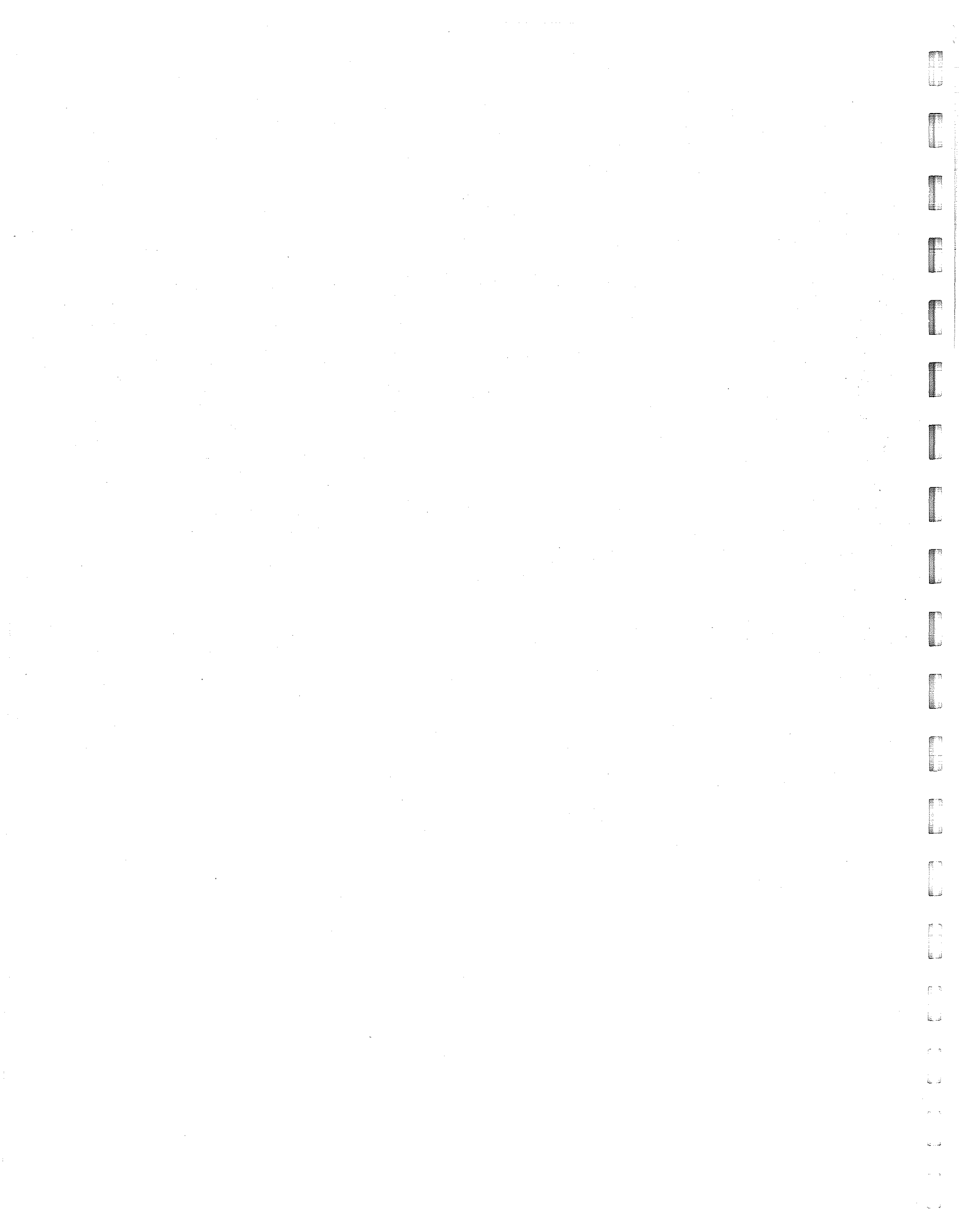
# Capital Equipment Advisory Council

# Report to the Legislature

**February 1994**

Pursuant to 1993 Minn. Laws Chap. 375
Art. 9 Sec. 49 Subd. 1



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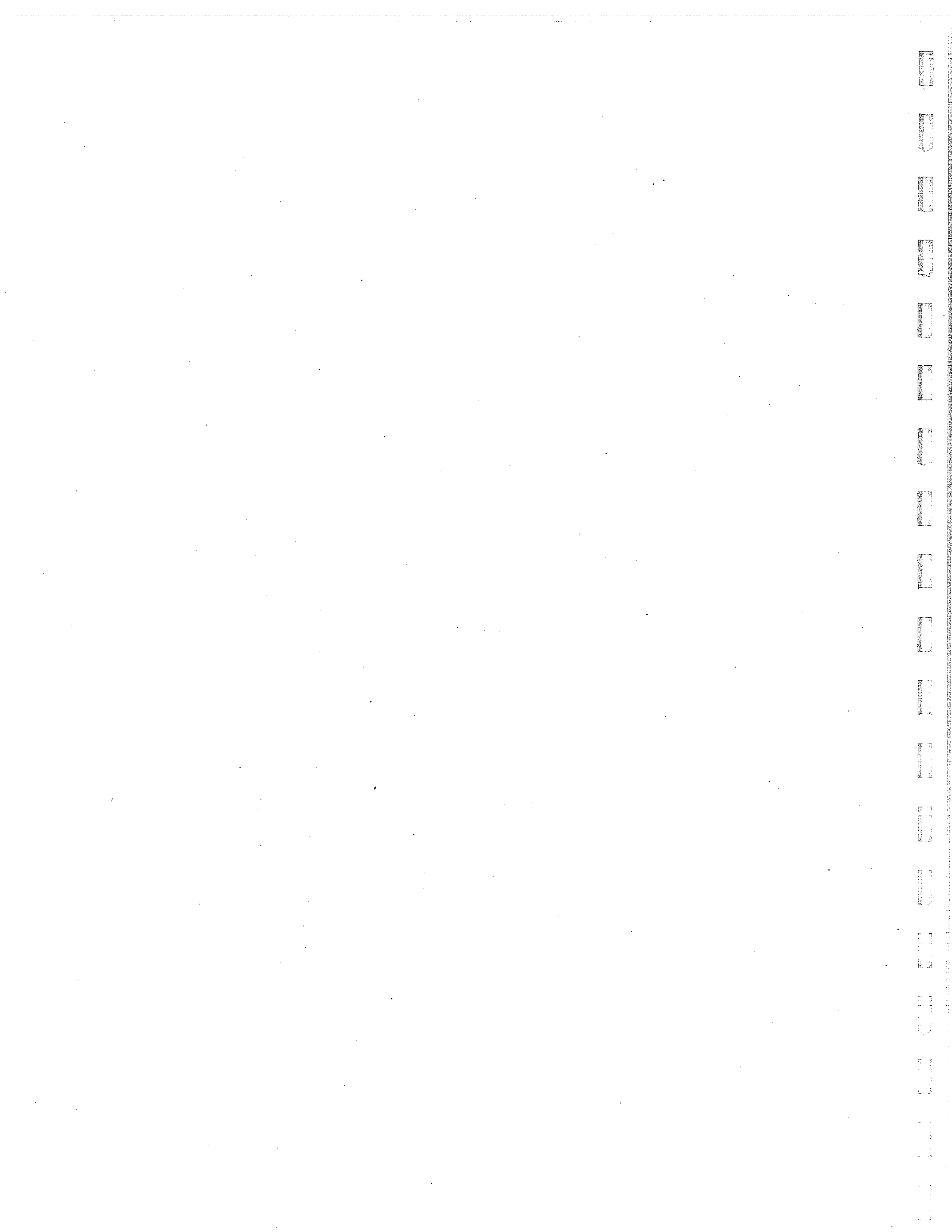

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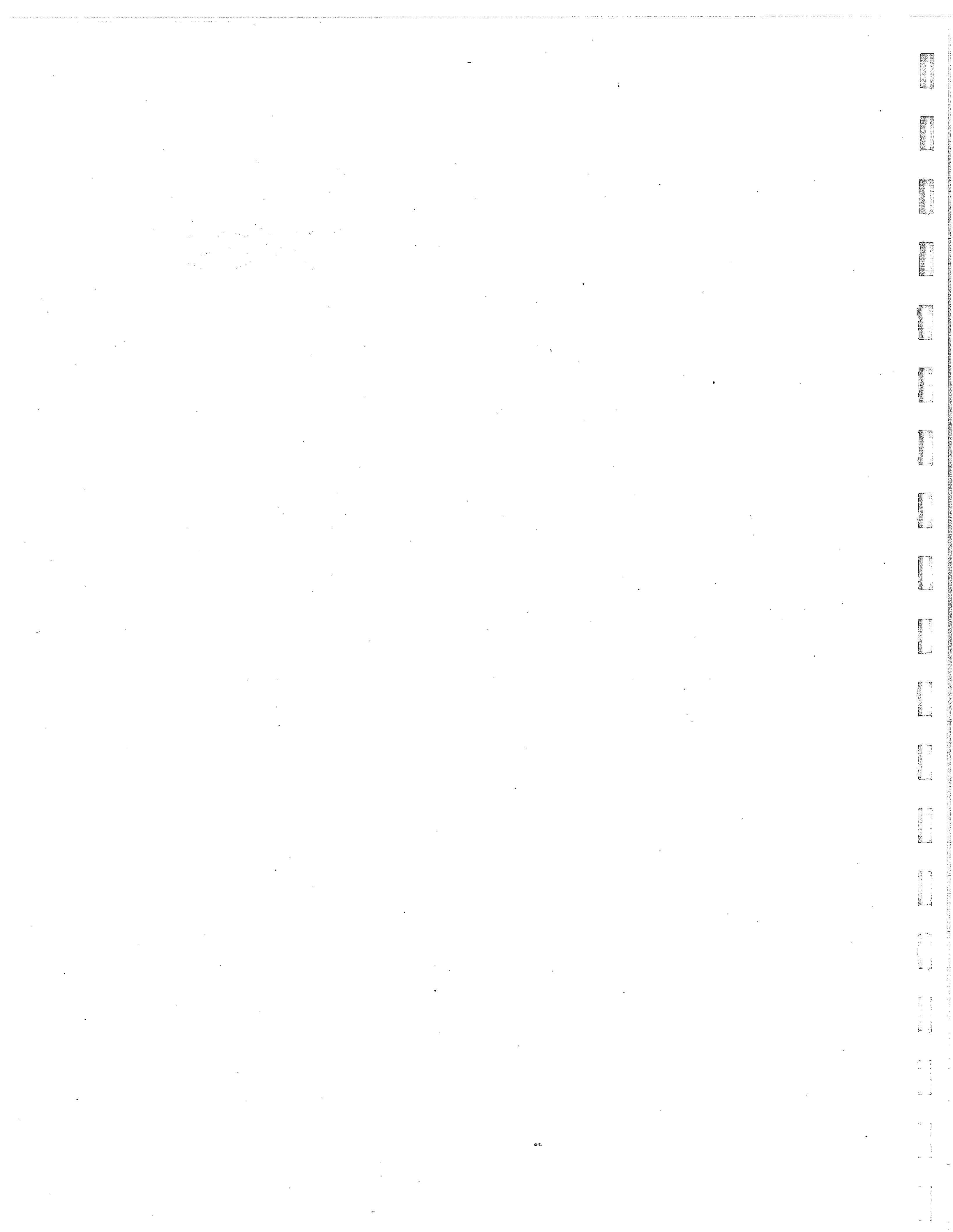

# Introduction

This report fulfills the responsibility of the Advisory Council under its legislative charge to study Minnesota's sales taxation of capital equipment and report to the 1994 Legislature.[1]

The report

- outlines the tax policy principles or goals for the sales tax treatment of capital equipment (**Chapter 1**)
- relates the history of the taxation of capital equipment under the Minnesota sales tax (**Chapter 2**)
- summarizes other states' taxation of capital equipment (**Chapter 3**)
- analyzes the effect of capital equipment taxation on economic growth in Minnesota (**Chapter 4**)
- makes recommendations to the legislature (1) for expanding the sales tax exemption for capital equipment and (2) for offsetting the revenue loss.

## Legislative Charge: Capital Equipment Advisory Council

In 1993, the legislature substantially amended the capital equipment sales tax exemption statute to include most of the positions the Department of Revenue had taken in administering the law. The legislature also established a state advisory council to study the capital equipment exemption and report its findings to the legislature by February 1, 1994.

The enabling legislation (see Appendix E) requires the Council's report to include the following:

- an overview of the purpose, intent, and application of the existing exemption;
- appropriate tax policy goals for the capital equipment exemption;
- an evaluation of the effect the exemption has in encouraging new investments, economic activity, and job creation; and
- analysis of alternative versions of the exemption, either expanding or narrowing it, including expansions contained in the administrative law judge's report.

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[1]1993 Minn. Laws chap. 375, art. 9, § 49. See Appendix E for a copy of the legislation.

The Council's report also is to include revenue neutral recommendations for modifying the exemption.

# Council Membership

The following members were appointed to the Advisory Council:

Morrie Anderson, Commissioner of Revenue

**Governor's appointees**

Marybeth Brady, First Bank System
Hal Lofgreen, St. Cloud State University
Sandy Navin, General Mills
Art Rolnick, Federal Reserve Bank, Minneapolis

**House appointees**

Representative Irv Anderson
Representative Dee Long
Representative Bill Macklin
Dale Busacker, Ernst & Young
Leslie R. Johnson, Grand Metropolitan

**Senate appointees**

Senator Bill Belanger
Senator Len Price
Senator Ember Reichgott-Junge
Bob Teichert, 3M
Diane Weber, Blandin

Bob Cline, Director of the Tax Research Division, Department of Revenue; Joel Michael and Pat Dalton, Legislative Analysts, Research Department, Minnesota House of Representatives; and Keith Carlson, Fiscal Analyst, Senate Tax Committee Staff, provided the primary staff assistance to the Advisory Council.

# Chapter 1

## Tax Policy Principles and the Sales Tax

In principle the sales tax is a tax on income used for consumption. A general sales tax, which is an ad valorem tax based on price, should apply to most goods purchased by individuals for personal consumption. The practice of taxing business inputs, including capital equipment, conflicts with the idea that the sales tax is a tax on final consumption.

There is general consensus among most analysts that a tax should be:

- equitable;
- efficient;
- simple to understand;
- easy to administer; and
- an adequate revenue raiser.

These principles can conflict with each other. Policy changes that advance one goal may violate another. Policy makers, therefore, need to be sensitive to tradeoffs among the principles to achieve an appropriate balance in formulating proposals for tax changes.

Generally, the sales tax would be more efficient, easier to understand and administer, and provide more stable revenues if business inputs, including capital equipment, were exempt from the tax. Horizontal equity would be increased with taxation of a broader range of final consumption goods and exemption of most business inputs. The ability of sales tax revenues to increase with growth in the economy would also be enhanced by broadening the base of final consumption goods that are taxed. Vertical equity would increase or decrease, depending upon what revenue sources were substituted for the sales tax on capital equipment.

### Equity

**A tax should be *fair* or *equitable*, both in terms of *horizontal equity* ("equal taxation of equals") and *vertical equity* (the tax burden should rise or at least should not fall as income rises).**

The equity principle addresses the issue of fairness in the distribution of the sales tax burden among taxpaying households. To evaluate fairness, sales taxes paid by households are compared to their ability to pay, generally measured by a taxpayer's total, current money income. These effective tax rates (or burdens) can be compared for taxpayers at different

income levels, as well as for taxpayers at the same level of income. In other words, the equity principle has two important dimensions, horizontal and vertical.

**A sales tax on capital equipment violates**

- **the principle of horizontal equity by contributing to different tax burdens among households with the same income, and**
- **the principle of vertical equity because taxing capital equipment is regressive.**

**Horizontal equity examines tax burdens of taxpayers at the same level of income.** The widely-accepted horizontal equity principle is that taxpayers with similar levels of income should pay approximately the same amount of tax. If the sales tax is a tax on consumption, tax burdens for taxpayers with the same level of income and consumption should not vary because of the composition of spending. In general, broad tax bases, uniform tax rates and minimum exclusions increase horizontal equity. Horizontal equity would increase if the sales tax was broadened to include more final consumption purchases. Many purchases by individuals, especially purchases of services, are not subject to sales tax. As a result, households with the same income pay different amounts of tax depending on what they chose to consume. For example, persons who devote more income to buying boats and cars pay more sales tax than similar people who spend their money on expensive clothes.

**A tax on capital equipment violates the policy of horizontal equity.** Inclusion of business inputs, also known as intermediate goods, in the sales tax base leads to a special problem known as *pyramiding* or *cascading*. Pyramiding occurs when the sales tax on an intermediate good is incorporated into a higher price for a final good. The amount of pyramided sales tax that is reflected in the price of a good depends on the amount of intermediate goods used in the production process and on the extent to which these intermediate goods are taxed. The effect of sales tax pyramiding is that different goods are taxed at different rates; the total tax depends both on the direct tax paid on the final purchase for consumption and the indirect tax paid through pyramiding. Persons with the same income but different consumption patterns will have different tax burdens due to these tax differentials as well as exemptions for certain consumption goods.

Table 1 displays some examples of differential effective sales tax rates that result from pyramiding of the tax on business inputs. The table breaks down the tax paid directly on final purchases and indirectly through sales taxes on business inputs that are passed along in higher consumer prices. Table 1 shows that indirect sales taxes result in substantial effective tax rates on consumers, even though the final sale of the product or service is exempt. For example, although health services are exempt, the indirect effective tax rate is 0.38 percent.

In addition, the table shows that the extent of pyramiding varies significantly across industries.

**Table 1**
**Effective Sales Tax Rates as a Percent of Consumer Price**

| Products | Direct | Indirect | Total |
|---|---|---|---|
| Construction and Mining | 0.02 | 4.85 | 4.87 |
| Manufacturing | | | |
| Durable Goods | 6.26 | 0.64 | 6.90 |
| Nondurable Goods | 4.73 | 0.59 | 5.32 |
| Transportation | 0.00 | 4.46 | 4.46 |
| Utilities and Communications | 3.25 | 1.33 | 4.58 |
| Finance, Insurance, Real Estate | 0.00 | 0.75 | 0.75 |
| Personal and Other Services | 2.20 | 1.27 | 3.47 |
| Eating and Drinking Establishments | 6.50 | 1.03 | 7.53 |
| Health Services | 0.00 | 0.38 | 0.38 |
| Business Services | 0.00 | 1.89 | 1.89 |

**Vertical equity compares effective sales tax rates for taxpayers at different income levels.** A tax is described as progressive, proportional or regressive if effective tax rates rise, remain constant, or fall as income increases. There is almost universal support for the vertical equity principle that a fair tax is a tax with a proportional or progressive distribution of tax burdens. Because higher-income taxpayers save a larger percentage of their incomes, even a broad-based consumption tax will be regressive. Most state sales taxes contain a number of exclusions from the base which may reduce regressivity (e.g. food) or increase regressivity (e.g. investment advisory services) relative to the base of a comprehensive consumption tax.

**A tax on capital equipment is as regressive as the overall sales tax.** Sales taxes which are initially collected by businesses from consumers or are initially paid by businesses on their purchases of inputs (capital equipment, for example) are assumed to be subsequently shifted through market adjustments to households as consumers, business investors, workers or landowners. **Incidence theory and analysis** is used to predict the final distribution of sales taxes by households after all shifting has occurred. According to the *1993 Minnesota Tax Incidence Study* the distribution of the total sales tax burden on Minnesota residents is regressive. The sales tax on business inputs is about as regressive as the overall sales tax.

**Reducing the sales tax on capital equipment will decrease the regressivity of the sales tax.** Generally accepted incidence theory suggests that the burden of the sales tax on capital equipment is divided into two parts. The part of the tax that equals the national average tax on capital is borne by capital, because capital generally cannot move to another location (another state or locality) to avoid the tax. The part of the tax in excess of this average capital tax will be shifted back to labor in lower wages, forward to consumers in higher

prices, or to landowners. Where this shifting occurs, depends upon the market for the goods being produced. If the market is local, the tax will be shifted forward to consumers in higher prices. If the market is national, the price will be set by competition in the national market and the tax cannot be shifted forward in higher prices. Thus, for products marketed nationally in a competitive market, this part of the tax will largely be shifted back to labor and to a lesser extent to Minnesota landowners.[2]

Available evidence suggests that Minnesota's taxation of manufacturers' capital is higher than the national average. Thus, reducing this tax will lower the tax that falls on labor, land, and Minnesota consumers (for locally produced goods). Exempting capital equipment should reduce the regressivity of the tax, if the reduced revenues are not replaced by spending reductions or tax increases that are more regressive than the existing tax.

## Efficiency

**A tax should be *efficient* or *neutral*; it should minimize interference as much as possible with market decisions.**

The principle of efficiency presumes that a market economy generally yields the best possible allocation of private goods and services. Put another way, allowing individuals and firms to decide how, where, when, and what to produce and consume is the best way of meeting most people's desires for private goods and services, given the constraint of finite resources. The market's ability to satisfy individual consumer preferences is reduced by tax structures that either favor consumption of one good over others or favor certain forms and manners of production.

Taxes inevitably interfere with private sector decision making. Under the principle of efficiency, a tax should be as neutral as possible; its inevitable impact on private sector decisions should be minimized. The sales tax should be structured, as much as possible, in a way that does not distort or change how or what goods and services are produced or consumed. It should not affect a firm's decision regarding methods of production nor should it reduce the competitiveness of certain firms based on their size or organizational structure.

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[2]For a more extensive discussion of these issues see Dept. of Revenue, *Minnesota Tax Incidence Study* 41-72 (Nov., 1993).

**A sales tax on business inputs, including capital equipment, generally violates the principle of efficiency because:**

- **it favors products that are made with exempt or more lightly taxed inputs;**
- **it favors firms, typically larger firms, that are more vertically integrated; and**
- **it may affect business location decisions and make Minnesota locations less attractive than sites in other states.**

**A sales tax on capital equipment distorts business production decisions.** Taxing some inputs, such as capital equipment, favors processes that use relatively more exempt or lightly taxed inputs (e.g., labor or raw materials). If replacement capital equipment is taxable, a firm may opt to continue to use older, less efficient equipment instead of modernizing a plant.

**A sales tax on capital equipment favors vertical integration, and larger firms.** If sales tax is imposed on the purchases of business inputs, there is an incentive to produce those inputs "in-house." This in-house production, known as *vertical integration*, allows a business to avoid the sales tax because there is no taxable transaction. Vertical integration is a more viable option for larger firms. Small firms do not use enough of many inputs to produce them efficiently within the company. The result is that input costs for larger firms may be lower due to vertical integration, making smaller firms less competitive.

A special case favoring vertical integration exists in current Minnesota law. Currently a firm that directly purchases qualifying capital equipment for a new plant pays no sales tax on the equipment. A firm whose equipment is purchased and installed by a contractor as part of a building contract pays the tax.

**A sales tax on capital equipment may influence where businesses locate.** A Minnesota business might be less competitive with similar businesses outside the state because the sales tax increases the cost of inputs. This argument assumes that the sum of other costs, including other business taxes, are equal. The effect of the sales tax on the competitiveness of Minnesota locations should not be evaluated in isolation; it should be incorporated in an analysis of the net effect of all business taxes (including corporate and property taxes) on interstate competitiveness.

## Simplicity

**A tax should be *simple* and easy for the public to see and understand, both to facilitate compliance and to hold the government *accountable* for the effects of the tax.**

The principle of tax simplicity means that tax provisions should be uncomplicated and easily understood to maximize voluntary compliance. Qualifications and arbitrary distinctions should be avoided to minimize the number of decisions or judgement calls made by either the taxpayer or tax administrators. Visible and open taxes should be preferred to hidden taxes so that people understand the impact of the tax.

**Minnesota's capital equipment exemption violates the policy of simplicity because:**

- **it contains numerous qualifications that are difficult for businesses to understand and comply with; and**
- **it is a hidden tax.**

**The distinction between qualifying "expansion" equipment and non-qualifying "replacement" equipment can be difficult for businesses to make.** Although the statute explicitly prohibits refunds for replacement equipment performing substantially the same function in an existing facility, this provision is not nearly as straightforward as it sounds. The Department of Revenue has had to adopt numerous definitions and policies in order to administer the exemption in a consistent manner. In 1993 the legislature amended the definition of capital equipment to include definitions of such terms as "replacement," "facility," "function," and "expansion."[3] However, the statutory definitions themselves are not precise enough to be easily applied to particular circumstances and production activities.

**The exclusion of contractor-installed equipment creates hardships for many businesses.** Entering into lump-sum construction contracts covering materials and labor is a common practice on major projects. This arrangement significantly complicates taxpayer compliance. Because of the requirement that exempt capital equipment must be "used by the purchaser," no refund is allowed in cases where equipment has been purchased and installed by a

[3]Minn. Stat. § 297A.01, subd. 16. For the most part, the 1993 legislation codified what had been Department of Revenue policy.

contractor.[4] These circumstances have caused many refund denials. Besides creating difficulties for business, the exclusion also violates the efficiency principle since it discriminates against businesses based on their method of acquiring equipment.

**Due to pyramiding, a tax on capital equipment is a hidden tax.** As stated earlier, a sales tax on business inputs is often incorporated into higher prices for final goods or in lower wages paid to labor. These hidden or indirect taxes make it hard to determine the total tax paid on different goods. Pyramiding also results in a hidden tax on products such as food, the final sales of which are exempt from sales tax. This hidden tax thwarts the legislature's purposes in exempting sales of these products from taxation.

## Ease of Administration

**A tax should be *easy* for the government *to administer and* for taxpayers *to comply with.***

The costs associated with tax administration or compliance impose a "deadweight loss" on the economy. Money spent on administration diminishes the amount of goods and services the government could otherwise deliver. Compliance costs reduce the amount that businesses have for wages or investment. Minimizing these costs will increase the total production of both the public and private sectors.

**The structure of the capital equipment exemption creates significant, unnecessary administrative and compliance costs.**

**The Department of Revenue spends considerable time and resources administering the capital equipment exemption.** Many administrative difficulties are related to the problems faced by taxpayers. The fact that production activities involve a great number of different products and procedures means the department often must administer the program on a case-by-case basis while, at the same time, remaining consistent with the law's overall requirements. Department policies are also under constant review to respond to new technologies and changing industrial practices. Clearly, the current capital equipment program takes up a significant share of departmental resources.

[4]In most states, sales to contractors of supplies, materials, and equipment are generally considered final retail sales, and contractors are liable for any sales or use tax which may be due. The tax paid typically becomes part of the contractor's overhead.

**Businesses also spend considerable time and resources in complying with the capital equipment exemption.** The complexity of the current law, and the need for supporting documentation when applying for the exemption imposes costs on businesses as well as the Department of Revenue. In addition a business must expend resources when it chooses to go through the appeals process.

**The refund process significantly increases taxpayer compliance costs.** The department has recently implemented a 30-day turnaround time for processing refund claims, generally eliminating the months-long delays which many businesses experienced in the past. Nevertheless, requiring the tax to be paid and then issuing a refund is time consuming for businesses. The costs associated with this exemption would be reduced if the exemption was available at time of purchase.

## Revenue Adequacy

**A tax should provide *adequate revenues*. An ideal tax would provide stable revenues that grow with increases in the size of the economy.**

The basic reason the state imposes taxes is to raise revenues to fund public services. In an ideal world, the revenue raised by the tax would be stable, varying little over the business cycle. Stable revenues help in the government's planning and budgeting. Revenue should also keep pace with the growth in the economy. If revenues lag, the state must either increase tax rates or provide fewer public services relative to the size of the economy.

**Imposing the sales tax on capital equipment tends to increase the volatility of revenues across the business cycle, while expanding the base would tend to increase the tax's overall elasticity.**

**Taxation of capital equipment may increase variations in sales tax revenue over the course of a business cycle.** Firms tend to delay capital investment during recessions and make capital investments during expansion periods. Therefore, the taxation of capital equipment may increase the relative decline in sales tax revenue during economic downturns, and increase the relative growth of revenue during expansions.

**A broader sales tax base would allow sales tax revenue to keep pace with general economic growth.** People consume different things as their income changes. For instance, people with higher incomes are more likely to hire a personal trainer, use a financial planner or buy expensive clothing. A broader tax base, that includes more items of personal consumption, will help sales tax revenue keep pace with general economic growth.

# Chapter 2

# History and Purpose of the Capital Equipment Exemption

## Legislative History

The Minnesota sales tax was adopted in 1967. The sales tax applied to business purchases of equipment and supplies and did not contain an exemption for capital equipment.

The legislature enacted the capital equipment sales tax refund in 1984 to encourage construction of new and expansion of existing manufacturing plants.[5] The Ford Motor Company, which was considering an expansion of its St. Paul plant at that time, initially proposed the exemption.

The 1984 legislation provided for a 2 percent refund of the then 6 percent sales tax rate on purchases of qualifying equipment. Qualifying capital equipment was defined as (1) equipment used for manufacturing, fabricating or refining a product for sale at retail and (2) used for the establishment of a new or physical expansion of an existing facility. Equipment used to extract, receive or store raw materials was specifically excluded from the refund. This new, partial "exemption" was not like the other sales tax exemptions. In the case of capital equipment, the buyer paid the tax at the time of purchase and applied to the Department of Revenue for a refund of the tax paid.

The distressed counties refund was enacted in the 1985 first special session.[6] The legislature enacted the distressed county refund principally to encourage paper plant expansions in northern Minnesota and to stimulate economic growth in areas of the state with high unemployment. The law provided a complete sales tax refund for capital equipment totaling over $100,000, if put in service in connection with a new manufacturing facility or expansion of an existing facility within designated distressed counties. An expansion qualified if it resulted in at least a 20 percent expansion in production capacity or if total capital investment in a one year period exceeded $25 million. In the years the program was in effect (1985 to 1991), between 30 and 40 counties were designated each year as "distressed" by the Commissioner of Trade and Economic Development.

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[5]See Appendix A for a chronology with effective dates.

[6]1985 Minn. Laws, 1st Sp. Sess. chap. 14, art. 8 § 18, codified as Minn. Stat. § 297A.257.

Several major amendments were made to these two statutes. In 1986, a subdivision was added to the distressed county statute which provided a refund of sales tax for construction materials to construct a new or to expand an existing manufacturing facility within a distressed county, if total capital investment over a three year period exceeded $75 million. This law change also allowed building owners to apply for the refund when the sales tax on construction materials was paid by a contractor or builder. An earlier Department of Revenue interpretation of the refund program had held contractor or builder purchased equipment did not qualify for the refund.

In 1987, the legislature added the "taconite tax relief area" to the distressed county statute (effective July 1, 1987). This added additional counties or portions of counties to the areas qualifying for refunds.

The most significant change occurred in the 1989 special session, when the legislature changed the tax incentive from a partial exemption of 2 percent to a complete exemption. The refund process, however, remained in place.

During the 1990 session, mining and quarrying were added to the list of qualifying activities.

The 1993 legislature amended the statute to include most of the language that the Department of Revenue had proposed as an administrative rule in the fall of 1992 and later withdrawn from the rulemaking process. (See the description below under Administrative Rulemaking.) Replacement equipment for mining or production of taconite was also exempted during this session. The amendments defined on-line computer data services as a qualifying production activity.

## Court Cases

To date, five court decisions have construed the capital equipment exemption:[7]

- *Color Ad Packaging, Inc. v. Commissioner of Revenue*
- *West Publishing Company v. Commissioner of Revenue*
- *Cowles Media Inc. v. Commissioner of Revenue*
- *Northern States Power Company v. Commissioner of Revenue*
- *Potlatch Corp. v. Commissioner of Revenue*

In *Color Ad*, a printing company's refund claim was denied on the basis that the purchases were made before the effective date of the refund provisions. The tax court, however, found in favor of taxpayer, and the decision was affirmed by the Minnesota Supreme Court.

In *West Publishing*, West purchased computer equipment for expansion of its WESTLAW computerized legal research service and applied for a sales tax refund. The department denied the claim on the grounds that West was not manufacturing tangible personal property

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[7]See Appendix A for a chronology of the court cases that includes dates and specific citations.

with the purchased equipment. The tax court found for West; the Supreme Court affirmed in an evenly split (3-3) decision with no written opinion.

*Cowles Media* involved the issue of replacement equipment. The Minneapolis Star Tribune Company purchased equipment to use in printing its newspaper. The commissioner denied part of the refund claim because he considered the equipment to be replacement equipment, which is not eligible for a refund. The tax court held that the equipment that replaced existing equipment did not qualify as an expansion. Cowles did not appeal.

The replacement issue was revisited in the *Northern States Power* case. In this case, NSP purchased equipment to generate electricity in its Riverside and Blackdog plants and then applied for a refund of the sales tax paid on the equipment. The department denied the claim on the grounds the equipment replaced equipment performing substantially the same function in an existing facility. The tax court held for NSP. The Minnesota Supreme Court affirmed the tax court decision, holding that the new equipment expanded the production capacity of the facilities, even though it replaced old equipment performing the same function. In other words, replacement equipment could qualify for the capital equipment sales tax refund if it significantly expanded production capacity.

In *Potlatch*, the sole issue before the tax court was whether the capital equipment refund should be computed at 2 percent or the entire 6 percent tax rate. The Court had to interpret the 1989 law change providing that the 6 percent refund was applicable to sales after September 30, 1989, but that it did not apply to sales made under bona fide contracts that were enforceable before October 1, 1989. Most of the taxpayer's purchase orders were entered into before October 1, 1989. The tax court found that the taxpayer's contracts were enforceable before the effective date and thus not eligible for the 6 percent refund. Potlatch did not appeal.

The case of *Donaldson Corporation v. Commissioner of Revenue* is currently pending before the Minnesota Tax Court. The main issue in this case is whether the purchased equipment is replacement equipment.

## Administrative Rulemaking

### *The Department's Proposed Rule*

The Department of Revenue first issued a fact sheet in July 1984 indicating its position on the capital equipment exemption statute. The process of developing the administrative rule started in the fall of 1989 when the Department of Revenue began rewriting all of the sales tax rules.[8] On January 16, 1990, the *State Register* published a Notice of Intent to Solicit Outside Opinion regarding the taxation of capital equipment.

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[8]See Appendix A for a chronology with specific dates.

On January 8, 1991, the department informally circulated an initial draft of the proposed capital equipment rule. Several companies and individuals responded to the department's request for comments. Members of the Minnesota Bar Association's Sales and Use Tax Subcommittee drafted a number of individual comments which were sent to the department by Subcommittee Chairperson, Jerome Geis, with his summary dated February 4, 1991.

On September 8, 1992, the *State Register* published the final proposed rule, along with a notice of hearing. The hearing was held October 15, 1992 at the Department of Revenue with administrative law judge, Jon Lunde, presiding. This hearing consisted mainly of testimony by interested parties, such as the Tax Section of the Minnesota Bar Association, various tax attorneys and accountants, and persons representing individual taxpayers in different industries. Based on this testimony, the rule-making record (proposed rule, statement of need and reasonableness, various correspondence relating to the proposed rule), and applicable statutory and case law, the judge issued his findings on December 30, 1992. Chief administration law judge William Brown approved and issued the final report on December 31, 1992.

*Administrative Law Judge (ALJ) Ruling*

The administrative law judge's report found a number of provisions of the proposed capital equipment exemption rule to be in substantial violation of the law, and therefore defective. The defects he found related to:

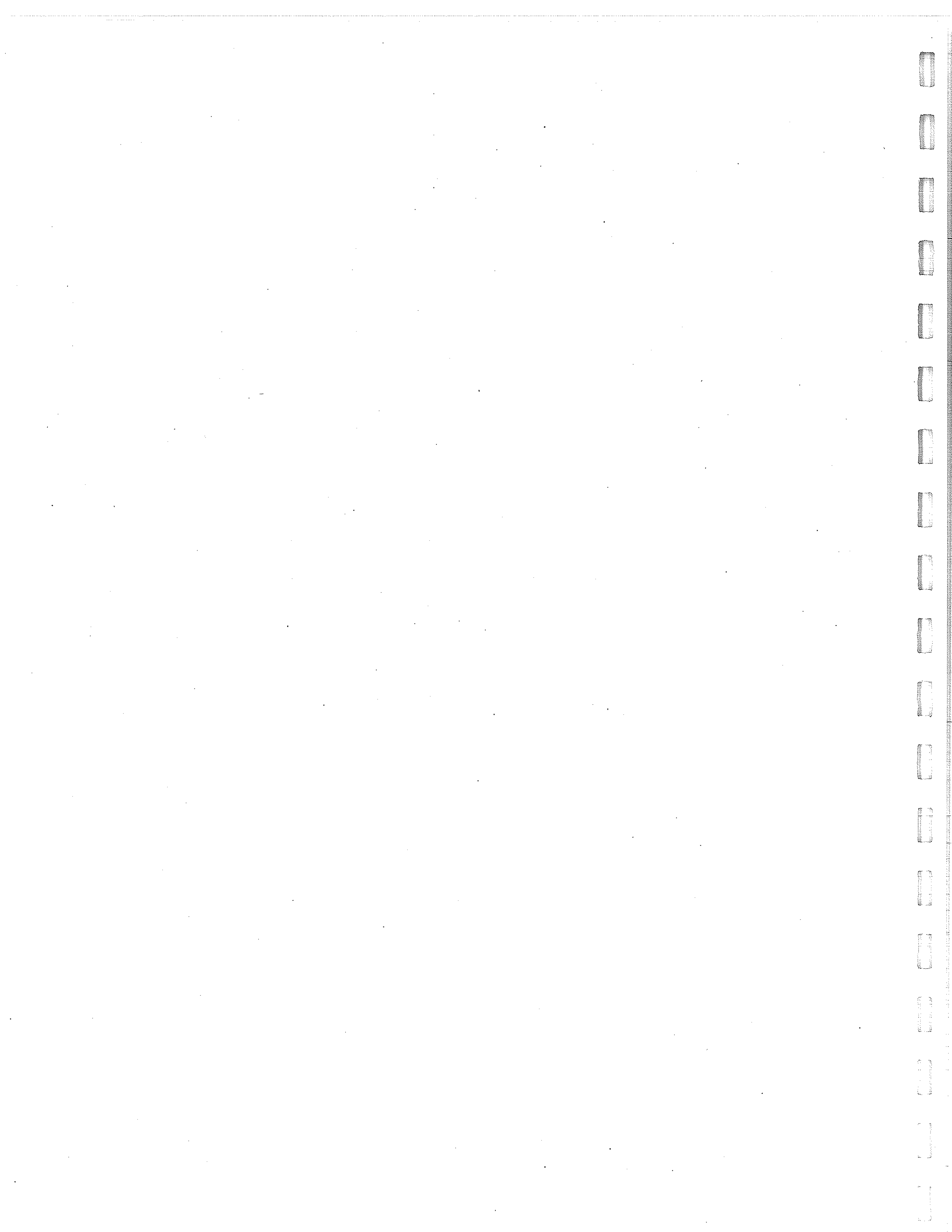
- the department's position regarding what "used in manufacturing..." means;
- the treatment of legally required pollution control equipment, and safety devices and environmental control devices;
- the definition of "product" which the ALJ concluded must include intangible manufactured products;
- what "the replacement of equipment performing substantially the same function" means; and
- the definition of "replacement parts."

Two of the findings related only to whether the portion of the rule was needed and reasonable. Judge Lunde found that including logging in the list of non-manufacturing businesses was not reasonable. He also found that excluding all foundations from the definition of machinery and equipment was not reasonable. The ALJ's adverse finding are summarized in more detail in Appendix B.

*Department of Revenue Response*

Under the administrative procedures act, defects due to substantial violations of the law must be corrected or the rule withdrawn.[9] In light of several of the report's adverse findings and required modifications, which if followed could have lead to a significant fiscal loss to the State of Minnesota, Commissioner Morris Anderson withdrew the rule and sought guidance and clarification from the legislature. The *State Register* published the notice of withdrawal February 1, 1993.

[9]Minnesota Rules 1400.1200, subpart 3



# Chapter 3

## Other States' Sales Taxation of Capital Equipment

**Other states' taxation of capital equipment is an important factor in considering whether Minnesota should expand its sales tax exemption for capital equipment.**

The Minnesota economy is an open economy -- labor, capital, goods, and services flow freely across its borders to and from other states. Thus, the state must compete with locations in other states for new capital investment, as well as to retain existing facilities. Minnesota's relative tax treatment of capital, including the sales tax on equipment, can affect its success in this competition.

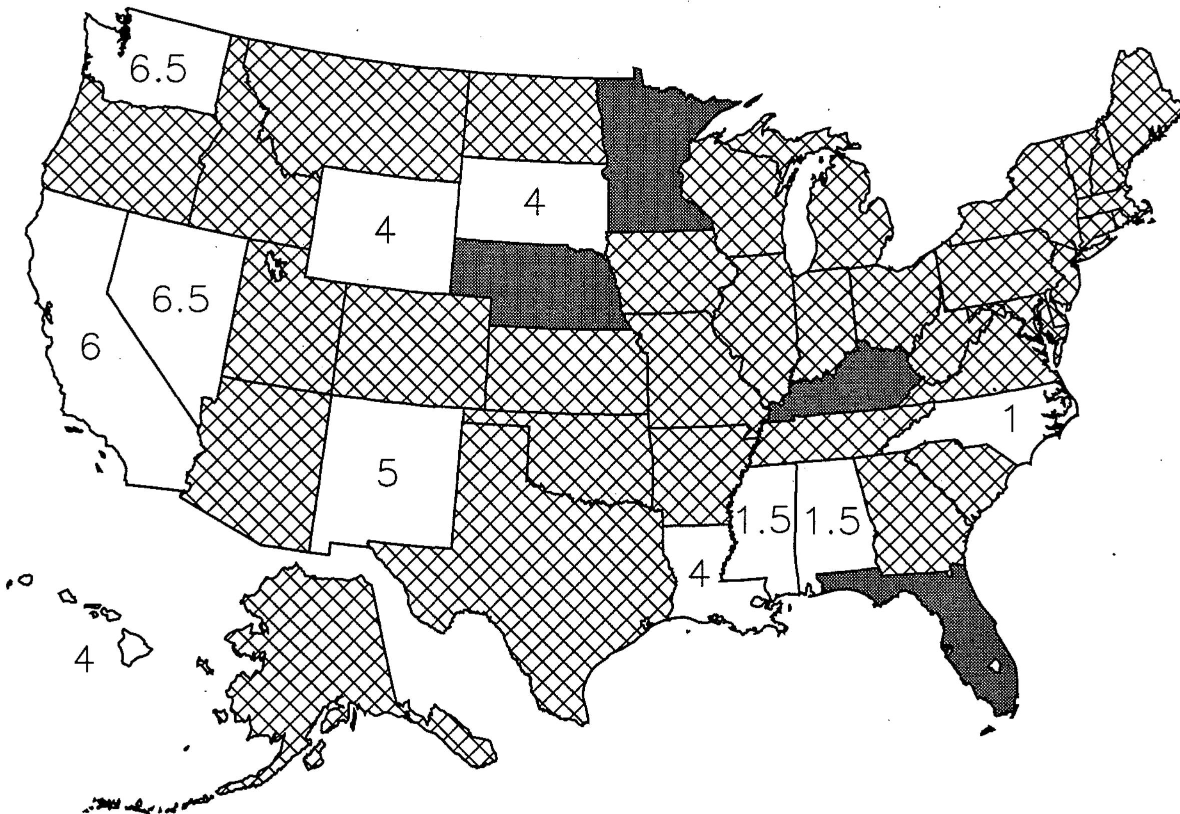
In general, capital is mobile. Land, of course, is fixed and cannot be moved, no matter the tax or business climate. However, the owners of other forms of capital can move to the location that provides the highest return on investment. With improvements in communications, other technological advances, and increased transportation efficiencies the mobility of capital is perhaps greater than ever. Businesses are more able now to locate or relocate plants and other facilities to take advantage of production efficiencies, a better labor force, access to markets, or a better tax climate -- whatever will increase their return on investment. Economic theory and practical evidence suggests that capital investment will move to locations that increase the return on investment.

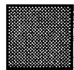
Tax factors, such the sales tax on capital equipment, can and will affect these location and investment decisions. If Minnesota imposes a heavier burden of sales taxation on equipment purchases than other states, the state will be at a disadvantage in competing for capital investment. Other factors (e.g., higher quality or less expensive labor, better public capital or services, access to markets, or other tax factors) will be needed to offset the disadvantage of the sales tax on capital equipment.

**Most states exempt manufacturers' purchases of capital equipment from sales tax. Minnesota's taxation of replacement equipment deviates from this practice and is imposed at a relatively high rate of 6.5 percent.**

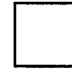
Thirty-eight states, including Minnesota, exempt equipment purchases for new and expanding manufacturing facilities or do not impose a sales tax. Of the 12 states that impose sales tax on this equipment, three impose rates of 1.5 percent or less. Table 2 and the map of the United States show the exemptions and tax rates.

# Sales Taxation Exemptions for Capital Equipment





New and expansion equipment only

New, expansion, and replacement equipment


No exemption (rate shown)

For state investment credit, see Table 2

House Research Graphics

Thirty-five states, excluding Minnesota, exempt replacement equipment for manufacturing facilities. Of the 14 states that impose taxes on this equipment, three (Alabama, Mississippi, and North Carolina) impose special low sales tax rates of 1.5 percent or less. Minnesota's 6.5 percent rate is tied with Nevada and Washington for the highest rate of tax on capital equipment.

Of Minnesota's adjoining states, all but South Dakota exempt both new and expanding and replacement capital equipment from the sales tax. South Dakota imposes a 4 percent sales tax rate and has no general exemption for manufacturing capital equipment. South Dakota does refund the sales tax on equipment and building materials for manufacturing projects with expenditures over $60 million, and provides partial refunds for projects with expenditures between $20 and $60 million.

**Minnesota's property tax exemption for equipment does provide an advantage relative to many states that impose a personal property tax. However, three surrounding states, Illinois, Wisconsin, and North Dakota, impose neither a sales nor personal property tax on manufacturing capital equipment.**

Many of the states with sales tax exemptions for manufacturing equipment impose property taxes on this equipment. In fact, nine states impose both a personal property tax and sales tax on capital equipment.[10] Minnesota exempts manufacturing equipment and inventories from property taxation which provides some equalization of its disadvantageous sales taxation of equipment.

However, several of Minnesota's neighboring states provide both personal property and sales tax exemptions for manufacturing equipment. Illinois, North Dakota, and Wisconsin have both exemptions.[11] Although South Dakota imposes its 4 percent sales tax on capital equipment, it exempts manufacturing equipment from property taxation and has the additional attraction to capital of no corporate franchise or individual income taxes and a sales tax refund for certain large projects. These neighboring states are likely to be Minnesota's principal competitors for significant capital investment, particularly when transportation or market access factors are important. The sales and personal property taxation are displayed in the map of the five state area.

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[10]Most of these states' situations can be explained by other offsetting factors. Three states impose their sales taxes at reduced rates (Alabama, 1.5%, Mississippi, 1.5%, and North Carolina, 1%). California has an investment tax credit that comes close to offsetting the sales tax for businesses with franchise tax liability. Nevada, Texas, Washington, and Wyoming impose no individual income tax. New Mexico allows a credit against its gross receipts (sales) tax for manufacturing equipment purchases in certain situations. Thus, Louisiana is the only state that imposes both personal property and sales taxes on capital equipment with no readily apparent offsetting factor.

[11]In fact, only one other state in the nation, New York, has both exemptions.

**The readily available evidence on Minnesota's tax treatment of capital equipment, relative to other states, makes a good case for further reduction of Minnesota sales tax of capital equipment.**

To accurately determine Minnesota's competitiveness in attracting and retaining capital investment, one would need to compare all relevant factors that affect production costs, both tax and nontax, across many industries and types of facilities. Such an effort is beyond the scope of the Council's time or resources. However, a general comparison of Minnesota's tax treatment of capital investment with other states suggests Minnesota taxes capital somewhat more heavily than other states, particularly its surrounding states. If this is so, Minnesota will need to rely on other factors to offset this disadvantageous tax treatment. This suggests that Minnesota could improve its competitiveness in attracting new capital and retaining existing investment by restructuring its tax system to shift more of the tax burden from capital to consumption. Exempting additional capital equipment from sales taxation and offsetting the reduction by expanding the tax to untaxed consumption would achieve this effect.[12]

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[12]The same effect could be achieved by reducing government spending on items that are not capital in nature.

## Table 2
## Sales Tax Treatment of Business Equipment -- Other States

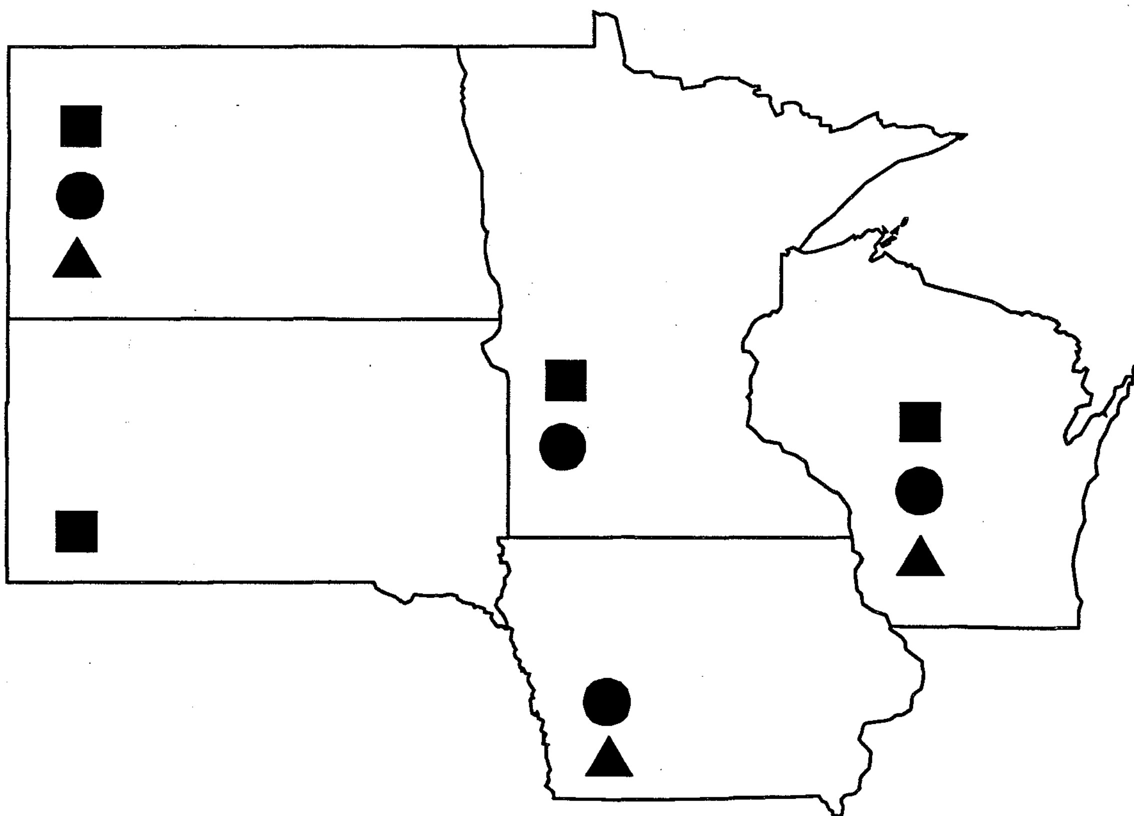
| State | State Sales Tax Rate* | Sales Tax Rate on Manufacturing Equipment | | Pollution Control Equipment | Property Tax on Equipment | | Business Investment Tax Credits |
|---|---|---|---|---|---|---|---|
| | | New/expand. | Replace. | | Industrial | Nonindustrial | |
| Alabama | 4% | 1.5% | 1.5% | Exempt | Taxable | Taxable | Enterprise zones |
| Arizona | 5% | Exempt | Exempt | Taxable | Taxable | Taxable | Enterprise zone; jobs credits |
| Arkansas | 4.5% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones |
| California | 6% | 6%(1) | 6% | Taxable | Taxable | Taxable | New jobs credits; enterprise zones; general 6% investment tax credit |
| Colorado | 3% | Exempt | Exempt | Taxable | Taxable | Taxable | Enterprise zones; new bus. facility credit; research and experimental credit |
| Connecticut | 6% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones; new facility credit |
| Florida | 6% | Exempt | 6% | Mostly taxable | Taxable | Taxable | Enterprise zones |
| Georgia | 4% | Exempt | Exempt | Exempt | Taxable | Taxable | New jobs credits in less-developed areas |
| Hawaii | 4% | 4% | 4% | Exempt | Exempt | Exempt | Enterprise zones; new jobs credits |
| Idaho | 5% | Exempt | Exempt | Exempt if required by law | Taxable | Taxable | Jobs expansion and capital investment credits |
| Illinois | 6% | Exempt | Exempt | Exempt | Exempt | Exempt | Investment, new jobs, and personal property replacement credits |
| Indiana | 5% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones; research credit; credit for varying percentages of Indiana gross receipts |
| Iowa | 5% | Exempt | Exempt | Exempt | Taxable | Exempt | New jobs credit; seed capital credit |
| Kansas | 4.9% | Exempt | Exempt | Taxable | Taxable | Taxable | Enterprise zones; venture capital and R&D credits |
| Kentucky | 6% | Exempt | 6% | Exempt | Taxable | Taxable | New jobs and venture; capital credits |
| Louisiana | 4% | 4% | 4% | Taxable | Taxable | Taxable | Enterprise zones; new jobs and new facility credits |
| Maine | 6% | Exempt | Exempt | Mostly exempt | Taxable | Taxable | Jobs and investment credits; seed capital credit |
| Maryland | 5% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones |
| Massachusetts | 5% | Exempt | Exempt | Taxable | Taxable | Taxable | Enterprise zones; investment tax credit for manufacturers; R&D credit |
| Michigan | 4% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones; small business and central city high tech credits; minority venture capital credit |
| MINNESOTA | 6.5% | Exempt | 6.5% | Taxable | Exempt | Exempt | Enterprise zones; corporate R&D credit |
| Mississippi | 7% | 1.5% | 1.5% | Taxed at 1.5% | Taxable | Taxable | Enterprise zones; jobs, R&D and corporate headquarters credit |
| Missouri | 4.225% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones; new bus. facility credit; seed capital credit |
| Nebraska | 5% | Exempt | 5% | Exempt | Taxable | Taxable | Employment expansion and investment credits |
| Nevada | 6.5% | 6.5% | 6.5% | Taxable | Taxable | Taxable | None |
| New Jersey | 6% | Exempt | Exempt | Exempt | Taxable | Taxable | Urban enterprise zones; urban development zones |

| State | State Sales Tax Rate* | Sales Tax Rate on Manufacturing Equipment | | Pollution Control Equipment | Property Tax on Equipment | | Business Investment Tax Credits |
|---|---|---|---|---|---|---|---|
| | | New/expand. | Replace. | | Industrial | Nonindustrial | |
| New Mexico | 5% | Taxable | Taxable | Taxable | Taxable | Taxable | Credits for sales tax on mfg. equipment under certain conditions |
| New York | 4% | Exempt | Exempt | Taxable | Exempt | Exempt | Business facility, investment, and employment expansion credits; economic development zones; credit for sales tax paid on pollution control equipment |
| North Carolina | 4% | 1% | 1% | Taxed at 1%(2) | Taxable | Taxable | North Carolina enterprise credit; new jobs in distressed counties credit |
| North Dakota | 5% | Exempt | Mostly exempt | Taxable | Exempt | Exempt | New industries credit; research experimental expenditure credits |
| Ohio | 5% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones; urban jobs credit; refiners' property tax credit |
| Oklahoma | 4.5% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones; investment credit; venture capital credit |
| Pennsylvania | 6% | Exempt | Exempt | Exempt | Taxable | Taxable | Economic revitalization and employment incentives credits |
| Rhode Island | 7% | Exempt | Exempt | Exempt | Taxable | Taxable | Investment credit |
| South Carolina | 5% | Exempt | Exempt | Exempt | Taxable | Taxable | New jobs, corporate headquarters and infrastructure credits |
| South Dakota | 4% | 4%(3) | 4%(3) | Taxable | Mostly exempt | Exempt | N/A |
| Tennessee | 6% | Exempt | Exempt | Taxable | Taxable | Taxable | Industrial machinery; investment credit |
| Texas | 6.25% | Exempt(4) | Exempt(4) | Mostly taxable | Taxable | Taxable | N/A |
| Utah | 5% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones |
| Vermont | 5% | Exempt | Exempt | Taxable | Taxable | Taxable | Jobs development and new jobs credits; job development zones credit |
| Virginia | 3.5% | Exempt | Exempt | Exempt | Taxable | Taxable | Enterprise zones; telecommunications credit |
| Washington | 6.5% | 6.5% | 6.5% | Taxable | Taxable | Taxable | N/A |
| West Virginia | 6% | Exempt | Exempt | Exempt | Taxable | Taxable | R&D and jobs expansion credits; business investment and corporate relocation credits |
| Wisconsin | 5% | Exempt | Exempt | Exempt | Mostly exempt | Taxable | Development zones |
| Wyoming | 4% | 4% | 4% | Taxable | Taxable | Taxable | N/A |

* Local Sales taxes also apply in most states.
(1) Exemption for start-up businesses.
(2) Maximum tax of $80 per piece of equipment
(3) Refund of sales tax on equipment and construction materials is provided for projects with expenditures of $60 million or more; 67% refund for projects between $40 and $60 million; 33% refund for projects between $20 and $40 million.
(4) Complete exemption being phased in from 1990 through 1994. State rate in 1993 is 3.125%.

Sources: Raabe, William A. and Boucher, Karen J., 1992 Multistate Corporate Tax Guide; Maxwell Macmillan, State and Local Taxes: Sales & Use Taxes (looseleaf service); Commerce Clearing House, State Tax Review, 1993 table of state gasoline, sales, and cigarette tax rate; Federation of Tax Administrators, Sales Taxation of Services: Who Taxes What?, April 1991; Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, Vol. 1, February 1993; information provided directly by state tax departments.

# Tax Exemptions for Manufacturing Equipment



■ Personal property tax exemption

● Sales tax exemption for new and expansion

▲ Sales tax exemption for replacement

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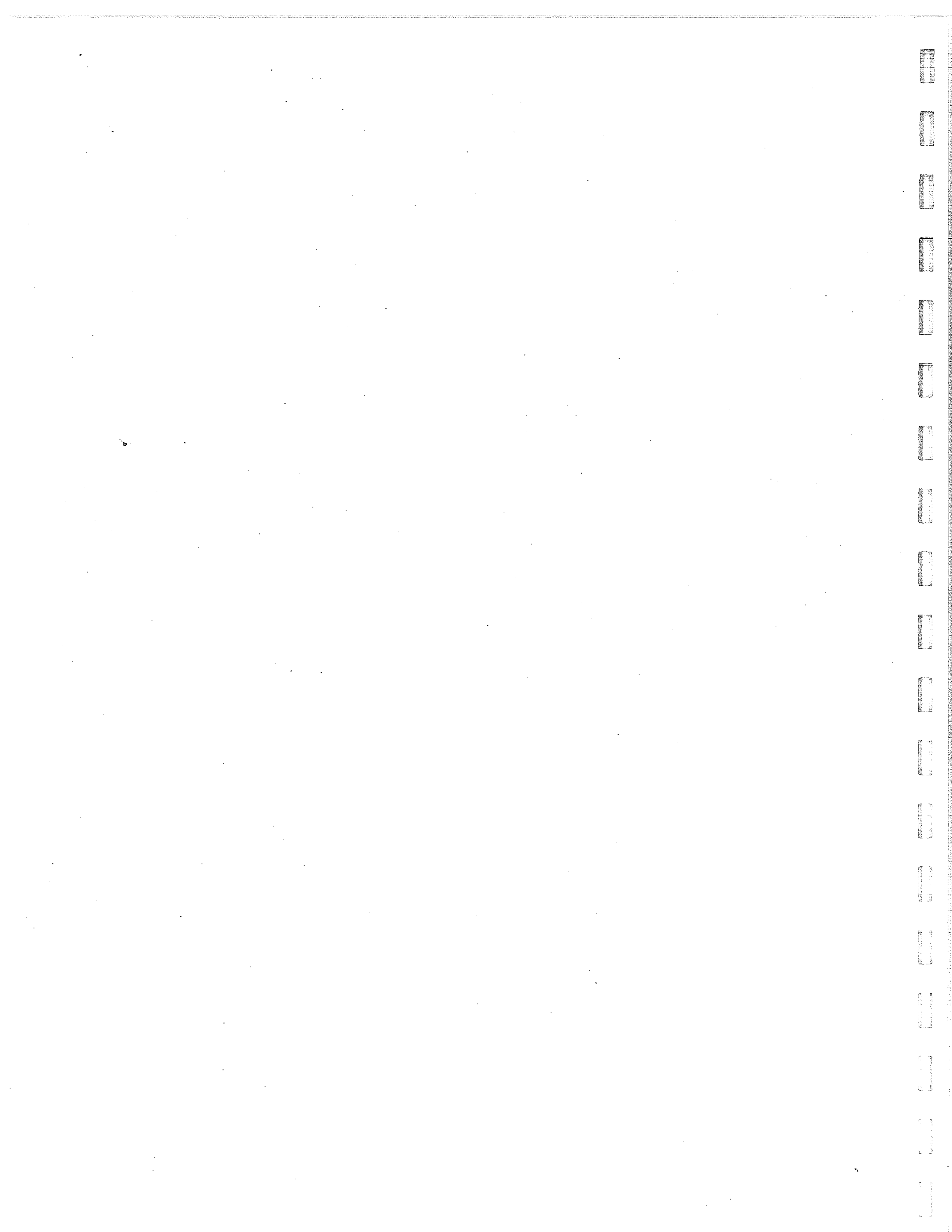

# Chapter 4

## Economic Impacts of Expanding the Sales Tax Exemption

### Introduction

An important rationale for reducing the sales tax on business purchases of machinery and equipment is to increase the level of new investment in Minnesota. Higher levels of equipment investment are expected to expand employment, increase the value added per worker and result in higher incomes for Minnesota residents. The higher level of economic activity would also generate higher tax revenues for state and local governments.

In practice, no attempt is made to quantify the economic impact of tax incentive proposals on the level of state economic activity when evaluating legislative proposals. There are several important reasons for not estimating such feedback effects. First, there is little agreement on the magnitude of behavioral responses by firms to tax incentives. The fundamental problem is distinguishing between investments which would have been made otherwise and new investments due to the incentive. Second, even if the behavioral responses to investment incentives were known with certainty, it is extremely difficult to model the secondary effects which spread out from the initial response to all sectors of the state's economy (the multiplier effect), as well as to economic activity in other states. Finally, any reduction in state revenues due to the new tax incentive would have to be paid for through increases in other taxes or reductions in state spending. It is the combined effect of all of these changes which has to be simulated to identify the net impact of the proposal on the state's economy and the state budget.

While recognizing the challenges and limitations to estimating the economic impacts of tax incentive proposals, the Advisory Council asked staff to use available state economic and revenue forecasting models to try to measure the economic impact and revenue feedback effects from expanding the sales tax exemption for capital equipment. A Minnesota economic forecasting model developed by Regional Economic Models, Inc. (REMI) was used to simulate the expected impact of a balanced budget proposal expanding the capital equipment exemption. This model has been used by a number of state agencies over the past decade for policy analysis.[13]

[13]The REMI model is described in detail in George I. Treyz, *Regional Economic Modeling*, Kluwer Academic Publishers, 1993.

## Balanced Budget Package

The components of the expanded sales tax exemption are described in detail in Chapter 5. The Advisory Council recommendations include extending the exemption to (1) replacement equipment, parts and accessories, special tooling, and replacement/enhancement software, (2) pollution control equipment, (3) contractor purchased and installed equipment, and (4) purchases of computers and software. These recommendations apply to purchases by industries qualifying for the current refund program.

In the economic simulation the static revenue loss is offset by a general tax increase on consumer expenditures. This is modeled as a reduction in the real purchasing power or spendable income of Minnesota consumers. The expansion of the sales tax exemption is modeled as an investment tax credit for qualifying equipment purchased by businesses currently qualifying for the sales tax exemption.

The balanced budget package was incorporated into the REMI simulation model as a $150 million business cost reduction beginning in calendar year 1995 offset by an equal increase in consumption taxes in the same year. The simulation did not attempt to model the specific revenue-raising recommendations outlined in Chapter 5 which may differ in economic impact from a consumption tax increase. In addition, the simulation does not attempt to adjust for any one-time revenue shifts or phase-in effects of beginning the exemptions on July 1, 1994.[14]

## Methodology

The REMI model uses an input-output structure to identify the complex interactions among Minnesota industries. Aggregate demand equations for consumption, investment, government spending and exports from Minnesota determine overall spending on Minnesota output. A key feature of the model is a set of equations which determine the shares of Minnesota and U.S. purchases supplied by Minnesota firms. These shares respond to relative business costs in Minnesota, including the cost of capital.

The expansion of the sales tax exemption in the REMI model is treated as an investment tax credit (ITC) which directly reduces the cost of investing in machinery and equipment. If all machinery and equipment qualified for the ITC, the effective ITC rate in the manufacturing sector would be 6.5 percent. The economic simulation uses an ITC rate of 4.63 percent. This is less than the 6.5 percent rate to account for the share of manufacturing machinery and equipment that is not used directly in production and the portion that currently qualifies for exemption as new or expanding equipment. (The rate was adjusted upwards to account for several smaller pieces of the Advisory Council recommendations, e.g., software, that were not directly related to capital spending.)

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[14]The estimate of the full static revenue loss of the exemption proposal for fiscal year 1995 is $167 million, including a one-time revenue cost of $13 million.

Because the ITC rate in the REMI model applies to all sectors, an adjustment was needed to offset the ITC change for non-manufacturing industries. This was accomplished by increasing the corporate tax rate in non-manufacturing sectors so that the relative cost of capital in these sectors remained unchanged.

As mentioned earlier, the revenue increase to offset the cost of expanding the capital equipment exemption is modeled as an across-the-board increase in taxes on consumption expenditures. The tax increase borne by Minnesota residents enters the model as an increase in the consumer price index which reduces consumers' spendable income. The model simulation compares the current-law economic forecast through 1999 with the new economic levels after imposing the balanced budget changes. The difference in forecasts is summarized in Table 3.

## Economic Impact

The economic simulation is designed to show the private and public sector impacts of the balanced budget package. The package is "balanced" in the sense that the static revenue gains and losses to the state budget are equal in the initial year of the simulation. However, the tax changes result in a shift in taxes from business purchases of capital equipment to consumer expenditures. This shift leads to higher levels of investment in machinery and equipment and lower levels of consumer spending in the Minnesota economy.

According to the REMI Model Simulation, the structural change in the state sales tax will result in increased Minnesota employment, economic activity and personal income over time. While the private sector will receive most of the economic benefits, the higher level of economic activity will also generate a positive feedback in the form of higher state and local tax revenues.

It is important to note that the simulation of the impact of the balanced budget package assumes that there is no simultaneous change in the tax structures or cost of capital in other states. If other states are lowering the cost of capital through expanded tax incentives at the same time, the simulation would overstate the stimulative impact of the proposal.

As shown in Table 3, total employment in Minnesota is projected to increase by 2,680 jobs in 1999 due to the tax changes. Personal income would be $169 million higher in 1999, an increase of one-tenth of one percent over the baseline forecast.

### Revenue Feedback

As shown in Table 3, the increase in personal income would generate additional state revenues of $13 million a year by 1999. This positive feedback would offset 5 to 6 percent of the static revenue loss from the exemption for fiscal years 1995 to 1997. Although the additional capital equipment purchased in response to the investment incentive would not be subject to property taxes, local governments' property and sales taxes may also increase due

to the positive economic feedback. No attempt was made to estimate any indirect impact on local government revenues.

**Table 3**
**REMI Simulation of Sales Tax Exemption Package**
**($ Changes in Millions)**

| | Calendar Year | | | | |
|---|---|---|---|---|---|
| | **1995** | **1996** | **1997** | **1998** | **1999** |
| Gross State Product | $81 | $155 | $214 | $267 | $315 |
| Personal Income | $33 | $ 89 | $120 | $147 | $169 |
| State Taxes | $ 3 | $ 8 | $ 10 | $ 12 | $ 13 |
| Employment | | | | | |
| Manufacturing | 543 | 828 | 997 | 1,100 | 1,154 |
| Non-manufacturing | 155 | 872 | 1,184 | 1,393 | 1,526 |
| Total New Jobs | 698 | 1,700 | 2,181 | 2,493 | 2,680 |

# Chapter 5

## Recommendations of the Advisory Council

This chapter contains the Advisory Council's recommendations to the 1994 Legislature. The recommendations are based on the Council's deliberations and public testimony presented at the Council's hearings, written materials submitted by interested parties, and staff presentations and analyses.

The recommendations are divided into recommendations for expanding the sales tax exemption for capital equipment and, as required by the enabling legislation, recommendations for provisions to offset the revenues lost by expanding the exemption. Each recommendation contains (1) a description of the recommended changes, (2) a revenue estimate, prepared by the Department of Revenue, and (3) a statement of the rationale for the proposed change.

The recommendations are listed in the Council's order of priority with Recommendation 1 having the highest priority and so forth. In addition, this chapter contains a final recommendation urging a long run restructuring of the sales tax. The Council's sales tax recommendations drafted as legislative bill language are contained in Appendix G.

In making these recommendations, the Advisory Council was guided by

- the tax policy principles outlined in chapter 1,
- evidence that reducing the taxation of capital is important to ensure the competitiveness of Minnesota as a location for manufacturers as discussed in chapter 3, and
- Department of Revenue analyses that show that reducing the sales tax on capital equipment will stimulate economic growth and increase the overall wealth and economic well being of Minnesotans, as described in chapter 4.

## Recommendations to Expand the Exemption

### Recommendation 1: Exempt replacement equipment, parts, and accessories and convert the refund to an exemption.

**Description of Proposal**

The Council recommends expanding the exemption to include all machinery and equipment that is purchased to replace machinery and equipment used for a qualifying purpose. It will no longer be necessary to determine whether the replacement equipment is performing a substantially different function or producing a different end product. The replacement equipment does not have to:

- Be faster, more efficient or increase production capacity
- Result in a physical expansion of the facility
- Meet a "bright-line" test for capacity expansion
- Replace obsolescent, damaged or worn out equipment

**Parts and accessories.** All repair parts that are used to restore a qualifying piece of machinery or equipment to working condition would qualify as capital equipment. All accessories added to qualifying machinery or equipment would qualify as capital equipment. Accessories are items that work in conjunction with a piece of machinery or equipment and that enhance the performance of the basic machine.

**Special tooling.** Special tooling which includes dies, patterns, gauges and other tooling which have value and use only to the purchaser would qualify as capital equipment when used in qualifying activities.

**Software.** Under current law, software which was purchased with or prior to placing qualifying machinery or equipment into service was treated as part of the machinery or equipment if the software was essential to control, regulate or operate the qualifying equipment. All software purchased to replace or enhance existing software for qualifying equipment would now qualify as capital equipment under the proposal.

**Foundations and special purpose buildings.** Under current law, building materials used for foundations to support machinery are taxable, as are special purpose buildings used for production processes. These foundations for qualifying equipment, the special purpose buildings, and the building materials used to construct them would be exempt.

## Revenue Estimate

| | Revenue Loss in Millions |
|---|---|
| FY 1995 | $98 |
| FY 1996 | $89 |
| FY 1997 | $94 |
| Biennium | $183 |

Note: The FY 1995 estimate includes a $13 million one-time cost of converting from a refund to an exemption.

## Rationale

**Expanding the capital equipment exemption to replacement equipment and parts will simplify the tax and reduce compliance and administration problems.** Problems with interpreting definitions, such as equipment versus parts and expansion versus replacement equipment, would be significantly reduced. Eliminating these two distinctions will make the tax easier for taxpayers to comply with and for the department to administer. This is an important reason for expanding the exemption to replacement equipment, parts and accessories. The distinction between equipment used in a new or expanded facility, compared with replacement equipment is one of the most difficult for the department, taxpayers, and the courts to apply. Exempting replacement equipment would eliminate the need to develop bright line tests to distinguish replacement and expansion equipment. The expanded exemption would generally make it easier to administer the exemption at the time of sale, rather than a refund.

**Exempting replacement equipment, parts, and accessories from sales tax would improve efficiency.** This exemption would reduce distortion in individual business production decisions because it would remove a bias against upgrading and replacing older, less efficient equipment. It would also reduce the bias toward vertical integration which makes smaller firms less competitive with larger firms.

**Exempting replacement capital equipment will make Minnesota a more attractive location in the competition for investment of mobile capital.** Most states, including all of Minnesota's adjoining states except South Dakota, exempt replacement capital equipment from sales taxation. Available evidence suggests that Minnesota's overall tax on capital is higher than the national average. The sales tax on replacement manufacturing equipment contributes to this higher than average capital tax. Reducing the tax will make Minnesota a more attractive place for new investment, reinvestment, and retention of capital facilities. Not only will new investment make Minnesota workers and businesses more productive, but it may be essential to retain the mobile portion of Minnesota's existing business base. This exemption will primarily benefit Minnesota workers and consumers, since capital owners can

mostly avoid the tax either by locating new investments outside of Minnesota or by passing it along to consumers in higher prices or to their workers in lower wages.

**Converting the refund to an up-front exemption would reduce administrative and compliance costs.** The refund structure for the capital equipment exemption was a product of legislative concerns over taxpayer application of complicated distinctions in the law (replacement versus expansion equipment, equipment versus parts, and so forth). If these distinctions can be eliminated, administrative and compliance cost could be saved by providing a traditional exemption. Most of the savings would come for eliminating these complicated and unclear legal distinctions. However, some savings will result from eliminating the refund process. Taxpayers would be relieved of paying the tax and filing refund applications that documented compliance with law. The Department of Revenue would not need to process and review these applications and mail checks to taxpayers. The department probably would need to increase its audit efforts somewhat, offsetting some of the administrative savings.

**The exemption would reduce the amount of hidden tax included in the price of final consumption goods.** Reducing taxes on this portion of business inputs would reduce tax pyramiding. The horizontal equity of the sales tax would be improved slightly. In addition, it would be easier to determine who actually pays the tax.

## Recommendation 2: Exempt pollution control equipment.

### Description of Proposal

Under this recommendation, machinery and equipment used by qualifying businesses to eliminate, prevent or reduce air, land, or water pollution that resulted from the production process would be treated as qualifying capital equipment. Pollution control equipment would not include buildings or structures housing such equipment or any equipment used within the interior of any building or structure primarily for the health, comfort, and safety of the employees. Pollution control equipment would not include equipment used to abate noise pollution generated by the production process.

Pollution control equipment would not include equipment used to control the environment within the manufacturing facility. Capital equipment currently includes environmental control equipment which is used to control atmospheric conditions such as temperature, lighting and air pressure when those conditions are essential to and are part of the production process.

Pollution control equipment will qualify as capital equipment even if it is not legally required in order to meet federal or state environmental standards.

**Revenue Estimate**

| Revenue Loss in Millions | |
|---|---|
| FY 1995 | $13 |
| FY 1996 | $15 |
| FY 1997 | $17 |
| Biennium | $32 |

**Rationale**

**Exempting pollution control equipment would simplify the tax and reduce compliance and administration problems.** Problems with the definition of "equipment necessary to production" would be reduced by this expansion. The problems with determining the tax treatment of equipment that performs pollution control as well as other functions would be eliminated.

**Exempting pollution control equipment would encourage spending in this area.** Pollution is an externality associated with some production. Encouraging businesses to reduce pollution output results in decreased external, social costs.

**By reducing the tax on capital, the exemption will make Minnesota a more attractive location for business investment.** See the discussion under recommendation 1.

**The exemption would reduce the amount of hidden tax included in the price of final consumption goods.** See the discussion under recommendation 1.

## Recommendation 3: Exempt contractor purchased and installed equipment.

**Description of Proposal**

The Council recommends expanding the exemption to include qualifying machinery and equipment, which was supplied and installed by a contractor. Under current law, qualifying capital equipment must be purchased by a qualifying business, since the law provides that the machinery or equipment *must be used by the purchaser* for a qualifying activity.

Under a "turn-key" construction contract, where the contractor both furnishes and installs the machinery and equipment, the transaction is treated under Minnesota law as a transfer of real property by the contractor to the manufacturer and neither the contractor nor the manufacturer qualifies for a capital equipment refund. The law would no longer distinguish between "user" and "purchaser" for purposes of the capital equipment exemption. The machinery or

equipment must be used for a qualifying activity but the law would no longer look at whether the contractor or manufacturer purchased the equipment.

**Revenue Estimate**

| | Revenue Loss in Millions |
|---|---|
| FY 1995 | $30 |
| FY 1996 | $31 |
| FY 1997 | $32 |
| Biennium | $63 |

**Rationale**

**Exempting contractor purchased and installed equipment from sales tax would improve efficiency.** This exemption would reduce distortion in individual business production decisions because it would remove a bias against different methods for purchasing equipment. It would make smaller firms, who may have more of a tendency toward contractor purchased equipment, more competitive with larger firms.

**This expansion of the capital equipment exemption would simplify this portion of the tax and reduce compliance problems.** As stated earlier in the report, significant confusion and hardship have resulted from imposition of the sales tax on contractor purchased equipment that otherwise would have qualified for the exemption or refund. Expanding the exemption for these purchases would reduce some of these problems. It would eliminate the incentive and necessity for manufacturers to structure installation and fabrication contracts in ways that enable them to qualify as purchasers.

It should be noted that if the exemption includes these purchases, it would be more difficult to administer this as an up-front sales tax exemption. This exemption would require auditing of contractor purchases to insure that the exemption is used appropriately.

**By reducing the tax on capital, the exemption will make Minnesota a more attractive location for business investment.** See the discussion under recommendation 1.

**The exemption would reduce the amount of hidden tax included in the price of final consumption goods.** See the discussion under recommendation 1.

## Recommendation 4: Exempt manufacturers' purchases of computers, peripheral equipment and software.

### Description of Proposal

Manufacturers' purchases of computers, peripheral equipment and non-custom (canned) software would be exempt. This exemption would apply to non-production hardware and software. (Production-related items are included in recommendations 1, 2, and 3.)

### Revenue Estimate

| | Revenue Loss in Millions |
|---|---|
| FY 1995 | $27 |
| FY 1996 | $31 |
| FY 1997 | $35 |
| Biennium | $66 |

### Rationale

**Exempting manufacturers' purchases of computers, peripheral devices, and software used outside the production process would improve efficiency.** This exemption could reduce distortions in manufacturers' purchasing decisions by removing the current sales tax bias which discourages upgrading and replacing older, less efficient equipment. Exempting business inputs beyond the production process would increase economic efficiency by minimizing interference in market or investment decisions.

**Enacting a manufacturers' sales tax exemption for non-production hardware and software would make Minnesota a more attractive location in the competition for mobile capital.** Minnesota would be one of only two states exempting computer equipment that is not directly involved in production. Eliminating the tax should make Minnesota a more attractive place for new investment and reinvestment in manufacturing headquarters and ancillary facilities. It would also help retain the mobile portion of Minnesota's existing business base.

**Expansion of the exemption would simplify the tax and reduce compliance and administrative problems.** Many computer systems are used for both production and administrative purposes. This exemption could significantly reduce compliance and administrative problems, as well as the expenses that go with them. It would no longer be necessary to distinguish between production and non-qualifying uses.

**The exemption would reduce the amount of hidden tax included in the price of final consumption goods.** See the discussion under recommendation 1.

The combined estimated effect of the recommendations to reduce revenues is summarized below. These are static revenue estimates of the cost of the exemption. They do not reflect dynamic or feedback effects as discussed in Chapter 4.

**Table 4**
**Revenue Estimate Summary for Recommendations Expanding the Exemption**
**(amounts in million)**

| Recommendation | FY95 | FY96 | FY97 | 1996-97 Biennium |
|---|---|---|---|---|
| #1 Replacement equipment, etc. | $98 | $89 | $94 | $183 |
| #2 Pollution control | 13 | 15 | 17 | 32 |
| #3 Contractor purchases | 30 | 31 | 32 | 63 |
| #4 Computer equipment | 27 | 31 | 35 | 66 |
| Total | $168 | $166 | $178 | $344 |

## Recommendations for Offsetting Revenues

## Recommendation 1: Update to the 1993 federal individual and corporate income tax rules.

### Description of Proposal

In the Omnibus Budget Reconciliation Act of 1993, Congress enacted a number of changes to the definitions of federal taxable income under the individual and corporate income taxes. Minnesota's individual income and corporate franchise taxes generally follow federal definitions of taxable income in determining taxable income. The Council recommends that the legislature conform to the federal changes adopted by Congress in 1993. No changes in the rates or brackets of the taxes should be made.

This recommendation will both expand and narrow taxable income in a variety of ways and modify other tax provisions, such as tax credits. The overall effect is to increase state revenues, as detailed below. The largest effects are to increase the amount of old age, survivors, and disability social security benefits that is subject to tax, to extend permanently the limit on itemized deductions, to limit the deduction for business meals and entertainment, to increase the amount of the earned income credit (the basis for Minnesota's Working Family Credit), and to allow expanded expensing of business equipment. A detailed itemization of the provisions with cost impact can be found in the Department of Revenue's Revenue Analysis in Appendix D.

**Revenue Estimate**

| General Fund Revenue Gain (Loss) in Millions | |
|---|---|
| FY 1994 | $(6.4) |
| FY 1995 | 35.4 |
| Biennium | $29.0 |
| FY 1996 | $37.9 |
| FY 1997 | 54.5 |
| Biennium | $92.4 |

A detailed revenue estimate is found in Appendix D.

**Rationale**

Minnesota's individual income and corporate franchise taxes are closely linked to their counterpart federal taxes. This linkage results in dramatic reductions in compliance costs for taxpayers and in lower administrative costs for the Department of Revenue. Since taxpayers must bear the cost of complying with federal law, the state can lower additional state compliance costs by closely following the federal rules. This linkage permits state taxes to be simpler and easier to understand. The Commission encourages the legislature to continue its recent practice of closely conforming to federal law.

Although the legislature could offset the projected increase in revenues by adjusting income tax brackets or rates, the Council recommends that the additional revenues from federal conformity be used to offset the reduced revenues resulting from expanding the sales tax exemption for capital equipment.

## Recommendation 2: Impose restrictions on tax increment financing.

**Description of Proposal**

The Council recommends that the legislature enact new restrictions on the use of tax increment financing (TIF) to yield savings in state costs to offset, in part, the cost of expanding the sales tax exemption for capital equipment. These new restrictions should take two forms: (1) limits on the creation of new economic development districts and (2) requiring the use of surplus tax increment revenues from any existing TIF districts to reimburse the state for the increased school aid costs from the aid formulas' exclusion of TIF values.

## Revenue Estimate

The estimated revenue will depend upon the specific limits imposed. However, the Council believes that the use of surplus TIF revenues to reimburse the state for its costs could save well in excess of $10 million per year for several years.

## Rationale

**The Council believes that a general exemption for purchases of manufacturing capital equipment is a more effective way of encouraging capital investment in Minnesota than the use of TIF.** One purpose of tax increment financing is to stimulate the location of new and expanded manufacturing facilities in Minnesota, one of the goals of an expanded sales tax exemption for capital equipment. At least three reasons suggest the capital equipment exemption is a more effective method of stimulating capital investment.

> **First, tax increment financing involves very high transaction costs, as compared with the capital equipment exemption.** Use of TIF requires city council approval. This requires the business to spend time (and perhaps hire lawyers and lobbyists) to convince the city that its proposal merits assistance. In addition, the complexity of TIF usually requires employing bond lawyers, fiscal consultants, and investment bankers to design the "deal." Some of TIF revenues also get diverted to pay for the cost of the local economic development staff and planners. These transaction costs can absorb more than 10 percent of the incentive provided. By contrast, the capital equipment exemption involves few, if any, of these high transaction costs.
>
> **Second, the benefits of the sales tax exemption are limited to equipment investment and available evidence suggests that equipment investment tends to be more mobile and, thus, more able to locate in other states.** By contrast, TIF focuses its incentives on reducing real estate taxes and, implicitly, investment in structures. Structures are more fixed and less mobile. Concentrating tax reductions on equipment is more likely to increase overall capital in the state than granting expanded benefits to real estate. In addition, some of the benefit of TIF undoubtedly "leaks" out to landowners (i.e., the receipt of or the expectation of receiving TIF is capitalized in higher land values). Land, of course, is the one form of captive capital. The benefits of this leakage are essentially lost; they do not work to attract new investment.
>
> **Third, available evidence suggests that the expanded equipment investment will yield larger productivity gains than investment in structures.** Reducing taxation of this form of capital seems more likely to yield economic benefits to the state, than TIF's focus on the property tax on structures. In addition, TIF simply cannot be used to attract much equipment investment by manufacturers because construction of new structures is not involved.

**The financial structure of TIF encourages cities to spend surplus increments on activities with low public-cost benefit ratios.** The tax price to cities of spending surplus TIF revenues can be as low as 25 percent of the nominal cost.[15] This financial structure encourages cities to spend TIF revenues on new activities, so long as the benefit to the city is higher than 25 percent of the actual cost. This is likely to lead to inefficient uses of public money. Because of this situation, the Council believes that the legislature should require some of these revenues to be repaid to cover school costs and to offset the state education aid.

## Recommendation 3: Use the budget surplus to cover the phase-in costs of expanding the exemption.

### Description of Proposal

The Council recommends using the budget surplus to pay two one-time costs of expanding the capital equipment exemption:

(1) the one-time cost of converting the refund to an exemption and

(2) the difference between the revenues raised by updating to the 1993 federal tax legislation in fiscal years 1995 and 1996 and the amount raised in later fiscal years, after the new income tax provisions are fully phased-in.

### Revenue Estimate

Converting the refund to an exemption will result in a one-time budget cost during the transition period until refunds for purchases made before the effective date of the exemption have been paid. This amount is estimated to be $13 million and will be incurred in fiscal year 1995.

Conforming to the 1993 federal tax will yield higher revenues in the 1996-97 biennium than in 1994-95, as the federal provisions are fully phased-in. Approximately $63.4 million more revenues will be received in 1996-97 biennium than in 1994-95 biennium.

The one-time costs to be funded through use of the surplus are summarized below.

[15]Put more concretely, the city has a fiscal choice of decertifying a district or spending the money on new activities. If it decertifies the district, 25 to 40 percent of the taxes paid by the former TIF property would lower property taxes on other properties in the city. The rest would benefit taxpayers outside of the city, but in the school and the county or the state budget through the school aid formula.

**Use of Surplus to Offset One-Time FY 1995 Costs ($ millions)**

| | |
|---|---|
| Conversion of refund to exemption | $13.0 |
| Federal update phase-in | 63.4 |
| Total | $76.4 |

**Rationale**

The most recent forecast of state revenues and expenditures shows a surplus after full funding of the budget and cash flow reserve. This surplus largely results from one-time events and should not be relied upon to fund a permanent reduction in the tax base, such as the proposed expansions of the capital equipment exemption. However, it is appropriate to allocate this money to one-time costs, such as the cost of converting the refund to an exemption and the lower yield of the federal update proposal before its full effect is phased-in.

## General Recommendation

### The legislature and administration should explore options for exempting business inputs from sales tax and broadening the range of final consumption purchases subject to the sales tax.

**Taxing business inputs, including capital equipment, violates most of the policy principles outlined in chapter 1 of this report.** In the long run the sales tax exemption should be expanded to include most intermediate inputs in all sectors of business, not just capital equipment used in manufacturing. Elimination of sales taxes on business inputs will decrease hidden taxes, decrease revenue instability, and increase economic efficiency.

**A good point to start expanding the exemption to non-manufacturers would be to exempt computers and related equipment.** Computer equipment is a good place to begin exempting purchases by non-manufacturers for five major reasons:

- This expansion of the capital equipment exemption would simplify the tax and reduce compliance and administration problems. Many computer systems are used for both production and administrative purposes. As such, this exemption could significantly reduce compliance and administration problems, as well as the expenses that go with them.

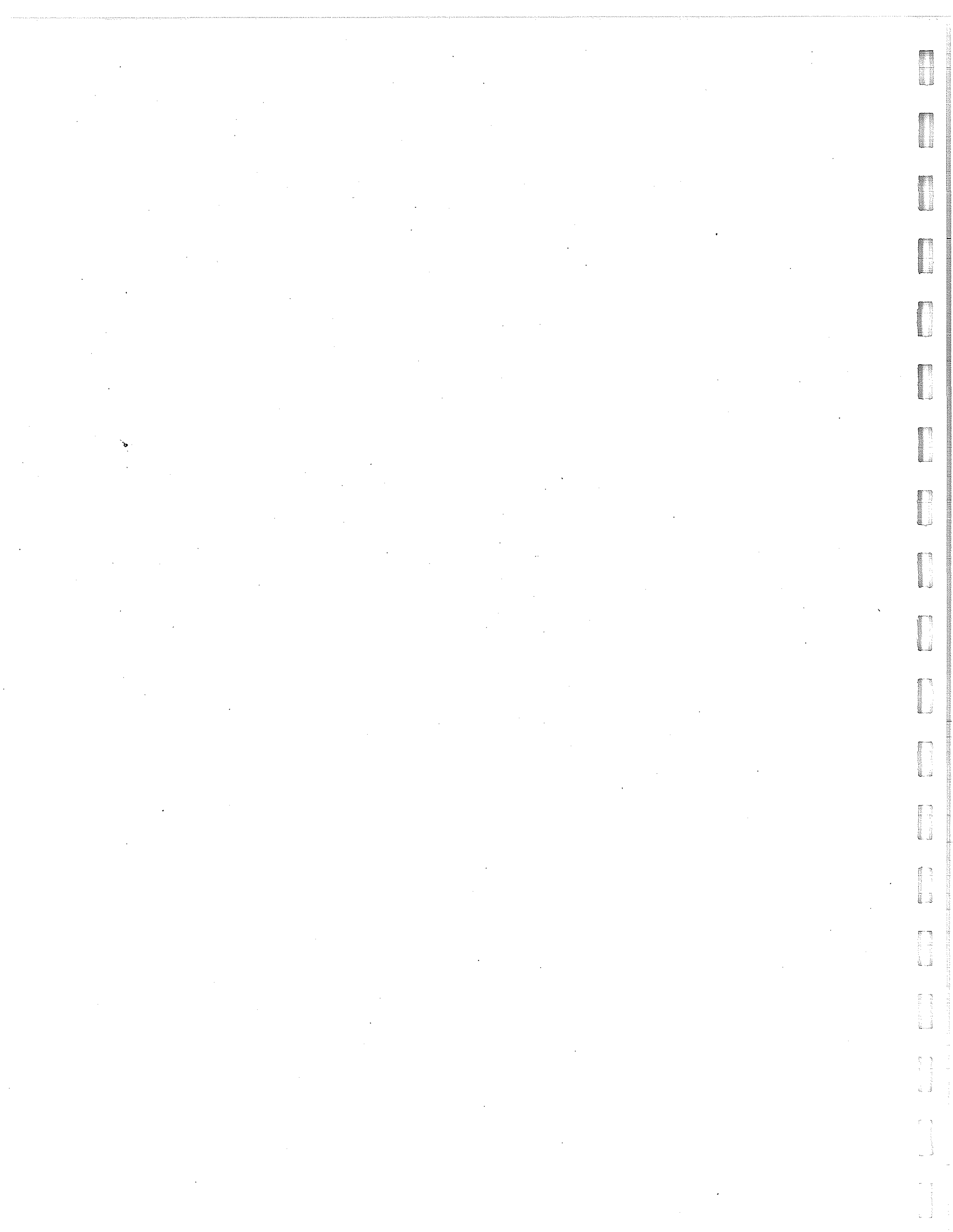
- All industries use computer equipment. In varying degrees, all will benefit from this exemption.

- Computer equipment is an important ingredient in our emerging information-driven economy. Minnesota is well positioned to benefit from the growth of information-intensive businesses because of our past experience designing, manufacturing, programming and operating computers. This exemption complements a significant trend in the development of our economy while building on existing expertise.

- This exemption will give Minnesota an advantage over other states. With one exception (Iowa), states with sales taxes tax the equipment purchases of non-manufacturers. Iowa exempts computer equipment from its sales tax.

- Minnesota communities, particularly those in greater Minnesota, can compete effectively for computer intensive non-manufacturing jobs. These businesses produce some type of service, such as data processing, financial management, and insurance claims processing. They ship their "product" through the telecommunications system. The cost of doing so is not affected by distance, especially so when compared with highway, rail, barge or air transportation. As such, Minnesota communities can frequently compete more effectively for these jobs than for many traditional manufacturing jobs. Furthermore, Minnesota needs these jobs to help diversity its economic base. Exempting computer equipment from the sales tax may help Minnesota communities compete against other states for computer-intensive, non-manufacturing jobs.

**Broadening the base of final consumption purchases subject to sales tax supports most of the policy principles outlined in chapter 1.** Base broadening would increase horizontal equity and economic efficiency. The ability of sales tax revenues to increase with growth in the economy would be enhanced. Depending on options chosen for base expansion or use of other devices such as low income credits, the sales tax could be made less regressive and easier to understand and administer. Alternatives for expanding the tax base to consumption items are listed in the table in Appendix F. This table includes revenue estimates and the extent to which the items are taxed by other states. The Council does not recommend or endorse any of these base broadening measures.



# Appendix A

## Chronology of the Capital Equipment Statutes, Court Decisions and Rulemaking

### Statutory Changes

| | |
|---|---|
| July 1, 1984: | Sales tax rate reduced to 4 percent on new and expanded capital equipment. |
| August 1, 1985: | Sales tax eliminated on capital equipment purchases in excess of $100,000 when used for new or expanding manufacturing facilities in a distressed county. |
| May 1, 1986: | Sales tax eliminated for building materials and supplies used to construct or expand qualified manufacturing facilities in distressed counties. |
| July 1, 1987: | Distressed county provisions are extended to taconite tax relief area. |
| October 1, 1989: | New and expanded capital equipment became subject to total exemption rather than partial rate reduction. |
| July 1, 1990: | Mining and quarrying were added as qualifying activities for capital equipment exemption purposes. |
| July 1, 1991: | Distressed county and taconite tax relief area provisions are repealed. |
| May 5, 1993: | Capital equipment statute is amended to specify exemptions and clarify definitions; established advisory council; expanded exemption to include replacement equipment in mining and taconite production. |

### Court Decisions

*Color Ad Packaging, Inc.*, Minnesota Tax Court, Docket No. 4738, dated 9/18/87; Minnesota Supreme Court, 428 N.W. 2d 806, dated 9/16/88.

*West Publishing Company*, Minnesota Tax Court, Docket No. 5346, dated 7/11/90; Minnesota Supreme Court, 464 N.W. 2d 512, dated 1/3/91.

*Cowles Media Company*, Minnesota Tax Court, Docket No. 5869, dated 5/8/92.

*Northern States Power Company*, Minnesota Tax Court, Docket No. 5554, dated 9/9/92, Minnesota Supreme Court, dated 8/6/93.

*Potlatch Corporation*, Minnesota Tax Court, Docket No. 5944, dated 3/18/93.

**Rulemaking Process**

| | |
|---|---|
| January 16, 1990: | A Notice of Intent to Solicit Outside Opinion regarding the taxation of capital equipment was published in the *State Register*. Deadline for comments was February 16, 1990. |
| March 20, 1990: | Department of Revenue met with several members of the Minnesota State Bar Association's Tax Section to discuss the rule. |
| July 1990: | The Sales and Use Tax Subcommittee of the Minnesota State Bar Association Tax Section submitted its written comments. |
| January 8, 1991: | The department informally circulated an initial draft of the proposed Capital Equipment Rules. |
| January - February, 1991: | Responses to the proposed rule received by the department. |
| September 8, 1992: | The *State Register* published the proposed rule, along with a notice of hearing on the rule. |
| October 15, 1992 | Rule hearing held at Department of Revenue, Administrative Law Judge Jon Lunde presiding. |
| November 6, 1992: | Deadline for public comments following hearing. |
| November 13, 1992: | Deadline for the department's response to public comments. |
| December 30, 1992: | Judge Lunde completed the report and submitted it to Chief Administrative Law Judge William Brown. |
| December 31, 1992: | Judge Brown approved Judge Lunde's findings and conclusions. Department of Revenue received the report and the rule record from the Administrative Hearings Office. |
| February 1, 1993: | The *State Register* published the Notice of Withdrawal of the Capital Equipment Rule. |

# Appendix B

## Summary of Adverse Findings of the Administrative Law Judge (ALJ)

This appendix summarizes the findings of Administrative Law Judge Jon Lunde that were adverse to the Department of Revenue proposed administrative rule on the sales tax exemption for capital equipment.

1. Machinery and equipment used in manufacturing (finding 21).

   This finding refers to the definition of "machinery and equipment" (subpart 2, item A of the rule). Judge Lunde found that the first three sentences of Item A were unduly restrictive and inconsistent with the language of the exemption statute and the court's holding in *United Power* (a Minnesota case interpreting a property tax exemption for pollution abatement equipment and determining whether certain equipment was necessary and integral to the production process). According to the judge, this constituted a substantive violation of law under the Administrative Procedure Act. To correct this defect, the department would have had to amend the rule to reflect the scope of the exemption statute and the holding in *United Power*, 483 N.W. 2d 74, 1992. Judge Lunde suggested that the department include language specifying that machinery and equipment includes "devices reasonably necessary to carry out the purpose of the exempt device."

2. Logging (finding 26).

   This finding concluded that the Department had failed to establish the need and reasonableness of subpart 2, item C of the proposed rule which states that logging is not a manufacturing business. To correct this defect, the word "logging" would have had to be deleted from the exclusionary language in item C.

3. Pollution control (finding 35).

   Finding 35 concluded that disallowing an exemption for legally required pollution control equipment is inconsistent with the governing statutes (thus a substantive violation of the law) and was not shown to be necessary and reasonable. To correct this defect, the rule would have had to be amended to recognize an exemption for pollution control equipment.

4. Safety devices and environmental control devices (finding 40).

   This finding is similar to number 35, except it requires recognition of legally required safety devices, including legally required environmental control devices. The ALJ found this to be a substantive violation of law.

5. Foundations (finding 45).

   This finding refers to subpart 2, item A, subitem 2 of the proposed rule, which excluded "foundations." Judge Lunde was persuaded that the department had failed to establish the need and reasonableness of excluding all foundations from the exemption. To correct this defect, the department's rule would have had to be amended to recognize foundations that

are an integral part of manufacturing, or reasonably necessary to carry out the qualifying process.

6. Product (finding 56).

   This finding concluded that subpart 2, item I of the proposed rule, which defined product to mean tangible personal property, electricity or steam, was "inappropriate and at variance with the statute." The ALJ found the reasoning and authority cited by the tax court in the *West Publishing* case persuasive. He defined the word "product" as well as "raw materials." Based on the *West* decision and his definitions of product and raw materials, he found the proposed definition of "product" constituted a "substantive violation of the law." To correct this defect, the definition would have had to be amended to include both tangible and intangible products.

7. Replacement of equipment performing substantially the same function in an existing facility (finding 92).

   Number 92 found that the department's interpretation of the statutory language prohibiting refunds for "machinery or equipment purchased or leased to replace machinery or equipment performing substantially the same function in an existing facility", to be inconsistent with the statute and unreasonably narrow. Judge Lunde found that "replacement" equipment which also expanded productivity should qualify for a refund. To correct this substantive violation, language would have to be amended by changing it to include the following criteria:

   1) the same or similar end product is being produced;

   2) the new machinery or equipment increase plant production or capacity or are capable of performing faster or more efficiently than the machinery or equipment superseded,

   3) the superseded machinery and equipment was depleted, worn out, old, or inoperable, and

   4) the machinery or equipment was purchased or leased primarily for expansion or replacement.

   Under these criteria, the department would have to make a case-by-case evaluation of an equipment purchase and decide whether the equipment was acquired for replacement or expansion purposes. According to the ALJ, only equipment that replaces similar equipment because of damage, obsolescence, or ordinary wear and tear can automatically be excluded from the exemption.

8. Replacement Parts (finding 94).

   Number 94 found that the sentence "Replacement parts are those which upgrade or modernize machinery or equipment" to be inconsistent with the exemption statute. Replacement parts should refer to the replacement of old, worn out or defective parts.

# Appendix C

## Sales Tax on Capital Equipment Statutes

### 1984 Legislation

Sec. 2. Minnesota Statutes 1982, section 297A.01, is amended by adding a subdivision to read:

Subd. 16. **CAPITAL EQUIPMENT.** Capital equipment means machinery and equipment and the materials and supplies necessary to construct or install the machinery or equipment. To qualify under this definition the capital equipment must be used by the purchaser or lessee for manufacturing, fabricating, or refining a product to be sold at retail and must be used for the establishment of a new or the physical expansion of an existing manufacturing, fabricating, or refining facility in the state. Capital equipment does not include (1) machinery or equipment purchased or leased to replace machinery or equipment performing substantially the same function in an existing facility, (2) repair or replacement parts, or (3) machinery or equipment used to extract, receive, or store raw materials.

Sec. 4. Minnesota Statutes 1983 Supplement, section 297A.02, subdivision 2, is amended to read:

Subd. 2. **~~FARM~~ MACHINERY AND EQUIPMENT**. Notwithstanding the provisions of subdivision 1, the rate of the excise tax imposed upon sales of farm machinery ~~shall be~~, special tooling, and capital equipment is four percent.

Sec. 7. Minnesota Statutes 1982, section 297A.15, is amended by adding a subdivision to read:

Subd. 5. **REFUND; APPROPRIATION.** Notwithstanding the provisions of section 297A.02, subdivision 2, the tax on sales of capital equipment shall be imposed and collected as if the rate under section 297A.02, subdivision 1, applied. Upon application by the purchaser, on forms prescribed by the commissioner, a refund equal to the reduction in the tax due as a result of the application of the rates under section 297A.02, subdivision 2, shall be paid to the purchaser. The application shall include information necessary for the commissioner initially to verify that the purchases qualified as capital equipment under section 297A.02, subdivision 2. No more than two applications for refunds may be filed under this subdivision in a calendar year. Unless otherwise specifically provided by this subdivision, the provisions of section 297A.34 apply to the refunds payable under this subdivision. There is annually appropriated to the commissioner of revenue the amount required to make the refunds.

## 1989 Legislation

Sec. 3. Minnesota Statutes 1988, section 297A.02, subdivision 2, is amended to read:

Subd. 2. **MACHINERY AND EQUIPMENT.** Notwithstanding the provisions of subdivision 1, the rate of the excise tax imposed upon sales of special tooling~~, and capital equipment~~ is four percent and upon sales of farm machinery is two percent.

Sec. 4. Minnesota Statutes 1988, section 297A.15, subdivision 5, is amended to read:

Subd. 5. **REFUND; APPROPRIATION.** Notwithstanding the provisions of sections ~~297A.02, subdivision 2~~ 297A.25, subdivision 42, and 297A.257 the tax on sales of capital equipment, and construction materials and supplies under section 297A.257, shall be imposed and collected as if the rate under section 297A.02. subdivision 1, applied. Upon application by the purchaser, on forms prescribed by the commissioner, a refund equal to the reduction in the tax due as a result of the application of the ~~rates under section 297A.02, subdivision 2, or the~~ exemption under the section 297A.25, subdivision 42, or 297A.257 shall be paid to the purchaser. In the case of building materials qualifying under section 297A.257 where the tax was paid by a contractor, application must be made by the owner for the sales tax paid by all the contractors, subcontractors, and builders for the project. The application must include sufficient information to permit the commissioner to verify the sales tax paid for the project. The application shall include information necessary for the commissioner initially to verify that the purchases qualified as capital equipment under section ~~297A.02, subdivision 2~~ 297A.25, subdivision 42, or capital equipment or construction materials and supplies under section 297A.257. No more than two applications for refunds may be filed under this subdivision in a calendar year. Unless otherwise specifically provided by this subdivision, the provisions of section 297A.34 apply to the refunds payable under this subdivision. There is annually appropriated to the commissioner of revenue the amount required to make the refunds.

The amount to be refunded shall bear interest at the rate in section 270.76 from the date the refund claim is filed with the commissioner.

Sec. 7. Minnesota Statutes 1988, section 297A.25, is amended by adding a subdivision to read:

Subd. 42. **CAPITAL EQUIPMENT.** The gross receipts from the sale of capital equipment are exempt.

# Appendix D
# Revenue Analysis of Federal Update

**INDIVIDUAL INCOME TAX**
**CORPORATE FRANCHISE TAX**
**FEDERAL UPDATE - FULL**

General Fund
Revenue Gain or (Loss):

| | | |
|---|---|---|
| F.Y. 1994: | $ (6.4) | Million |
| F.Y. 1995: | 35.4 | Million |
| Biennium: | $ 29.0 | Million |
| F.Y. 1996: | $ 37.9 | Million |
| F.Y. 1997: | 54.5 | Million |
| Biennium: | $ 92.4 | Million |

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## REVENUE ANALYSIS SUMMARY

### Full Update to Federal Taxable Income and Earned Income Credit

The following provisions would be adopted by updating the reference to the Internal Revenue Code for the definition of federal taxable income and for the working family credit to include the changes made by the Omnibus Budget Reconciliation Act of 1993. The estimates assume that the provisions would be effective the same time that they are federally, including retroactivity.

| | FY 1994 | FY 1995 | FY 1996 | FY 1997 |
|---|---|---|---|---|
| | | (Amounts in Millions) | | |
| I. Revenue-Raising Provisions | | | | |
| A. Individual Income Tax | | | | |
| 1. Permanently extend itemized deductible limitation scheduled to expire (1/1/96) | $0.0 | $0.0 | $7.2 | $15.4 |
| 2. Permanently extend personal exemption phaseout scheduled to expire (1/1/97) | 0.0 | 0.0 | 0.0 | 4.2 |
| 3. Reduce deduction of business meals and entertainment from 80% to 50% (1/1/94) | | | | |
| Individual | 3.0 | 6.1 | 7.0 | 7.4 |
| Corporate | 2.7 | 5.5 | 6.4 | 6.7 |
| 4. No deduction for club dues (1/1/94) | | | | |
| Individual | 0.2 | 0.4 | 0.4 | 0.4 |
| Corporate | 0.2 | 0.4 | 0.5 | 0.5 |
| 5. No deduction for certain executive pay over $1 million (1/1/94) | | | | |
| Corporate | 0.1 | 0.2 | 0.2 | 0.2 |
| 6. Reduce maximum compensation for contributions to qualified retirement plans (1/1/94) | 0.7 | 2.4 | 2.8 | 2.9 |
| 7. Limit and modify moving expense deduction (1/1/94) | 0.6 | 2.0 | 2.5 | 2.7 |
| 8. Increase taxable portion of social security using a two-tier system (1/1/94) (TY 94 impact assumed to occur in FY 95) | 0.0 | 28.5 | 22.3 | 24.6 |

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| | FY 1994 | FY 1995 | FY 1996 | FY 1997 |
|---|---|---|---|---|
| | | (Amounts in Millions) | | |
| B. Provisions Affecting Business | | | | |
| 1. No deduction for certain lobbying expenses (expenses after 12/31/93) | | | | |
| Individual | Min. | 0.1 | 0.1 | 0.1 |
| Corporate | 0.2 | 0.4 | 0.4 | 0.5 |
| 2. Require mark-to-market method for dealers in securities (tax years ending on or after 12/31/93) | | | | |
| Individual | 0.9 | 0.7 | 0.9 | 0.9 |
| Corporate | 2.2 | 1.6 | 2.1 | 2.2 |
| 3. Prohibit double-dip related to FSLIC assistance (3/4/91) | | | | |
| Corporate | 1.0 | 0.2 | 0.1 | 0.7 |
| 4. Repeal stock-for-debt exception to Sec. 108 (stock transferred after 1/1/95) | | | | |
| Corporate | 0.0 | Min. | 0.2 | 0.3 |
| 5. Add passive losses to tax attributes reduced by discharge of indebtedness (1/1/94) | | | | |
| Individual | Min. | 0.2 | 0.4 | 0.7 |
| 6. Modify earnings stripping, portfolio interest, and conduit rules (tax years beginning after 12/31/93, with some exceptions) | | | | |
| Corporate | 0.2 | 0.3 | 0.3 | 0.3 |
| 7. Repeal deferral for excessive accumulated foreign earnings (tax years beginning after 9/30/93) | | | | |
| Corporate | Min. | Min. | Min. | Min. |
| 8. Treatment of exports of unprocessed softwood timber (transactions after 8/10/93) | | | | |
| Corporate | Min. | Min. | Min. | Min. |
| 9. Amortization of acquired intangible assets (acquired after 8/10/93) | | | | |
| Individual | 0.1 | 0.2 | 0.2 | 0.3 |
| Corporate | Min. | 0.7 | 1.4 | 2.0 |
| 10. No business travel deduction for spouse and dependents (1/1/94) | | | | |
| Individual | Min. | 0.1 | 0.1 | 0.1 |

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| | FY 1994 | FY 1995 | FY 1996 | FY 1997 |
|---|---|---|---|---|
| | | (Amounts in Millions) | | |
| II. Investment and Training Provisions | | | | |
| A. Education and Training | | | | |
| 1. Extend exclusion of employer-provided educational assistance (7/1/92-12/31/94) | | | | |
| Individual | $(2.7) | $(1.8) | $0.0 | $0.0 |
| B. Investment Incentives | | | | |
| 1. Targeted capital gains incentives for investment in small business (8/10/93) | | | | |
| Individual | (0.1) | (0.4) | (0.7) | (1.0) |
| 2. Elimination of ACE depreciation adjustment (property placed in service after 12/31/93) | | | | |
| Corporate | (0.4) | (1.4) | (1.9) | (1.8) |
| 3. Increase Sec. 179 expensing from $10,000 to $17,500 (tax years beginning after 12/31/92) | | | | |
| Individual | (7.8) | (2.5) | (2.6) | (1.7) |
| Corporate | (4.3) | (1.4) | (1.4) | (0.9) |
| 4. Exempt qualified small-issue manufacturing bonds (IDBs) permanently (7/1/92) | | | | |
| Individual | (Min.) | (0.1) | (0.2) | (0.2) |
| C. Expansion and Simplification of Earned Income Tax Credit (1/1/94) | 0.0 | (4.5) | (8.8) | (12.3) |
| D. Real Estate Investment Provisions | | | | |
| 1. Extend mortgage revenue bonds permanently (7/1/92) | | | | |
| Individual | (0.2) | (0.4) | (0.7) | (0.9) |
| 2. Passive loss relief for real estate professionals (1/1/94) | | | | |
| Individual | (1.0) | (2.2) | (2.3) | (2.5) |
| Corporate | (0.1) | (0.1) | (0.2) | (0.2) |
| 3. Facilitate pension investments in real estate (1/1/94) | | | | |
| Corporate (UBIT) | (0.1) | (0.2) | (0.2) | (0.2) |
| 4. Treatment of real property indebtedness of individuals (1/1/93) | (0.7) | (0.4) | (0.4) | (0.2) |
| 5. Increase recovery period for nonresidential real property from 31.5 to 39 years (property placed in service on or after 5/13/93) | | | | |
| Individual | 0.1 | 0.3 | 0.6 | 1.1 |
| Corporate | 0.2 | 0.7 | 1.4 | 2.4 |

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| | FY 1994 | FY 1995 | FY 1996 | FY 1997 |
|---|---|---|---|---|
| | | (Amounts in Millions) | | |
| E. Other Provisions | | | | |
| 1. Extend AMT treatment of charitable gifts of appreciated property permanently (7/1/92 for tangible personal property; 1/1/93 for all property | | | | |
| Individual | $(0.3) | $(0.2) | $(0.2) | $(0.2) |
| Corporate | (Min.) | (Min.) | (Min.) | (Min.) |
| 2. Extend 25% deduction for self-employed health insurance (7/1/92 - 12/31/92)* | (1.1) | 0.0 | 0.0 | 0.0 |
| 3. Involuntary conversion for principal residence in Presidentially-declared disaster areas (9/1/91) | (Min.) | (Min.) | (Min.) | (Min.) |
| F. Empowerment Zones and Enterprise Communities | | | | |
| 1. Additional $20,000 of Sec. 179 expensing (1/1/94) - Individual and Corporate | (Min.) | (Min.) | (Min.) | (Min.) |
| Subtotals | | | | |
| Individual | $(8.3) | $28.5 | $28.6 | $41.8 |
| Corporate | 1.9 | 6.9 | 9.3 | 12.7 |
| Total | $(6.4) | $35.4 | $37.9 | $54.5 |

* Although the federal bill extended the deduction to December 31, 1993, no Minnesota impact for 1993 because, beginning with tax year 1993, Minnesota allows 100 percent to be deducted.

# Appendix E

# 1993 Advisory Council Legislation

### Sec. 49. [ADVISORY COUNCIL; SALES TAX ON CAPITAL EQUIPMENT.]

Subdivision 1. **[CREATION; MEMBERSHIP.]** (a) A state advisory council is established to study the sales tax exemption for capital equipment under Minnesota Statutes 1992, sections 297A.01, subdivision 16, and 297A.25, subdivision 42, and to make recommendations to the 1994 legislature. The study shall be completed and findings reported to the legislature by February 1, 1994.

(b) The advisory council consists of 15 members who serve at the pleasure of the appointing authority as follows:

(1) six legislators; three members of the senate, including one member of the minority party, appointed by the subcommittee on committees of the committee on rules and administration and three members of the house of representatives, including one member of the minority party, appointed by the speaker;

(2) the commissioner of revenue or the commissioner's designee; and

(3) eight members of the public; two appointed by the subcommittee on committees of the committee on rules and administration of the senate, two appointed by the speaker of the house, and four appointed by the governor.

Subd. 2. **[SCOPE OF THE STUDY.]** (a) In preparing the study, the advisory council shall examine, at least, the following:

(1) an overview of the purpose, intent, and application of the provisions of the present exemption, including the department of revenue's experience in interpreting and administering the provisions and the impact of the exemption on state tax collections;

(2) appropriate tax policy goals for the exemption of capital equipment from the sales tax;

(3) the effect of the exemption in encouraging new investment, increases in economic activity, and creation of new jobs in Minnesota or other appropriate economic development goals;

(4) analyses of alternative versions of the exemption, either expanding or narrowing it and specifically including the expansions contained in the administrative law judge's report, that will further the tax policy and economic development goals developed under clauses (2) and (3). In analyzing alternatives, the advisory council must consider alternatives that expand the exemption and offset the reduction in state and local sales tax revenues by expanding the sales tax base to include final consumption items that are now exempt from taxation.

(b) The advisory council's report to the legislature must include recommendations for modifying the exemption in light of the tax policy and economic development goals. The recommendations must not provide for increasing or decreasing state revenues relative to the revenue department's estimates of the effect of applying the department's interpretations of present law. If the report recommends expanding the exemption, it must include recommendations to expand the tax base to offset the resulting loss of state and local revenues.

Subd. 3. **[STAFF.]** The department of revenue and legislative staff shall provide administrative and staff assistance when requested by the advisory council.

Subd. 4. **[COOPERATION BY OTHER AGENCIES.]** The commissioners of the department of trade and economic development, the department of labor and industry, the department of jobs and training, and the pollution control agency shall, upon request by the advisory council, provide data or other information that is collected or possessed by their agencies and that is necessary or useful in conducting the study and preparing the report required by this section.

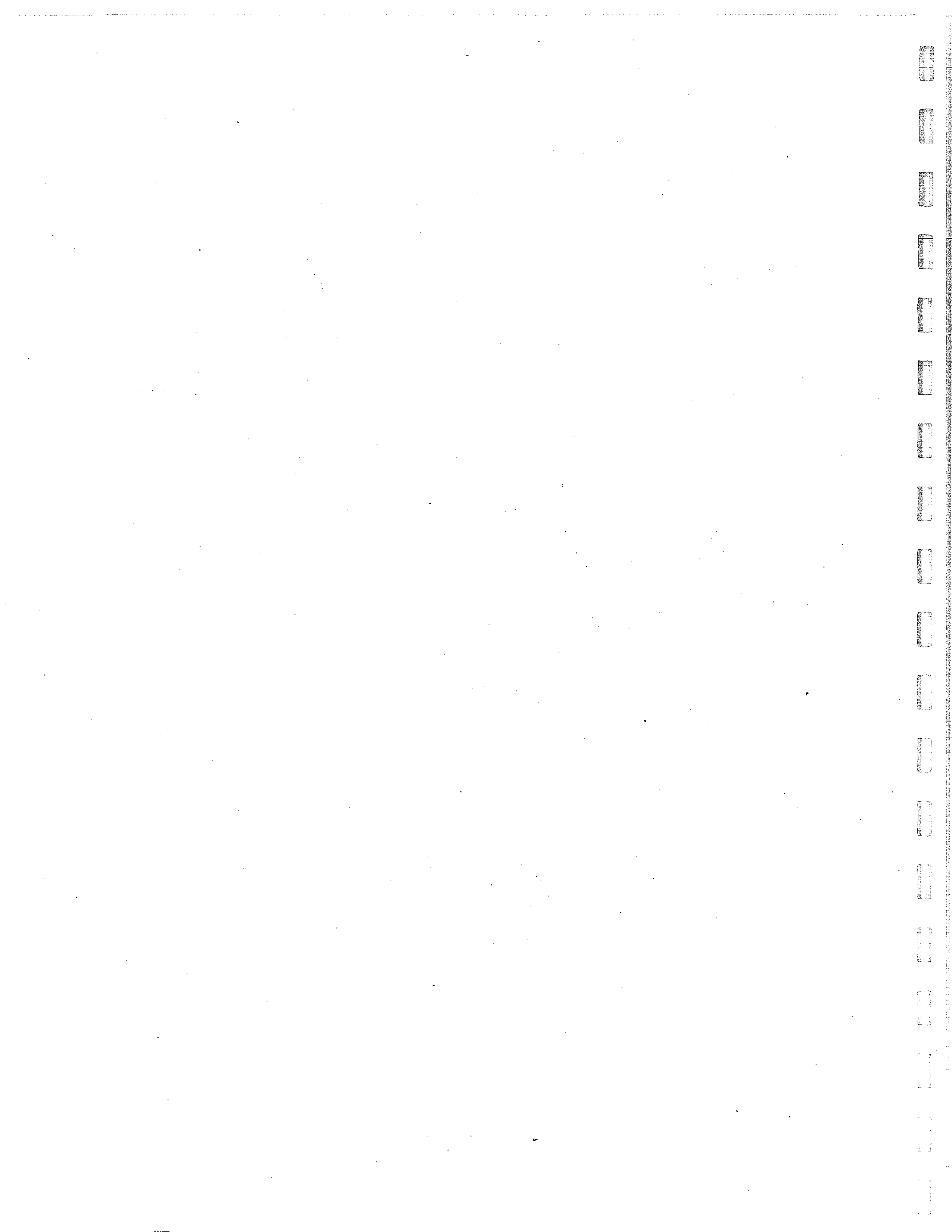
# Appendix F

## Sales Tax Base Expansion Options

| Base Expansion Option | Revenue Estimates (in millions) FY95 | FY96 | FY97 | Distributional Effect | Number of states with tax* | Surrounding states with tax** |
|---|---|---|---|---|---|---|
| Clothing and wearing apparel | $257 | $277 | $295 | decrease regressivity | 40 | 4 |
| Highway fuels | 171 | 170 | 169 | neutral | 5 | 0 |
| Residential construction services | 133 | 136 | 139 | decrease regressivity | 10<br>13 (repairs) | 2 |
| Home heating fuels | 92 | 98 | 105 | increase regressivity | 17 | 1 |
| Motor vehicle repair services | 72 | 77 | 82 | neutral | 21 | 3 |
| Personal services | 39 | 42 | 45 | neutral | 3 | 1 |
| Newspapers, magazine subscriptions, and textbooks | 44 | 45 | 47 | neutral | ? | 0 (newspapers)<br>3 (magazines) |
| Residential sewer and water services | 40 | 40 | 41 | increase regressivity | 11 (water)<br>7 (sewer) | 2 (water)<br>0 (sewer) |
| General repair services | 26 | 27 | 29 | neutral | 23 | 3 |
| On-line computer services | 0.3 | 0.3 | 0.3 | unclear | 13 | 1 |

* 46 states including the District of Columbia impose sales taxes (Source: Federation of Tax Administrators, *Sales Tax on Services* (April, 1991).

** The four surrounding states are Iowa, North Dakota, South Dakota, and Wisconsin.



# Appendix G

## Advisory Council's Legislative Bill Language

1 Sec. ... Minnesota Statutes 1993 Supplement, section
2 297A.01, subdivision 16, is amended to read:
3 Subd. 16. [CAPITAL EQUIPMENT.] (a) Capital equipment means
4 machinery and equipment ~~and-the-materials-and-supplies-necessary~~
5 ~~to-construct-or-install-the-machinery-or-equipment.--To-qualify~~
6 ~~under-this-definition-the-capital-equipment-must-be~~ purchased or
7 leased for use in this state and used ~~by-the-purchaser-or-lessee~~
8 primarily for manufacturing, fabricating, mining, ~~quarrying,~~ or
9 refining tangible personal property~~,~~ to be sold ultimately at
10 retail and for electronically transmitting results retrieved by
11 a customer of an on-line computerized data retrieval system~~,-or~~
12 ~~for-the-generation-of-electricity-or-steam,-to-be-sold-at-retail~~
13 ~~and-must-be-used-for-the-establishment-of-a-new-or-the-physical~~
14 ~~expansion-of-an-existing-manufacturing,-fabricating,-mining,~~
15 ~~quarrying,-or-refining-facility-in-the-state.--For-purposes-of~~
16 ~~this-subdivision,-"mining"-includes-peat-mining,-and-"on-line~~
17 ~~computerized-data-retrieval-system"-refers-to-a-system-whose~~
18 ~~cumulation-of-information-is-equally-available-and-accessible-to~~
19 ~~all-its-customers~~.
20 (b) Capital equipment includes all machinery and equipment
21 that is essential to the integrated production process. Capital
22 equipment includes, but is not limited to:
23 (1) pollution control equipment;
24 (2) equipment and devices used or required to operate,

1 control or regulate the production equipment, including
2 computers and computer software, together with all repair and
3 replacement parts, whether purchased separately or in
4 conjunction with the machine and regardless of whether the
5 machine or component parts are assembled by the taxpayer or
6 another party;
7 (3) machinery and equipment used for research and
8 development, design, quality control and testing activities;
9 (4) environmental control devices that are used to maintain
10 conditions such as temperature, humidity, light, or air pressure
11 when those conditions are essential to and part of the
12 production process; or
13 (5) materials and supplies necessary to construct and
14 install machinery or equipment.
15 (c) Capital equipment does not include the following:
16 (1) ~~machinery-or-equipment-purchased-or-leased-to-replace~~
17 ~~machinery-or-equipment-performing-substantially-the-same~~
18 ~~function-in-an-existing-facility~~ motor vehicles taxed under
19 chapter 297B;
20 (2) ~~repair-or-replacement-parts,-including-accessories,~~
21 ~~whether-purchased-as-spare-parts,-repair-parts,-or-as-upgrades~~
22 ~~or-modifications,-and-whether-purchased-before-or-after-the~~
23 ~~machinery-or-equipment-is-placed-into-service.--Parts-or~~
24 ~~accessories-are-treated-as-capital-equipment-only-to-the-extent~~
25 ~~that-they-are-a-part-of-and-are-essential-to-the-operation-of~~
26 ~~the-machinery-or-equipment-as-initially-purchased;~~
27 ~~(3)~~ machinery or equipment used to receive or store raw
28 materials including automated material handling and storage
29 machinery;
30 ~~(4)~~ (3) building materials, ~~including~~ except materials used
31 for foundations that support machinery or equipment or special
32 purpose buildings used in the production process;
33 ~~(5)~~ (4) machinery or equipment used for nonproduction
34 purposes, including, but not limited to, the following:
35 machinery and equipment used for plant security, fire
36 prevention, first aid, and hospital stations; machinery and

equipment used in support operations or for administrative purposes; ~~machinery-and-equipment-used-solely-for-pollution control,-prevention,-or-abatement,-machinery-and-equipment-used for-environmental-control,-except-that-when-a-controlled environment-is-essential-for-the-manufacture-of-a-particular product,-the-machinery-or-equipment-that-controls-the environment-can-qualify-as-capital-equipment,~~ and machinery and equipment used in plant cleaning, disposal of scrap and waste, plant communications, space heating and lighting, or safety;

(6) "farm machinery" as defined by subdivision 15, ~~"special tooling"-as-defined-by-subdivision-17,~~ and "aquaculture production equipment" as defined by subdivision 19; or

(7) any other item that is not essential to the integrated process of manufacturing, fabricating, mining, ~~quarrying,~~ or refining.

~~(c)~~ (d) For purposes of this subdivision:

~~(1)-the-requirement-that-the-machinery-or-equipment-"must be-used-by-the-purchaser-or-lessee"-means-that-the-person-who purchases-or-leases-the-machinery-or-equipment-must-be-the-one who-uses-it-for-the-qualifying-purpose.--When-a-contractor-buys and-installs-machinery-or-equipment-as-part-of-an-improvement-to real-property,-only-the-contractor-is-considered-the-purchaser;~~

~~(2)-the-requirement-that-the-machinery-and-equipment-must be-used-"for-manufacturing,-fabricating,-mining,-quarrying,-or refining"-means-that-the-machinery-or-equipment-must-be essential-to-the-integrated-process-of-manufacturing, fabricating,-mining,-quarrying,-or-refining.--Neither-legal requirements-nor-practical-necessity-determines-whether-or-not the-equipment-is-essential-to-the-integrated-process;~~

~~(3)-"facility"-means-a-coordinated-group-of-fixed-assets, which-may-include-land,-buildings,-machinery,-and-equipment-that are-essential-to-and-used-in-an-integrated-manufacturing, fabricating,-refining,-mining,-or-quarrying-process;~~

~~(4)-"establishment-of-a-new-facility"-means-the construction-of-a-facility,-or-the-purchase-by-a-new-owner-of-a facility-that-was-previously-closed-and-not-operational-for-a~~

1 ~~period-of-at-least-12-consecutive-months.--Relocating-operations~~
2 ~~from-an-existing-facility-within-Minnesota-to-another-facility~~
3 ~~within-Minnesota-does-not-constitute-establishing-a-new~~
4 ~~facility;~~
5 ~~(5)-"physical-expansion-of-an-existing-facility"-means~~
6 ~~adding-a-new-production-line,-adding-new-machinery-or-equipment~~
7 ~~to-an-existing-production-line,-new-construction-which-will~~
8 ~~become-part-of-the-existing-facility-and-which-is-used-for-a~~
9 ~~qualifying-activity,-or-conversion-of-an-area-in-an-existing~~
10 ~~facility-from-a-nonqualifying-activity-to-a-qualifying-activity;~~
11 ~~and~~
12 ~~(6)-performing-"substantially-the-same-function"-means-that~~
13 ~~the-new-machinery-or-equipment-serves-fundamentally-or~~
14 ~~essentially-the-same-purpose-as-did-the-old-equipment-or-that-it~~
15 ~~produces-the-same-or-similar-end-product,-even-though-it-may~~
16 ~~increase-speed,-efficiency,-or-production-capacity.~~
17 ~~(d)-Notwithstanding-prior-provisions-of-this-subdivision,~~
18 ~~machinery-and-equipment-purchased-or-leased-to-replace-machinery~~
19 ~~and-equipment-used-in-the-mining-or-production-of-taconite-shall~~
20 ~~qualify-as-capital-equipment-regardless-of-whether-the-facility~~
21 ~~has-been-expanded.~~
22 (1) "Equipment" means independent devices or tools separate
23 from machinery but essential to an integrated production
24 process. Equipment includes (A) computers and software used
25 primarily in operating exempt machinery and equipment; (B) any
26 subunit or assembly comprising a component of any machinery or
27 accessory or attachment parts of machinery, such as tools, dies,
28 jigs, patterns and molds; and (C) any repair or replacement
29 parts.
30 (2) "Fabricating" means to make, build, create, produce, or
31 assemble components or property to work in a new or different
32 manner.
33 (3) "Machinery" means mechanical, electronic, or electrical
34 devices that are purchased or constructed to be used for the
35 activities set forth in paragraph (a), beginning with the
36 removal of raw materials from inventory through the completion

1 of the finished end product, including packaging and palletizing
2 of the product.
3 (3) "Manufacturing" means an operation or series of
4 operations where raw materials are changed in form, composition,
5 or condition by machinery and equipment and which results in the
6 production of a new article of tangible personal property.
7 Manufacturing includes the generation of electricity or steam to
8 be sold at retail.
9 (4) "Mining" means the extraction of minerals, ores, stone,
10 and peat.
11 (5) "On-line data retrieval system" means a system whose
12 cumulation of information is equally available and accessible to
13 all the system's customers.
14 (6) "Pollution control equipment" means machinery and
15 equipment used to eliminate, prevent, or reduce air, land, or
16 water pollution resulting from an activity described in
17 paragraph (a). The term does not include equipment used to
18 abate noise pollution.
19 (7) "Primarily" means machine and equipment used 50 percent
20 or more of the time in an activity described in paragraph (a).
21 (8) "Refining" means the process of converting a natural
22 resource to a product, including the treatment of water to be
23 sold at retail.
24 (e) Notwithstanding the limits in paragraphs (a) to (d),
25 all computer equipment, including replacement computer
26 equipment, repair and replacement parts, and accessories and
27 computer software, including replacement software, that is
28 purchased or leased by a person engaged in an activity described
29 in paragraph (a) qualifies as capital equipment.
30 Sec. ... Minnesota Statutes 1992, section 297A.02,
31 subdivision 2, is amended to read:
32 Subd. 2. [MACHINERY AND EQUIPMENT.] Notwithstanding the
33 provisions of subdivision 1, the rate of the excise tax
34 imposed ~~upon-sales-of-special-tooling-is-four-percent-and~~ upon
35 sales of farm machinery and aquaculture production equipment is
36 two percent.

Sec. ... Minnesota Statutes 1992, section 297A.15, subdivision 5, is amended to read:

Subd. 5. [REFUND; APPROPRIATION.] Notwithstanding the provisions of section 297A.25, ~~subdivisions-42-and~~ subdivision 50, the tax on sales of ~~capital-equipment,-and~~ construction materials and supplies under section 297A.25, subdivision 50, shall be imposed and collected as if the rates under sections 297A.02, subdivision 1, and 297A.021, applied. Upon application by the purchaser, on forms prescribed by the commissioner, a refund equal to the reduction in the tax due as a result of the application of the exemption under section 297A.25, subdivision ~~42-or~~ 50, shall be paid to the purchaser. In the case of building materials qualifying under section 297A.25, subdivision 50, where the tax was paid by a contractor, application must be made by the owner for the sales tax paid by all the contractors, subcontractors, and builders for the project. The application must include sufficient information to permit the commissioner to verify the sales tax paid for the project. The application shall include information necessary for the commissioner initially to verify that the purchases qualified as ~~capital equipment-under-section-297A.25,-subdivision-42,-or~~ capital equipment or construction materials and supplies under section 297A.25, subdivision 50. No more than two applications for refunds may be filed under this subdivision in a calendar year. No owner may apply for a refund based on the exemption under section 297A.25, subdivision 50, before July 1, 1993. Unless otherwise specifically provided by this subdivision, the provisions of section 289A.40 apply to the refunds payable under this subdivision. There is annually appropriated to the commissioner of revenue the amount required to make the refunds.

The amount to be refunded shall bear interest at the rate in section 270.76 from the date the refund claim is filed with the commissioner.

Sec. ... Minnesota Statutes 1992, section 297A.25, subdivision 42, is amended to read:

Subd. 42. [CAPITAL EQUIPMENT.] The gross receipts from the

1 sale of capital equipment are exempt from the tax imposed under
2 this chapter, regardless of whether purchased by the owner or a
3 contractor or subcontractor.
4 Sec. ... [REPEALER.]
5 Minnesota Statutes 1992, section 297A.01, subdivision 17,
6 is repealed.
7 Sec. ... [EFFECTIVE DATE.]
8 Sections .. to .. are effective for sales made after June
9 30, 1994.

# Appendix H
# Individuals Presenting Testimony to the Advisory Council

Bill Blazer, Minnesota Chamber of Commerce
Dan Salomone, Minnesota Taxpayers Association
David Lawrence, Assistant General Counsel, Northern States Power Corporation
Kelvin Johnson, President, Printing Industry of Minnesota
Harris McKee, Vice President of Engineering, Brown Printing
Gary Meinke, Regional Manager, Heidelberg USA, Inc.
Rick Riesgraf, Partner, Carlson, Lundquist & Co., Inc.
David Baumgardner, Chief Financial Officer, H.M. Smyth Co., Inc.
David Copham, Liberty Check Printers
Doug Jordal, IDS Financial
Wayne Brandt, Minnesota Forest Industries, Minnesota Timber Producers Assoc.
Tony Goddard, President, St. Cloud Area Economic Development Partnership
Tom Vyvyan, Controller, M.E. International
Sean Nicholson, Manager, Sales and Use Tax Division, Dayton Hudson Corporation, Target Stores Division
Jeff Rose, Chairman, Minnesota Legislative State Tax Committee, Minnesota CPA Society
John Chell, Director, Office of Waste Management
John Conzemius, Cannon Falls, Minnesota
William F. Fox, Professor and Head, Department of Economics, University of Tennessee
John M. Urbanchuk, Vice President, AUS Consultants
Jeff Wood, Grand Metropolitan, Inc.

This list does not include Revenue Department or legislative staff and does not include the numerous individuals and organizations that submitted written testimony and materials.