

**Report of  
Sales Tax Advisory Council**

February 1, 1996

**Notice Required by Minnesota Statutes, sections 3.195, subdivision 2; 3.302, subdivision 3a.**

This report was prepared pursuant to the requirements of 1995 Minnesota Laws, chapter 264, article 2, section 42. The report was drafted by the Council and was published on January 29, 1996 in St. Paul, Minnesota.

The cost of preparing the report, as required by Minnesota Statutes, section 3.197, was \$1,815.31. This represents the cost of council members' per diem and mileage, postage, and similar expenses. It does not include the opportunity cost of the staff time and resources provided by the Revenue Department staff, the legislature, or others who served the Council without an explicit charge against the budget.

## Introduction

The sales tax advisory committee was created by Laws 1995, Chapter 264, Article 2, Section 42. Its chair and members were as follows:

**Chair:** Representative Ann Rest

**Members:** **Senate members** — Senators William Belanger, Gen Olson, Sandra Pappas, and Len Price

**House members** — Representatives Phil Carruthers, Tim Commers, Bill Macklin, Ann H. Rest, and Jean Wagenius

**Commissioner of revenue** — Matthew Smith

**Public members** — Debra Anderson, Russ Hagen, Hal Lofgren, Thomas F. Luce, Jr., Sandy Navin, Bob Teichert

The council met on September 22, 1995; October 12, 19, and 27, 1995; November 13 and 20, 1995; December 7 and 29, 1995; and January 4, 19, and 26, 1996.

At these meetings, the council conducted public hearings on and discussed the following topics:

- An overview of the sales tax
- Administrative and compliance problems with the sales tax
- Taxation of interstate sales
- Implications of international trade agreements
- Sales taxation of business inputs
- Difficulties with taxing mixed transaction businesses
- The incidence of the sales tax
- Current sales tax exemptions
- Implications of broadening the tax base and the exemption of necessities and refundable credits as mechanisms for reducing regressivity of the tax
- The value added tax as an alternative to the sales tax

The council also took testimony from the public on various sales tax issues. A working group of council members, Revenue Department staff, legislative staff, and interested members of the

public examined various administrative issues and made recommendations to the council.

Based these hearings, the information presented by the Department of Revenue and staff, public testimony, and the recommendations of the working group, the council makes the following recommendations.

## **Administrative Recommendations**

The council recommends that the Department of Revenue put into effect the following administrative changes:

### **I. Pre-audit Information Document**

The department should prepare a generic preaudit information document to be shared with taxpayers at the preaudit conference. The document should do the following:

- A. Inform the taxpayer what it should do to prepare for the audit.
- B. Inform the taxpayer what the department will do including:
  - (1) identify the structure of the taxpayer's accounting system,
  - (2) identify the records/accounts that will be examined, and
  - (3) maintain open communications with the taxpayer throughout the audit process, up to the time the assessment, if any, is determined.
- C. Inform the taxpayer of informal dispute resolution processes available before an order is issued. This process is in addition to the administrative review process available under Chapter 289A. Included in issues subject to informal dispute resolution would be any issues relating to sampling techniques used during the course of the audit.

### **II. Penalties**

The department should do the following:

- A. Publish its abatement policy so all taxpayers can or will be familiar with the department practices and can act accordingly when considering filing of an abatement request.
- B. Include the reason for the denial of an abatement request in its response to the taxpayer.

- C. Since it is department policy to automatically abate penalties on first time delinquent filers or payers, the department should consider eliminating the first time 5 percent late filing and 5 percent late payment penalties as part of its current study of penalties. In lieu of the late filing and payment penalties, the department should consider moving up the current 25 percent repeat violation penalty to the second violation. Under current administrative rule, the repeat violation penalty is imposed on the fourth delinquent payment within a 25 month period. Written notice warning the taxpayer that the penalty will be imposed for the next delinquent payment is required before the penalty can be assessed. The department should prepare its recommendations in time for presentation to the 1997 legislature.
- D. The department should include notice of right to request an abatement within any order or notice of assessment imposing a penalty.

### **III. Adjustment Line for Sales Tax Form**

Currently, a sales taxpayer who actually remits the tax to the department must file an amended return, if he or she under- or overpaid the tax due. Previously, an adjustment line on the sales tax return allowed taxpayers to make an adjustment in their current period tax remittance for any prior under- or overpayment. The department's "Sales Tax Reengineering Project" eliminated the adjustment line. The council recommends that the adjustment line be reinstated. Taxpayers using the adjustment line must self-assess interest on their under- or overpayments.

This recommendation may have minor revenue impact in those instances where a taxpayer who underpaid tax in the prior period uses the adjustment line to remit the underpayment in a subsequent tax period. Under current administrative practices where an amended return must be filed to remit any underpayment, a penalty may be assessed on the underpayment. Allowing payment of tax by reinstating the adjustment line may preclude collection of the penalty.

### **IV. Exemption Certificates**

Current law and administrative practices require vendors to obtain an exemption certificate from the purchaser if otherwise taxable goods are to be purchased tax exempt. Under current law, the good faith acceptance of an exemption certificate absolves the recipient of any liability if it turns out that tax should have been collected on the transaction, e.g., the exemption certificate was inappropriately used either through negligence or fraud by the purchaser. Current exemption certificates do not expire; they do not have to be renewed periodically.

The law's hold harmless provision for vendors receiving the exemption certificates in good faith and the fact that exemption certificates have a perpetual life creates an opportunity for misuse and underpayment of state tax. The council recommends that the department study placing an expiration date or requiring periodic renewal of the exemption certificates for nonprofit organizations.

## V. Intra Departmental Sales Tax Policy Study

During the calendar year 1996, the Department of Revenue should complete its internal sales tax policy study. It should present the results of its study and its recommendations to the sales tax advisory council before the conclusion of 1996. The council may incorporate those recommendations it endorses in its report to the 1997 legislature, if the council is extended per item III under "Legislative Recommendations With No Effect on State Revenues" below.

### Legislative Recommendations With No Effect on State Revenues

The recommendations of the council that need legislative authorization but involve no costs are as follows:

#### I. Statute of Limitations

The current law governing the statute of limitations for refund claims should be changed. Before 1995, a taxpayer could file a claim for refund for 3½ years from the due date of the return or two years after the payment of an audit assessment related to the audited time period, whichever was later. That law was changed at the Department of Revenue's request in 1995. The current law limits refund claims relating to periods earlier than 3½ years from the due date of the returns audited to only issues raised in an audit and only allows refunds up to the amount of the tax, penalty and interest assessed for that period.

The limitation on refund claims for periods earlier than 3½ years from the return due date **to only issues raised in an audit** should be eliminated. Thus, claims for refunds filed after 3½ years from the due date, but within 1 year from the date of the commissioner's order would not be limited to issues involved in the order. In other words, the taxpayer could claim a refund for any overpayment during the audit period.

The limitation on the **amount** of the refund claims for periods earlier than 3½ years from the return due date should also be eliminated in the case of most audits. Thus, claims for refunds filed after 3½ years from the due date, but within 1 year from the date of the commissioner's order would not be limited to the amount of the commissioner's order. In other words, the taxpayer could claim a refund for the periods in the audit that exceeds the amount of the additional tax, penalty, and interest imposed by the commissioner's order.

The limitation on amount would, however, still apply when an audit covers an extended period (i.e., beyond the 3½ year period). In such a case, the overpayments would continue to be limited only to offsetting tax, penalties, and interest assessed for the period beyond the general 3½ year

statute of limitation.<sup>1</sup>

## II. Vendor Refunds

Current department practices generally require a purchaser who paid the sales tax on legally exempt purchases in error to get a refund of the tax from the vendor. The council recommends that currently registered sales taxpayers be allowed to apply directly to the department for refund of sales tax previously paid on purchases in error when the cumulative amounts exceed \$500 annually. Refund claims would be limited to two a year.

The recommendation would offer purchaser/taxpayers an alternative way to be refunded an overpayment other than going back to the vendor to which the tax was remitted. To minimize the administrative burden imposed on the department by allowing these additional refund claims, it is limited to current sales tax permit holders. The limit to two claims per year and the *de minimis* provision limiting refund claims to a minimum of \$500 annually would further limit the additional workload on the department.

## III. Continuation of Council

The council recommends that the legislature extend the sales tax advisory council through 1996 with the retention of its current membership. This will allow continued study of sales tax issues and a more in-depth assessment of the feasibility of a value added tax structure as an alternative to the sales tax. The council should submit a final report to the 1997 legislature by February 1, 1997.

## Legislative Recommendations That Reduce State Revenues

The recommendations of the council that need legislative authorization but involve some state costs are as follows:

### I. *De Minimis* Rule for Consumer Use Tax

Under current law any Minnesota resident making a purchase out of state or receiving an untaxed purchase via the mail, should self-assess and remit a use tax of 6.5% of the purchase price less any sales tax paid to the state of purchase. Most Minnesotans are unaware of the obligation and fail to remit the tax. The Department of Revenue is unlikely to attempt to collect use tax on most purchases by individuals because of the administrative cost.

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<sup>1</sup>The statutory provision containing the statute of limitation also applies to other types of taxes, such as the income tax. See Minn. Stat. § 289A.40, subd. 1 (1995 Suppl.). The Council's recommendations apply only to the sales tax.

Rather than making many Minnesotans unwitting lawbreakers, the council proposes allowing individuals with purchases subject to the use tax of no more than \$770 in a year, a use tax exemption — i.e., an effective use tax exemption of \$50. Individuals making purchases subject to the use tax in excess of \$770 annually would be subject to use tax on all purchases, not just those in excess of \$770. Businesses and individuals who must register to collect sales and use tax would not qualify for this exemption, regardless of the amount of annual purchases subject to the use tax. The Department of Revenue is estimating the cost of this proposal.

## **II. Exemption for Goods Used or Consumed in Performing Taxable Services**

Under current law, tangible property consumed in the production of tangible personal property for sales at retail is exempt from tax. The intent of the exemption is to prevent **tax pyramiding**, multiple taxation of the same good so the tax actually exceeds 6.5 percent. No analogous provision exist for goods used or consumed in providing taxable services. For example, fertilizer consumed in performing taxable lawn care services are taxed; soaps and waxes used in car washes are taxed, even though the service is also taxed, and so forth. The council recommends that such purchases or use be exempted from tax. As a starting point, this exemption would be limited to taxable services defined under Minnesota Statutes, section 297A.01, subdivision 3, paragraph (i), but excluding solid waste collection and disposal services. This includes, among others, laundry and dry cleaning, car washes, building and residential cleaning, and lawn care. Preliminary estimates are that this would cost \$5.5 million annually.

## **III. Make Permanent the Temporary Exemption for Used Farm Machinery**

Used farm machinery is exempt from tax through June 30. Absent an extension or making the exemption permanent, the tax will revert to the 2.5% rate generally applicable to farm equipment. Making the exemption permanent or extending it would cost \$1.6 million annually. The council recommends that the exemption for farm equipment be limited to equipment for use in the trade or business of farming. Thus, it would not extend to purchases of, for example, antique or collectible farm equipment by collectors.

## **IV. Accelerate and Complete Phase-Out of the Tax on Replacement Capital Equipment**

The council recommends that the current phase-out of the tax on replacement capital equipment be accelerated and completed per the schedule on the next page with its incorporated costs.

Year	Current Law	Proposed Law	Cost (\$000)
FY 1997	3.8%	3.0%	4,400
FY 1998	2.9%	1.5%	10,900
FY 1999	2.0%	0.0%	18,700

Fully exempting replacement equipment will simplify administration of the tax by eliminating the distinction between new and replacement capital equipment. In addition, the proposed changes will provide an incentive for Minnesota manufacturers to re-invest in and modernize their facilities. Finally, it will slightly reduce the problem of pyramiding of the tax.



Representative Ann Rest  
Chair, Sales Tax Advisory Council