $15-20 million increases substantially. Then compound all that over a decade at the state's expected investment return and the phrase "real money" applies.

Strong Markets and Weak Demographics

The latest actuarial valuation reports indicate Minnesota's public pension plans should have an additional $16 billion under management right now just to pay for retirement benefits that employees have already earned. That's based on the current market value of assets and assumes realizing annual investment returns of 8% (or 8.5% in the case of TRA) indefinitely. The good news is this number actually reflects about $4 billion of progress in reducing unfunded liabilities over the previous year thanks to the SBI's 15.1% return in FY 17. And so far FY 18 is looking to be another excellent year with the state's equity benchmark, the Russell 3000, up 12.5% since July 1 as of this writing.

But even if the bear hibernates indefinitely and markets continue to perform well, pension plans face a major headwind – the cash flow dynamics of these increasingly mature plans. In the FY 16-17 biennium the cash flow net of investment returns for the state's pension plans was a negative $4.5 billion. In other words, $4.5 billion more went out of these funds in the form of benefit payments, refunds and administrative expenses than came in through contributions and state aids. These net outflows are guaranteed to increase as the baby boomer retirements pick up in earnest and the number of retirees drawing a pension increases sharply relative to any increases in the public employment base. In Minnesota's underfunded plans, this capital drain means the assets that remain must work that much harder to make progress on achieving full funding.

These cash flow dynamics also make the inherent risks associated with our 80% asset allocation in more volatile equity and alternatives markets much greater. As the accompanying table shows, a quarter century ago these pension plans had 17% more money coming in than going out (again net of investment performance) allowing the state to weather the occasional bad market year without too much trouble. Today, with twice as much money going out than coming in, our margin for error with respect to experiencing a really bad year or chronically missing expected returns for several years is gone.

How Times Have Changed: Pension Cash Flow In Per Dollar of Cash Flow Outlay

	1991	2017
MSRS General	$1.17	$0.48
TRA	$1.17	$0.43
PERA General	$0.91	$0.61

Meaningful Reform Remains in Hibernation

To the considerable credit of the members that sit on the Commission, the frequency of LCPR hearings and the agenda content reflects the seriousness with which legislative members are taking this issue. Commission agendas have included presentations from a wide variety of public pension practitioners, managers, researchers, and scholars from around the country offering important insights into the current state of affairs and various types of sustainability pursuits.

But buoyed by very cooperative investment markets, pension plan leaders are feeling no need to deviate from the repair proposals offered last year (and for that matter many years before that). Even TRA, which has long pushed back on the idea, has enough confidence to sign off on reducing the assumed rate of return to 7.5% – albeit provided some other assumptions get tweaked like cutting the annual rate of projected wage inflation by over half (!) for the next ten years. Repair specifics depend on the plan, but elements generally include reducing retirement benefit increases, contribution increases occasionally accompanied by state aid, cost-saving tweaks specifically targeting early retirees and anybody who doesn't want to spend their entire career in government, and last – but certainly not least – yet another 30-year reset of the period to pay off existing pension debt.

There is a palpable sense of urgency among all stakeholders as they ready themselves for another assault on the complicated politics surrounding public pensions. Everyone agrees that something absolutely needs to be done this year. However that "something" is still rooted in ideas and strategies that expose taxpayers, pension beneficiaries, and future government services to unacceptable risks.

Or as the Bard would say:

> ***Commission members, public employees, retirees, government officials and their agents all,***
>
> ***Stand like greyhounds in the slips,***
>
> ***Straining upon the start. The game's afoot:***
>
> ***Follow your spirit, and upon this charge***
>
> ***Cry "God, please let this market melt-up continue for several more years."***

■

MINNESOTA CENTER for
Fiscal Excellence
85 East Seventh Place
Suite 250
St. Paul, MN 55101
(651) 224-7477

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