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Roads Out of Perdition

A look at Minnesota highway finance past and present – and the policy considerations surrounding different revenue options being proposed.

Minnesota's economy continues to kick behind and take names. Conventional wisdom says the $1 billion-plus surplus will increase when the February forecast rolls around and legislators assemble their budget targets. And because of "Extreme Makeover: The People's House" the Capitol itself is in shambles and not a particularly enjoyable place to be. In short, everything seems to be aligned nicely for an expeditious, low-drama end to this budget-focused legislative session. But if one had to pick something that could change the session vibe in a hurry, transportation finance – and especially funding for roads and bridges – would be the pony to bet on.

Everyone agrees that Minnesota's transportation infrastructure demands attention, but fault lines between the political parties are clearly evident regarding the "what" and "how." Senate DFLers have proposed a full-scale assault, with a plan to raise an estimated $6 billion for transportation investments over the next decade covering the full transportation spectrum. The proposal includes hikes in vehicle registration fees, establishes a new 6.5% wholesale tax on gasoline, and provides for $1.4 billion in bonding for transportation infrastructure. In addition, the plan calls for an increase in the metro area sales tax and a reallocation of the state vehicle lease tax to pay for transit improvements. Governor Dayton's plan sees that scope but raises the investment to $11 billion over 10 years. Republicans have countered with a proposal that is far more limited in both size and scope – $750 million over four years focusing exclusively on roads and bridges – with all revenues coming from existing special fund balances and general fund surpluses. The difference has already sparked frustration prompting the governor to remark, "This is not a beginning of a sensible conversation."

Then and Now

Both sides agree that roads and bridges deserve attention, so this issue will likely be a focal point for any transportation package that does come together. Table 1 uses Federal Highway Administration (FHWA) data to demonstrate how highway finance has evolved in Minnesota over time and how our experience compares to national trends.

Back in 1975 the "Big 3" – gas taxes, vehicle registration taxes/license fees, and federal government aid – contributed 90% of Minnesota's current revenue for highways. Our highway revenue structure largely reflected the nation as a whole – the difference being greater reliance on registration taxes offset our disdain for toll roads. Twenty years later, demands on a weakening federal highway aid system were already beginning to take their toll. (Note: while the federal government actually increased its gas tax from 4¢ to 18.4¢ during this period, only 6.5¢ of this increase originally went to highways. In 1997 this changed when Congress once again dedicated all federal gas tax revenues to the Highway Trust Fund.) However, state user fee increases during this period – most notably the 13¢ increase in the state's gas tax, from 7¢ to 20¢ per gallon – combined with growth in the user base helped keep the revenue share of the "Big 3" largely unchanged (93.6%).

Fast forward to today, and the landscape of highway finance has been altered substantially. The "Big 3" now represent only 73% of current highway receipts. Although Minnesota's reduced reliance on traditional user fees is part of a nationwide trend, our financing structure now looks even more different than other states. Minnesota has moved in

Table 1: Revenues Used by States for Highways – Share of Total Current Receipts (Excludes Bonding)

	MN 1975	US Avg. 1975	MN 1995	US Avg. 1995	MN 2012	US Avg. 2012
Motor Fuel Taxes	32.5%	33.3%	37.3%	37.7%	27.2%	23.7%
Vehicle and Motor Carrier Taxes	22.4%	17.1%	35.8%	18.4%	20.9%	15.9%
Tolls	0.0%	6.7%	0.0%	5.5%	0.0%	8.5%
Other State Taxes and Fees	0.0%	0.5%	0.0%	2.8%	17.0%	6.4%
General Fund Appropriations	4.2%	2.6%	0.3%	2.5%	0.0%	4.8%
Miscellaneous	5.4%	3.3%	4.4%	3.0%	3.1%	8.3%
Federal Transfers	34.9%	35.7%	20.5%	28.3%	25.0%	30.2%
Local Government Transfers	0.6%	0.7%	1.7%	1.8%	6.8%	2.2%
Total Current Receipts	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: "Table SF-1: "Revenues Used by States for Highways" *Highway Statistics Series*," various years. Federal Highway Administration. Calculations by MCFE

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the direction of using other state taxes and fees and greater local support, while nationally the trend has been toward tolls, miscellaneous revenues, and larger general fund appropriations.

The growth in local government contributions is worth noting. Based on the latest FHWA statistics Minnesota ranks near the top of the nation in payments from local governments used for highways, on both a total dollar basis (4th) and as share of total current revenues used for highways (5th). According to MnDOT those contributions include federal matching, local participation in state highway projects, and locally funded enhancements to projects. Interestingly, as Table 1 indicates, Minnesota's local government contribution for highways in 2012 (6.8% of all current receipts) is roughly equal to the local government contribution (2.2%) plus general fund contributions (4.8%) on a national basis. Given where local government dollars come from, it seems reasonable to conclude our property tax frustration is at least a little bit fueled by our aversion to tapping the state's general fund for roads and bridges.

One other aspect about the changing nature of road finance is worth noting: Minnesota's increasing reliance on debt. From 1995 to 2001, new bond issues for highways never exceeded 2.1% of total state receipts for highways. From 2002 to the Great Recession (2008), average original bond issues increased to 5.2% of total state highway receipts. The remarkably low interest rate environment since then further propelled the use of debt financing. In 2012, original bond issues equaled 13.4% of total state highway receipts.

As Table 1 illustrates, there are a lot of potential levers to pull to fund road and bridge infrastructure. Following is a closer look at the policy issues surrounding some of the available options.

Gas Taxes… Excise and Otherwise

A public finance rule of thumb is: if you can justify a user fee, you should use it. Of all government services, roads are prime targets for the continued use of user-based finance because of the exceptionally strong relationship between user payments and the benefits received.

Rumors of the gas tax's demise as a reliable transportation funding source are greatly exaggerated. It's certainly true that declines in driving by Americans and significantly improved vehicle fuel economy have had an impact on the gas tax's ability to fund transportation. According to the federal Energy Information Administration, the average car traveled about 10% less in 2012 than in the peak year of 2005. That's a rather remarkable change.

Over the same period, fuel economy has improved 5% with more to come based on vehicle turnover and promulgated efficiency standards, thus creating a double whammy. However, the growing impotence of the gas tax is also rooted in its inability to keep up with inflation in construction costs over the past two decades. (See accompanying story for a closer look at highway construction cost inflation.) That is a function of public resistance and resulting [lack of] political will, not something innate to the gas tax itself.

Others criticize the tax, and proposals to increase it, because of its regressive nature. It's well-documented that gas taxes are highly regressive when they are matched to income, consuming a larger fraction of income for lower income households. However, research has also shown that when comparing gas taxes to total household expenditures – which is arguably a better measure of household well-being – lower income households devote a smaller share of their budgets to gasoline than higher income households. Although households in the top 5% of total spending do spend less on gasoline as a share of household expenditures than those who are less well off, the share of household expenditures devoted to gasoline is much more uniform across the population, "making the gas tax appear far less regressive than conventional analysis suggests." [1]

But the most pertinent fact about the gas tax is likely this: a public opinion poll conducted last November found Minnesotans overwhelmingly opposed a gas tax increase by an attention-grabbing margin of 80% - 15%. Those are the types of numbers that drive legislative agendas – and can throw tax policy theory out the window in the process.

Undeterred, Senate DFLers and the Governor have both proposed an alternative to an excise tax increase: a 6.5% gross receipts tax on sales to gasoline retailers. On the surface, it looks only like a different way to raise the gas tax – while being less transparent about it. Concerns about transparency could become an issue in the long run, but news reporting on the proposal has made it clear that the adoption would be equivalent to a 16¢ per gallon tax increase based on current prices. Moreover, the Department of Revenue has made it equally clear that it expects that tax to be passed fully on to consumers through higher prices at the pump.

The policy argument behind this proposal is that a wholesale gas tax based on price is more likely than the current per-gallon gas tax to keep up with inflation – especially since a vote is required to make an inflationary adjustment in the excise rate. As the price of gasoline rises with time, so would wholesale tax revenues. The problem, as we have recently seen, is that oil is a volatile global commodity – and even with a floor on the tax amount this wholesale tax would be a much more volatile revenue stream than the current excise tax. Resulting wholesale gas prices may track general inflation; they also may be completely disconnected from it.

Moreover, when fuel prices rise significantly, the risks of consumer gouging are just as strong, if not greater, than the risks of having revenues fail to keep up with road costs – especially when a gross receipts tax does not replace the excise tax (as was recently done in Virginia and the District of Columbia) but is paired with it as the current proposal would do. This is why a Carnegie Endowment report on transportation finance concluded in a discussion of ad valorem taxation on fuels that some form of protection in the form of stabilizers or shock absorbers should be a critical part of any tax of this nature.

Ideally, the federal government would assume a leadership role on the gas tax and reduce the pressure on states to become potential regional outliers with their fuel prices. Whether the recent whispers of interest in Washington will turn into reality remains to be seen.

Vehicle Taxes and Fees

Tabs and registration taxes are the other major source of transportation user revenues in Minnesota. According to FHWA data, Minnesota depends heavily on such revenues in both absolute and relative

[1] James Poterba, "Is The Gasoline Tax Regressive" NBER Working Paper No. 3578, January 1991

terms. In 2012 Minnesota ranked 11th nationally in total revenues collected from these sources. When considering the share of total highway user fee revenue from these sources (43%), Minnesota is 16th highest in the nation.

If the concept of strong dependence on user fees for road finance is still appealing to policymakers, but consumption trends and perhaps equity concerns give pause, this source is an obvious place to turn. Such is likely the thinking behind HF 324, a proposal to impose an "efficiency surcharge" on the motor vehicle registration tax ranging up to $95 as vehicle fuel economy increases. A surcharge on fuel-efficient vehicles may seem peculiar given the negative externalities of driving, but if the primary goal is to protect and strengthen the benefits principle in road finance while retaining transparency, it makes some counterintuitive sense. If nothing else a debate over this proposal would bring the paradox of the gas tax into sharp relief and prompt a needed discussion – which always lurks behind the scenes – about which policy purposes the gas tax is really supposed to accomplish.

Other State and Local Taxes

What's the functional difference between directly appropriating general fund money for transportation and dedicating general fund revenue streams to transportation? Mostly the kinder, gentler nature of the vote. Thanks to the 2006 voter-approved constitutional dedication of the motor vehicle sales tax, Minnesota ranks 9th in the nation in using "other state imposts" (other state taxes and fees) to support transportation. These revenues have played a major role in filling the revenue gap left by weakening user fee revenues and federal support.

As a result, it is not particularly surprising to see HF 215 introduced this session, which would dedicate sales tax revenues from the sale of motor vehicle parts for highway purposes. That is one (albeit politically dangerous) step away from expanding the sales tax base to auto repair services and dedicating those revenues for transportation as well. Future pushes for more sales tax base stripping to benefit transportation is something to watch out for given public attitudes toward the revenue-raising alternatives and the proven popularity and "success" of sales tax dedication in supporting conservation, recreation, and arts spending. From hubcaps to rearview mirror air fresheners, if it has "vehicle nexus" it may be a potential future target.

General Fund Support / Infrastructure Bank Capitalization

Conceptually, a strong case can be made that roads and transportation infrastructure deserve general fund support. The idea that roads should be paid for exclusively through user fees fails to acknowledge that roads also provide many general public benefits. Theory says if a public good or service generates such positive externalities it should be financed by general taxation.

From The Director

Our thanks to Gina Ceola for her contribution to this issue on the contentious topic of residency determination and her overview of influential court cases that have landed us where we are today. As she notes, it's an issue that is almost assuredly going to grow in relevance. Demographics alone are a driving force, but from practitioners I have spoken with, the one-two punch of current state income and estate tax policy is taking this to a whole new level.


Mark Haveman

Out of curiosity, I asked several snow belt colleagues who are fellow members of the Governmental Research Association for information on how their states are grappling with these issues. From the responses, it's clear Minnesota is not alone in the need to find a more discernible pathway through the "swamp." My colleague from New York, however, passed along something particularly interesting: a 127 page document from their Department of Taxation and Finance entitled, "Non-Resident Audit Guidelines." In its introduction, it purports to, "explain the tax laws and regulations concerning residency, discuss audit policies and procedures regarding the subject and address various technical and complex issues through examples and explanations." Also according to the introduction, "these guidelines have been established to ensure uniformity and consistency in the examination of nonresident returns." As the quotes suggest, the intended audience is primarily auditing staff, but paging through it suggests taxpayers themselves could benefit tremendously from a better understanding of both the considerations and process of analysis applied in these determinations as well as the considerable case law examples included in the guide which taxpayers might find highly analogous to their own situation.

My completely lay person impression of this document is that from a taxpayer's perspective, it offers a far more complete and detailed understanding of residency testing in application than found in the Department's "Income Tax Fact Sheets." The Department of Revenue should consider producing and publishing such a guide. The effort to put something like this together is probably not insignificant, but it's certainly cheaper than tax court for everyone involved.

This feature also presents an opportunity to remind all members to consider being a guest columnist for future issues of *Fiscal Focus*. Our intent with these occasional features (what we are calling "Practitioner's Corner") is to offer the opportunity to provide real world information, context, insight, and perspective on important tax topics of the day. One of the goals of our organization is to help bridge the gap between the "deep content" understanding of professionals in academia and business and the world of policymaking. We believe bridging this gap leads to better policymaking, and your contributions and insights can help us achieve that goal. Please do not hesitate to contact me if you have a feature idea or would simply like more information.

— M. H.

There is theory and then there is practice. Minnesota is certainly not alone in keeping the state general fund off limits to roads and bridges. According to most recent FHWA statistics, only 30 states support highways through general fund appropriations. As Table 1 suggests, those that do generally offer only very modest support relative to total current revenues.

Much of the sensitivity and frustration surrounding road finance, especially in the business community, is heightened by the fact that policymakers raised over $2 billion in new general fund revenues just two years ago, and actual receipts have beaten forecasts rather consistently since that time. Yet none of this "windfall" has found its way into roads and bridges spending, arguably the most critical element of our competitiveness infrastructure.[2] Nor are the Senate or the Governor's plans proposing to change this. For some perspective, if Minnesota mirrored the national average share of current highway receipts from general fund appropriations, general fund spending for roads and bridges would be around $250 million per biennium.

Conceptually, since general fund revenues capture the effects of inflation, increasing reliance on them might mitigate inflation-related road finance issues. Practically, competition for general fund dollars would almost certainly render that advantage null and void. The appropriation process would probably limit transportation finance purchasing power increases much like inflation does in the current system. Additionally, policymakers are likely under enormous pressure from other spending interests to keep roads and bridges away from the state general fund. Like a "Battle Royale" wrestling match, the last thing current combatants in the general fund cage want to see is a new and powerful competitor join the fray.

In the totality of road and bridge needs, a couple hundred million in general fund money may seem like token support. One way to leverage those dollars to get bigger returns is to recapitalize and significantly expand the state's transportation revolving loan fund program (TRLF) – a.k.a. state government's transportation infrastructure bank.

[2] Area Development's 27th Annual Site Selection Survey of executives and economic development consultants continues to rank "highway access" as the 2nd most important site selection factor.

Established in 1997, the TRLF operates much like a commercial bank, providing low interest loans to cities, counties, and other governmental entities for eligible transportation projects. When the loans are repaid, the funds are returned to the TRLF to finance other projects. Currently capitalized in the neighborhood of only $50 million, governments across Minnesota have used the TRLF to finance a wide variety of transportation needs including purchases of right-of-way, improvements to interchanges, transit capital, construction of a pedestrian tunnel/skyway, road reconstruction, preliminary design, and parking ramps.

According to MN DOT the TRLF is "an innovative finance tool that can be used to finance transportation projects that may not get financed through traditional transportation funding methods." Primary benefits include faster project completion (with resulting cost savings), the ability to respond to unique opportunities as they arise in a timely way, cheaper financing (recent loans have been as low as 1% for 20 years while avoiding traditional costs of bond financing), and the ability to fund additional projects as loans are repaid.

Interestingly, MN DOT reports that in recent years, requests for loans have not exceeded the available balance because most entities are more interested in grants than loans. But in an era where grant demand will always overwhelm supply and other options are needed, it seems shortsighted not to build up infrastructure bank capacity – especially for major road and bridge projects with inter-generational life spans.

Other Out of the Box Ideas

The transportation finance proposals to date are notable for a relative dearth of innovative financing mechanisms. Ideas are out there. The state Chamber of Commerce has advocated a closer look at value capture mechanisms based on the idea that public investment costs should be at least partially covered by the private gains public investment generates. (We will examine this idea more closely in a forthcoming Issue Brief.) HF 325 directs MN DOT to implement a mileage-based user fee system in Minnesota. Expansions of congestion pricing and public-private partnerships have both been the subject of state sponsored transportation studies over the past several years.

But all these have their own design, administrative, and implementation issues that need thoughtful examination and careful attention. This creates both uncertainty and a sense of risk, which are not allies of policymaking. It is unclear whether any of these strategies can overcome these barriers and resistance based on their unfamiliarity to become a bigger part of transportation finance in Minnesota.

Agreement on the nature, scope, and scale of state's transportation infrastructure needs is a challenging political task in its own right. Agreement on financing takes the challenge to another level. Like a Rubik's Cube, "solving" one side has potentially major repercussions for other sides of the transportation puzzle. Circumstances may suggest a low-stress legislative session, but the forthcoming topical debate promises to be one of the most intense the state has seen is some time. ■

Why is Minnesota Highway Construction Inflation So Much Higher than the Nation's?

The strikingly large difference between state and national measures of highway cost inflation suggests that the source of, reasons for, and measurement of cost inflation must be part of the larger transportation finance debate.

Cost inflation in constructing highways and bridges is a big deal in transportation finance. Construction cost indexes are used both to evaluate transportation spending trends in real dollars and to project the revenues needed to finance long-range transportation plans. In addition, many policy advocates argue that government should use construction cost indexes to adjust critical revenue streams like the gas tax to maintain purchasing power.

So in this light, consider a comparison of the Minnesota Highway Construction Composite Cost Index (prepared by the Minnesota Department of Transportation); and the National Highway Construction Cost Index (prepared by the U.S. Department of Transportation Federal Highway Administration or FHWA) which measures "the average change over time in the prices paid by State Transportation departments for roadway construction and materials."

Comparison of Changes in Highway Construction Cost Indexes (March 2003 to June 2014)*

	Cumulative Change	Annualized Change
Minnesota Highway Construction Composite Cost Index	87.5%	5.7%
National Highway Construction Cost Index	10.1%	0.9%

*March 2003 marks the inception of the FHWA's NHCCI)

To put it mildly, that is a rather startling and amazing difference over just 10 years of time. The potential implications for transportation finance are huge. If, for example, in 2003 Minnesota had instituted annual adjustments to the gas tax based on changes to the highway construction cost index, our gas tax rate today would be either 57¢ or 22¢ per gallon depending on which construction cost index policymakers had selected.

Some of this difference is certainly influenced by supply and demand realities unique to Minnesota as well as other state-specific factors (material and engineering mandates and specifications, topographic conditions, etc). But another contributing factor is the difference in methodologies employed in deriving these cost indexes.

Both Minnesota's Highway Construction Composite Cost Index and the federal NHCCI reflect unit prices paid for the different components of road construction (excavation, surfacing, etc.) based on actual project bids. These unit prices include the costs of material, labor, equipment, overhead and profit. Both indexes use quantities of individual cost components as weights to their respective prices in calculating the aggregate price index.

However, Minnesota's highway cost index identifies a base year (1987), and the relative quantities of the inputs used for highway construction projects at that time. The state then tracks price changes in all those inputs over time, weights them according to the 1987 base year, and aggregates the changes to derive its cost index.

The resulting MN DOT highway construction cost index is relatively straightforward and easy to understand but has an important weakness. The aggregate price index for highway construction depends not only on the price indexes of the individual construction components but also on the weights assigned to them. Weightings of construction inputs will change over time for many reasons, including advances in equipment, materials, and information technology. Moreover, substitution effects occur when component prices change in relative terms (e.g. equipment for labor). Practically, certain rising input prices can also lead to a change in the mix and timing of projects. And the further you go out from the "base year" of analysis (now 28 years), the bigger the impact all this is likely to have on measures of construction inflation.

According to the FHWA, the use of such "fixed weight" price indexes, "usually overstates the impact of price increases and understates the impact of price decreases as the current period moves further away from the base period." For these reasons, the FHWA's highway cost index no longer employs a fixed weight methodology like that used by MN DOT. Instead, it employs an index methodology that captures the effects of changes both to the cost of different items and how their relative weights in highway construction change over time. In the process, it accommodates the effects of input substitutions and minimizes the problem of basing inflation estimates on practices and purchasing patterns that do not reflect current road construction realities. According to the FHWA, the Fischer Ideal Index Formula (the name of this approach) "give good approximations to the theoretical or 'exact' cost-of-living index and yet is relatively simple to compute and use," and concludes that "these advantages strongly suggest that it is an excellent choice for building the NHCCI."

How much of this huge differential can be assigned to Minnesota-specific supply, demand, and mandate issues and how much to technical differences in measuring inflation? That's difficult to say. One thing is certain: highway construction inflation will continue to weave its way into transportation finance debates in many influential ways. As just one example, the additional $12 billion in trunk highway funding over 20 years that was reported to be needed to finance an "economic competitiveness" scenario was based on construction costs inflating at 5% per year.

The current debate is all about how much money is needed and where it should come from. This comparison suggests a hearing on cost inflation sources, reasons, and measures is no less important and deserves to be included as part of the whole transportation finance discussion. ■

Minnesota Residency: The "Domicile Swamp"

Guest columnist Gina Ceola, Director, PWC Minneapolis, provides a practitioner's perspective on the complexity of Minnesota's residency testing and why Minnesota's residency laws need greater clarity and simplification.

Gina Ceola
PWC Minneapolis

A couple defying conventional wisdom and moving back to Minnesota from Florida. Another couple touring the U.S. in their motor home. An NBA referee. A businessman relocating to Nevada. What do all these people have in common? All found their way into Minnesota courtrooms regarding their status as Minnesota residents and their associated state income tax liabilities.

Tax practitioners know that there is no shortage of wealthy individuals contemplating thawing out permanently in warmer climates. Minnesota individual income taxation creates just another incentive – an incentive that has recently grown. Notably, the tax years at issue in all the above court cases were prior to Minnesota's top individual income tax rate climbing to fourth in the nation, at 9.85%. Recent tax policy changes may or may not trigger more out-migration from Minnesota, but they most certainly have drawn a lot more attention to the issue of how residency is determined.

The factual differences in these cases illustrate the significant subjectivity, ambiguity, and uncertainty surrounding residency status determinations. Over time, one thing has become abundantly clear: there is a need for far more clarity and simplification in Minnesota's residency laws. Otherwise, as Minnesota Supreme Court Justice Barry Anderson warned of taxpayers in one dissenting opinion, they "enter the domicile swamp at their own peril." [3]

Superficially Simple, Practically Unpredictable

On its face, the residency laws in Minnesota appear deceptively clear. Minnesota law provides two definitions of "resident": "(a) The term "resident" means any individual domiciled in Minnesota ... and (b) "Resident" also means any individual domiciled outside the state who maintains a place of abode in the state and spends in the aggregate more than one-half of the tax year in Minnesota ..." [4]

State law also provides that all residents' income is subject to Minnesota tax. Nonresidents' income is subject to Minnesota allocation rules. Part-year residents with income, gains, losses, and deductions from the distributive share of a partnership, S corporation, trust, or estate are not subject to allocation outside Minnesota during the time the individual was a resident of the state. (Determined based on a ratio the numerator being the days the individual was in the state, the denominator being the number of days in the partnership, S corporation (etc.) year). [5]

Part–year residents are defined as follows[6]:

1 ". . . if you moved to or from Minnesota during the year . . . or . . .

2 spent at least 183 days in Minnesota and maintained an abode in Minnesota for a portion of the year . . . [then] you are considered a Minnesota resident for income tax purposes for the length of time you maintained an abode in Minnesota, even though you may have been domiciled in another state for the full year."

So far, so good. But the water quickly gets murky when one attempts to change their domicile from Minnesota but continues to "maintain a place of abode in the state." Minnesota administrative rules make clear that an individual can have only one domicile, and once domicile is shown to exist, it is ***presumed*** to continue until the contrary is shown.[7] Therefore, individuals moving out of Minnesota may still be found to be Minnesota residents for income tax purposes if they fail to establish another domicile outside of Minnesota.

Figure 1: Factors Considered in Determining Minnesota Residency for Income Tax Purposes

A. location of domicile for prior years;
B. where the person votes or is registered to vote, but casting an illegal vote does not establish domicile for income tax purposes;
C. status as a student;
D. classification of employment as temporary or permanent;
E. location of employment;
F. location of newly acquired living quarters whether owned or rented;
G. present status of the former living quarters, i.e., whether it was sold, offered for sale, rented, or available for rent to another;
H. whether homestead status has been requested and/or obtained for property tax purposes on newly purchased living quarters and whether the homestead status of the former living quarters has not been renewed;
I. ownership of other real property;
J. jurisdiction in which a valid driver's license was issued;
K. jurisdiction from which any professional licenses were issued;
L. location of the person's union membership;
M . jurisdiction from which any motor vehicle license was issued and the actual physical location of the vehicles;
N. whether resident or nonresident fishing or hunting licenses purchased;
O. whether an income tax return has been filed as a resident or nonresident;
P. whether the person has fulfilled the tax obligations required of a resident;
Q. location of any bank accounts, especially the location of the most active checking account;
R. location of other transactions with financial institutions;
S. location of the place of worship at which the person is a member;
T. location of business relationships and the place where business is transacted;
U. location of social, fraternal, or athletic organizations or clubs or in a lodge or country club, in which the person is a member;
V. address where mail is received;
W. percentage of time (not counting hours of employment) that the person is physically present in Minnesota and the percentage of time (not counting hours of employment) that the person is physically present in each jurisdiction other than Minnesota;
X. location of jurisdiction from which unemployment compensation benefits are received;
Y. location of schools at which the person or the person's spouse or children attend, and whether resident or nonresident tuition was charged; and
Z. statements made to an insurance company, concerning the person's residence, and on which the insurance is based.

Note: Any one of the items listed above will not, by itself, determine domicile.

How do you "test" domicile? Here is where the murky water turns into Justice Anderson's swamp. Minnesota provides guidance in three "Income Tax Fact Sheets" as well Minnesota Administrative Rule 8001.0300, which articulates the 26 factors considered in determining residency (Figure 1).

The Department of Revenue makes clear that "[a]ny one of the items listed . . . will not, by itself, determine domicile." [8] The Minnesota Supreme Court has made clear that factors must be weighed in each particular case, and the "trier of fact may consider the acts and circumstances of that person in evaluating the sincerity of the [taxpayer's] announced intent."[9] Although practitioners may desire a more bright line test, such as guidance on the relative weighting of each factor, Minnesota's courts have not articulated what the weighting of the factors should be.

As a result, it's tempting to describe the 26 factor test and the Court's application of it using the infamous quote by U.S. Supreme Court Justice Potter Stewart regarding pornography: "I know it when I see it." [10] Whatever you feel about Minnesota's domicile rules and guidance, there is no question

3 Mauer v. Commissioner of Revenue, 829 N.W.2d 59 (Minn. 2013), 77.

4 MINN. STAT. 290.01, subd. 7 (2014).

5 MINN. STAT. 290.17, subd. 1(a) (2014); and MINN. STAT. 290.17, subd. 1(c) (2014).

6 Minnesota Income Tax Fact Sheet 2, Minnesota Department of Revenue

7 MINN. R. 8001.0300, Subp. 3 (2014).

8 MINN. R. 8001.0300, Subp. 3 (2014).

9 *Commissioner of Revenue v. Stamp*, 296 N.W.2d 867, (Minn.) 1980.

10 *Jacobellis v. State of Ohio*, 378 U.S. 184, 84 S.Ct. 1676, 1683.

the objective factors and fact sheets belie both an intensely subjective issue and an extremely heavy burden on the taxpayer to prove a change in domicile. A trip through some high profile court cases illustrates both these realities.

"Welcome to the Hotel Minnesota?"

In *Sanchez v. Commissioner of Revenue*, [11] the taxpayers sold their home and traveled around North America in a motor home. The taxpayers used a mail-forwarding service to establish a South Dakota address which they used to apply for drivers' licenses, open checking accounts, obtain credit cards, register vehicles, and register to vote. Notably, all parties agreed that the Sanchezes left Minnesota with no intent to ever reside again in the state.

But as noted earlier, once domicile is shown to exist, it is presumed to continue until the contrary is proven. The issue of fact was whether the Sanchezes actually established a new domicile in South Dakota. The Minnesota Supreme Court found that any physical presence that taxpayers had in South Dakota was not sufficient to establish intent to make it their home and integrate their lives into the community, or establish sufficient connections to it. Consequently, the taxpayers did not establish a domicile in South Dakota and the court held that they continued their Minnesota domicile.

Colorful legal opinions are the often hallmark of a controversial topic and frustrated judges. The dissent from Supreme Court Justice Alan Page demonstrates Justice Anderson is not alone in his general opinion about the state of residency testing. Reiterating that everyone agreed the Sanchezes left Minnesota with no interest or intent to ever return, he noted:

> "[t]his court has never before held that a taxpayer must shackle themselves to another state in any specific fashion or for any specific period of time in order to effect a change in domicile. But, after today's decision, taxpayers wishing to establish a change in domicile will have to buy or rent property in another state and remain physically present in that state for some undefined period of time. The logical absurdity of the court's decision is that because the Sanchezes did not buy or rent property or spend sufficient time in South Dakota, they remain to this day subject, at the Commissioner of Revenue's whim, to Minnesota's income tax even though they have completely abandoned their Minnesota domicile." [12]

[11] MINN. R. 8001.0300, Subp. 3 (2014).

Checking the Scorecard

Justice Anderson coined the term "domicile swamp" in his dissenting opinion regarding the Department's interpretive practices in *Mauer v. Commissioner of Revenue*[13]. In this case Mauer, a National Basketball Association referee, appealed a decision by the Department that he was a full-time legal resident of Minnesota for the 2003 and 2004 tax years, and not Florida as Mauer claimed. The Court held that Mauer still had a Minnesota domicile for the years at issue.

As previously noted, taxpayers have the burden of proving a new domicile outside of Minnesota. When arguing the question of domicile in the lower court, Mauer and the Department argued at length over the applicability and weight of the 26 factor test. The parties agreed that six factors weighed in favor of a Florida domicile and six did not apply, but did not agree on the remaining 14 factors. The Minnesota Supreme Court has rejected the notion that the sheer quantity of factors favoring non-residency status outweighs the factors favoring domicile in Minnesota.[14] In other words, residency determination is not just an addition problem. However, of the remaining 14 factors, the Court proceeded to count eight factors in favor a Minnesota domicile and six as neutral.

In its ruling, the Court explained that the taxpayer's acts, as opposed to his declarations, weighed in favor of the presumption that his domicile remained in Minnesota. For example, the following acts were found to be mere assertions, or declarations:

- registering to vote in Florida,
- completing a declaration of domicile in Florida,
- terminating taxpayers Minnesota homestead exemption, and
- opening a bank account in Florida.

[12] Id.

[13] *Mauer v. Commissioner of Revenue*, 829 N.W.2d 59, 78 (Minn. 2013).

[14] Id. at 69, citing, *Dreyling v. Commissioner of Revenue*, 711 N.W.2d 491, 495 (Minn. 2006).

The Court noted a series of more significant acts:

- the taxpayer did not sell his home in Minnesota, nor did he make a good-faith effort to sell it;
- the taxpayer continued to spend significantly more time in Minnesota than Florida, and kept and insured several motor vehicles in Minnesota and not Florida, and
- the taxpayer maintained employment in Minnesota as a high school football referee.

All this begs the question, which factor mattered "most"? In this case "Factor W" – which relates to the percentage of time the person is physically present in Minnesota and the percentage of time the person is physically present in each jurisdiction other than Minnesota – received considerable attention. The Court determined the taxpayer spent more time in Minnesota than in any other single jurisdiction. The Court also found that while one factor is not conclusive in determining residency, there was sufficient evidence to support the Tax Court's weighing of Factor W in favor of its finding of a Minnesota domicile. But in his dissent, Justice Anderson disagreed with the weight assigned to Factor W, noting that Mauer's unusual occupation requires extensive travel that undercuts the traditional approach of simply adding up the number of days in any one location.

The Company You Keep

Just months prior to the Mauer decision, the Minnesota Supreme Court ruled on another residency case in *Larson v. Commissioner.* [15] In this case a businessman argued the Tax Court erred in concluding that he was a Minnesota resident for income tax purposes during the 2002–2006 tax years instead of a Nevada resident. Once again, the factor test offered a mixed bag of evidence (homesteaded property, a driver's license, voter registration, and club memberships all in Nevada versus larger amounts of property ownership, bank accounts, maintenance of mail delivery, vehicle registration and family all in Minnesota.) "Factor W" (time in state) came out clearly in favor of Minnesota even though Larson never spent more than 169 days in Minnesota in any given year from 1999-2006.

[15] *Larson v. Commissioner*, 824 N.W2d, 329 (Minn. 2013).

Governor's Budget Released

The first budgetary salvo of the 2015 session landed on January 27 with the release of Governor Dayton's $42 billion biennial budget. The governor clearly prioritized children's interests in his new spending initiatives. His budget proposal includes $1 billion in new spending and tax expenditures, reducing the forecasted budget balance from $1.037 billion to $35 million. About 40% of this new spending, $418 million, will go to K-12 and higher education – largely through 1% increases in General Education revenue for schools in FY 2016 and FY 2017 and additional money for pre-kindergarten and school readiness programs – and for $100 to expand the state's child and dependent care tax credit.

The tax items in the bill are fairly limited in number, but assuredly matter very deeply to those being targeted. An increase in the child and dependent care credit is the only real tax expenditure being proposed. Revenue raisers include "modernization of the railroad property tax" ($31.49 million) and a host of corporate tax provisions (totaling $17.4 million) comprising:

- Elimination of corporate tax shelters used by insurance companies
- Restricting financial institutions' ability to move income
- Taxing business sales by non-Minnesotans using an installment sale
- "Preventing transactions meant only to evade taxes" (a.k.a. economic substance)

In some respects the budget proposal is interesting for what it lacks. There are no new dollars for local government aids at the city, county, or township levels and no major changes to the property tax system except in the railroad area – a marked departure from the governor's first term. There are also no major spending initiatives that seem designed to single out rural interests. Governor Dayton's budget seems to reflect his "One Minnesota" motto – now we'll see what lawmakers think.

Fiscal Summary of Governor's Tax Initiatives (in thousands, parentheses indicate losses to the General Fund)

Category and Item	FY2016	FY2017	FY2018	FY2019
Individual Income Tax	($43,500)	($46,690)	($48,110)	($51,440)
Child and Dependent Care Credit Expansion (with income tax interaction)	(48,600)	(51,280)	(52,790)	(56,110)
Working Family Credit Disallowance for Non-res	5,100	5,200	5,300	5,300
Statewide Property Tax Base Expansion Interactions	0	(610)	(620)	(630)
Corporate Franchise Tax (No detail available)	$8,000	$9,400	$11,700	$13,800
Sales and Use Tax	$2,640	$1,570	$1,580	$1,600
6.5% Wholesale Gas Tax Interaction with Tribal Payments	(1,470)	(2,750)	(2,740)	(2,730)
Motor Vehicle Lease Reallocation	4,000	4,200	4,200	4,200
New Annual Solid Waste Tax Rate for Construction/Demolition Waste	110	120	120	130
Estate Tax (Recapture Tax Change Related to Eminent Domain)	($50)	($50)	($50)	($50)
Statewide Property Tax (Base Expansion for Railroad Rolling Stock)	$11,300	$21,100	$21,300	$21,400
Cigarette/Tobacco Products Tax (Anti-Smuggling Fines/Compliance)	$2127	$2127	$2127	$2127
General Fund Total	($19,483)	($12,543)	($11,453)	($12,563)
Other Funds	($3,795)	($3,975)	($3,970)	($3,965)

Source: Data from Minnesota House Fiscal Analysis Department, calculations by MCFE.

However, this decision emphasized another factor very heavily. As Figure 1 notes, the Department and the courts also examine the existence, nature, and location of relationships – both personal and business – in residency determinations. Larson maintained strong professional connections with Minnesota-based legal, accounting, investment and health care firms – using these organizations more often than Nevada counterparts. The Court, agreeing with the Tax Court, found that Larson's connection with Minnesota – including professional relationships during the years at issue – when compared to his connection with Nevada, provided evidence that he did not intend to change his domicile. It didn't matter, as Larson argued, that the focus in determining intent should be limited to 1998 when the physical move was made. The Court disagreed, stating the Tax Court appropriately looked not only at Larson's stated intent and actions, but also at the acts and circumstances of life after a move. In the Supreme Court's eyes, the Tax Court had looked at the "sincerity of taxpayer's intent" and appropriately determined his actions after 1998 demonstrated his continued intent to remain domiciled in Minnesota, not Nevada.

When Does The Clock Start Ticking?

The most recent Minnesota Tax Court decision on residency is *Curtis G. & Stacy S. Marks v. Commissioner of Revenue*, which addressed a unique issue regarding the interplay between domicile and the physical presence test when dealing with a part-year resident.[16] The issue in this case was the Department's interpretation of the definition of "resident" under §290.17 subd. 7(b):

> . . . any individual domiciled outside the state who maintains a place of abode in the state and spends in the aggregate more than one-half of the tax year in Minnesota, . . . [f]or purposes of this subdivision, presence within the state for any part of a calendar day constitutes a day spent in the state...

The Marks were Minnesota residents until 1999. In 1999, the Marks moved to Florida and became Florida residents but continued to maintain a home in Minnesota during the years they were Florida residents. In 2007, the Marks moved back to Minnesota from Florida.

The Department assessed the Marks additional income taxes for 2007, claiming that as Minnesota residents, no income could be allocated outside of the state. The Department argued that there was no dispute that the Marks maintained an abode in Minnesota, and they were physically present in Minnesota for more than 183 days during the 2007 tax year. The Marks stipulated they were in Minnesota for more than 183 days during 2007, however, they argued that at the point they decided to move back to Minnesota, they had not yet been physically present for 183 days or more. The Court agreed with the Marks' interpretation, specifically, that the 183 days is only considered for the time period when the taxpayer is domiciled outside of the state. In other words, the days the Marks spent in Minnesota, after they had already moved to Minnesota, do not count towards the 183 day test. Therefore, it was held that the Marks were part-year residents, consequently, their income was subject to allocation under Minnesota Statute §290.17.

This may not be the last we hear from the Marks. The Court concluded that an evidentiary hearing is to be scheduled to determine when during 2007 the Marks became domiciled in Minnesota and such, from that date forth they would be a Minnesota resident. This is when the Marks will begin wading in the domicile swamp.

Draining the Swamp

Despite the cloud of ambiguity always hanging over residency determinations, two things can be concluded with considerable confidence. First, the combination of demographics and state tax policy changes portend many more legal squabbles and rich additions to Minnesota case law on this topic. With the increase in the individual rate, it is very unlikely there will be a slowdown any time soon in the number of wealthy and/or aging Minnesotans who are considering a move to a warmer climate but want to retain relationships and presence in Minnesota.

Second, pressure to bring more clarity and predictability to these determinations is only going to increase. The backlash from the business community regarding the Larson decision and the weight the Court gave to professional relationships retained in Minnesota was quick and broad-based. The emphasis placed on this factor is very likely to have a profoundly chilling effect on the ability of Minnesota professional service firms to continue to serve former or part-time residents. Lawyers in Florida and Arizona are using the case to convince clients they should drop their Minnesota-based lawyers.

The Minnesota State Bar Association and all professionals would like to see more clarity on the 26 factor test and are focused on amending the residency law to exclude the factor related to business relationships. This is a start; but there is more to come on this issue. There are benefits to be gained for all stakeholders by working together to drain the swamp. ■

[16] *Curtis G. & Stacy S. Marks v. Commissioner of Revenue*, RIA SLT MN 8463-R, 10/23/2014.

Recent Release: Comparing Minnesota's Local Prices of Government

Opinions about the claim governments are making on citizens and the economy inform bedrock debates every legislative session. It's the reason why policymakers directed Minnesota Management and Budget (MMB) to publish its "Price of Government" report as a transparency tool and a way to track and communicate trends on this issue at the state level. But in a time when legislative agendas are likely to be influenced as much by geography as political affiliation and property taxes remain under the microscope, getting a handle on the "Price of Local Government" in Minnesota seems no less important.

Our new issue brief, "Comparing Minnesota's Prices of Local Government," examines this topic and calculates the Price of Local Government (POLG) for all 87 counties in five different ways. Each approach captures a different but important perspective on the claim local governments within a county collectively have on residents and the local economy:

- a "traditional" Price of Local Government calculation (total own source revenues / personal income) replicating the methodology MMB uses in developing the state's official "Price of Government" report;
- a per capita POLG which measures the dollar burden imposed for local benefits and services delivered;
- a money income POLG based only on the earnings and related income that can actually be used to pay taxes and fees to government;
- a POLG estimate net of the ability of local governments to export some of their local tax burdens to non-county residents; and,
- a local effort property tax POLG focusing solely on the total property tax price paid by resident businesses and individuals to all local governments within a county.

To see where your county ranks on each measure, and to download the issue brief, visit our website: www.fiscalexcellence.org

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