

Report of the Sales Tax Advisory Council

February 18, 1997

— 1995 Minn. Laws Chap. 264 Art. 2
Sec. 42

— 1996 Minn. Laws Chap. 471 Art. 2
Sec. 26

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 H. Rest

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

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

Commissioner of Revenue — Jim Girard

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

The council met on May 29, 1996; June 20, 1996; July 9, 1996; July 23, 1996; November 22, 1996; December 5, 1996; December 19, 1996; January 6, 1997; and February 14, 1997.

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

- sales and use taxation of telecommunications, electronic services, information services and related sectors
- local sales and use taxes
- sales and use taxes imposed on governmental units
- sales and use taxation of drugs, medical devices and health care products
- the Department of Revenue's *Sales Tax Policy Review Project*

A working group of council members, Department of Revenue staff, legislative staff, and interested members of the public examined various administrative issues and made recommendations to the council.

Based on 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. Fabrication Labor

The department should prepare a study of the sales and use taxation of labor. The study should recommend general policy principles regarding the taxation of labor and the appropriate treatment of charges for "fabrication" or "installation" labor.

Under current law, no deduction is allowed from the taxable sales price for "labor or service costs," but a deduction is allowed for "charges for labor or services used in installing or applying the property sold." Distinguishing between the two--the former being "fabrication labor" and the later "installation labor"--is problematic. Some of the situations that should be addressed in that study include:

- **Engraving:** Under current department administration of the sales tax, engraving which occurs after a sale is treated as a nontaxable service although the cost of engraving which occurs before a sale is included in the taxable purchase price.
- **Assembly:** Under current department administration of the sales tax, assembly is not treated as taxable fabrication labor, but the line between assembly and fabrication labor is not clear. For example, is assembly of modular furniture never meant to be unassembled exempt assembly labor or taxable fabrication labor?
- **Automobile accessory installation:** The line between taxable fabrication labor and nontaxable accessory installation is not clear. Under current department administration of the sales tax, installation charges relating to automotive accessories that are deemed to be permanent in nature are taxed while installation charges for removable automotive accessories are exempt.

II. 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 taxes 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 the potential fraudulent use of exemption certificates to determine the extent of such abuse.

III. Recodification of the Sales and Use Tax Statute

The Council recommends that the Department of Revenue:

- (1) evaluate the time required and the cost of recodifying and rewriting the sales tax statute; and
- (2) advise the tax committees of both houses of Legislature of the cost, timing, and a possible process (involving legislative staff and taxpayers or their representatives) for recodifying and rewriting the statute.

The council makes this recommendation because the Minnesota sales tax statute is poorly organized and written. Substantive provisions are embedded in definitional provisions. Much of the statute's language is archaic and reflects drafting conventions of another era. The tax was written originally as a tax to be imposed almost exclusively on goods and the statute's language reflects this structure. The Legislature has, over time, expanded the tax to services without fundamentally rewriting the underlying structure. Changes in commercial practices over the last three decades were not anticipated in the drafting of much of the language. In general, the understandability and usability of the statute could be improved considerably.

Rewriting the statute, however, will require a significant investment of time and expertise. In addition, care must be taken to avoid unnecessarily changing settled expectations of taxpayers and tax administrators, based on the existing statutory language. Thus, the council recommends that the department assess the cost and time necessary to rewrite the statute and report to the 1997 Legislature. In addition, the department should develop a process for this rewrite and recodification that involves outside groups, such as members of the tax bar, the society of accountants, and legislative staff. The Legislature should, then, consider whether to provide funding for a recodification and rewriting of the statute.

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. Define "In the Regular or Normal Course of Business" For Purposes Of Administering the Sales and Use Tax

The council recommends that the Legislature enact statutes that define the terms "in the regular course of business" and "in the normal course of business."

The isolated and occasional sale exemption does not apply to someone making sales "in the regular course of business" when such sales are "in the normal course of business" of selling that kind of property. However, while these concepts are critical to determining what sales qualify for the isolated and occasional sales exemption, there is no statutory or regulatory definition of what they are. Therefore, these terms should be defined by statute. This statute should also authorize the commissioner to promulgate rules that provide additional guidance in applying the general statutory principals.

II. Local option sales and use taxes

The Council recommends that the Legislature adopt model statutory language for imposition of local sales and use taxes. This model statute would apply to both existing and any newly authorized taxes.

The Legislature should not enact a general authorization for local sales and use taxes and should exercise restraint in authorizing new local sales and use taxes for individual local governments. Specific authorization of local sales and use taxes for individual local governments should only occur after considerable deliberation of the need and justification for the exception to the general policy. (General state law prohibits enactment of local sales and use taxes. Any local sales tax that has been authorized, with the exception of the city of Duluth's which pre-dated the prohibition's enactment, has been authorized by *special legislation that provided an exception to this prohibition.*)

The model act would create consistency in exemptions and application of existing local sales taxes. This is an issue for businesses outside of a taxing area who are required to collect local taxes. The model statute should include the following:

- (1) The Legislature is responsible for authorizing which political subdivisions can impose a tax, the rate of the tax, the length of time the tax may be imposed, whether voter approval is required and how the tax proceeds can be used.
- (2) The tax must follow the state base.

- (3) There must be a compensating use tax.
- (4) Goods that are exempt when removed from Minnesota are exempt when removed from the political subdivision.
- (5) A credit is allowed for sales tax paid to other political subdivisions.
- (6) The full local tax rate applies to items taxed at less than the full state rate.
- (7) All state exemptions apply to local sales taxes.
- (8) Taxation of services are determined using the state guidelines.
- (9) All local taxes must be administered by the commissioner and are subject to the state penalty, interest and enforcement provisions. Department costs for administering the local taxes will continue to be reimbursed.
- (10) A 90 day notice to the commissioner is needed to commence or terminate a local sales tax.
- (11) The Legislature may want to set a uniform policy for assessing local taxes on motor vehicles.

III. Statute of Limitations on Refunds for Bad Debts

The council recommends that the Legislature amend the statute of limitations for filing claims for sales tax refunds for bad debts.

Present law allows filing of claims for seven years from the date prescribed for the filing of the return. (Minnesota Statutes, Section 289A.40, subdivision 2) Although not completely clear, this apparently means that refunds relating to bad debts must be claimed within seven years after the sales tax return on the original purchase was due. Under this standard, claims would be barred for refunds relating to certain bad debts which would still be deductible federally. The group proposes that refund claims be permitted through the later of:

- (1) The end of the 3 ½ year statute currently provided by Minnesota Statutes, Section 289A.40, subdivision 1, or
- (2) One year after the due date of the federal income tax return on which the loss may be claimed for federal income tax purposes.

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 Business Use Tax

Under current law, any business making an untaxed purchase that subsequently uses the item in Minnesota should self-assess and remit a use tax of 6.5 percent of the purchase price less any sales tax paid to the state of purchase. Many Minnesota businesses are unaware of the obligation and fail to remit the tax.

Rather than making these Minnesota businesses unwitting lawbreakers, the council proposes allowing businesses 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. *Businesses 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. [The Legislature may wish to exclude holders of sales tax permits from this exemption, since they should be aware of the payment obligation.]*

The Department of Revenue's preliminary estimates are that enactment of this recommendation would result in a revenue loss of \$200,000 annually.

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

The council recommends the Legislature exempt goods used or consumed in performing taxable services from the sales and use taxes.

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 exists 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. This includes, among others, laundry and dry cleaning, car washes, building and residential cleaning, telephone services, cable television services, lodging, massage, animal boarding services and lawn care.

The Department of Revenue estimates this recommendation would cost \$7.9 million in FY 1998 and \$8.3 million in FY 1999.

III. Permanently Exempt New and Used Farm Machinery from the Sales and Use Tax

The council recommends that the Legislature permanently exempt all farm machinery from the sales and use taxes. This recommendation would be consistent with the principle that business inputs should not be subject to tax and will slightly reduce the problem of pyramiding of the sales and use tax.

Under current law, used farm machinery is exempt from tax through June 30. New farm machinery is taxed at a 2.5 percent rate. Making the used farm machinery exemption permanent and prospectively exempting new farm equipment from the sales and use taxes would cost \$12.9 million in FY 1998 and \$13.3 million in FY 1999. The exemption would be limited to the current law definition of farm equipment. Thus, it would not extend to purchases of, for example, antique or collectible farm equipment by collectors.

IV. Accelerate and Complete the Phase-Out of the Sales and Use Tax on Replacement Capital Equipment

The council recommends that the current phase-out of the tax on replacement capital equipment be accelerated and completed by June 30, 1997. In addition, the council recommends that the new and replacement capital equipment refund be converted to an exemption on July 1, 1997.

Year	Current Law	Proposed Law	Preliminary Cost (\$000)
FY 1998	2.9%	0.0%	59,700
FY 1999	2.0%	0.0%	27,800

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.

The council also recommends that the Legislature exempt the capital equipment purchases by providers of services, both taxable services and non-taxable. Current law exempts capital equipment purchases only for on-line computerized data retrieval services. For providers of taxable services, this is a pyramiding issue. For providers of non-taxable services that sell their products nationally, this may be a competitiveness issue for Minnesota service providers. The council does not have an estimate of the cost of this exemption, but it is likely to be expensive. Because of the high cost, the Legislature may need to phase-in the exemption. In doing so, the Legislature should consider (1) whether the exemption will reduce pyramiding, (2) the most

effective targeted exemption to improve Minnesota's national competitiveness, and (3) the effect on administration and compliance costs.

V. Repeal the June Sales Tax Acceleration

The Council recommends that the Legislature repeal the accelerated payment of June sales tax liability, effective for the payment that is due in June 1998.

The accelerated June payment was adopted by the Legislature in 1982 to realize one-time budget savings during the budget shortfalls in the 1981-82 recession. The accelerated payment requires large sales tax payers with annual liabilities of \$120,000 or more to pay 75 percent of their estimated June liability before the end of the month. This payment would otherwise be due on the 20th of July. The accelerated payment moved a large share of one month's sales tax collections into the previous fiscal year.

The accelerated June payment causes substantial compliance and administrative costs for both taxpayers and the Department of Revenue. Although the cost of its repeal is substantial (over \$123 million), this is a one-time cost that does not permanently reduce the sales tax base or affect future state revenues.

VI. Vendor Allowance

The council recommends the Legislature enact an annual vendor allowance for vendors that remit \$120,000 or less of sales tax annually. The amount of the allowance would be the lesser of \$100 or the taxpayer's annual liability as reported on line 100 of the sales tax return. The intent of the recommendation is to compensate sales taxpayers for their costs of collecting the tax and remitting it to the state.

The department is preparing an estimate of the cost of this proposal.

VII. Interest on Refunds

The council recommends that the Legislature require that interest on purchaser refund claims filed with the Department of Revenue be computed from the 20th of the month following the month of the invoice date.

In 1996, the council recommended the implementation of purchaser refunds of erroneously paid sales tax by currently registered sales tax permittees. Refund claims were limited to no more than two per year with a \$500 minimum refund request for each claim. This recommendation was implemented in Laws 1996, Chapter 471, Article 2, Section 8. Per the provisions of Minnesota Statutes, Section 289A.56, subdivision 4, interest only accrues from the time the refund claim is

filed. This is different from the manner in which interest is computed if the purchaser goes back to the vendor and requests a refund of the erroneously paid tax. When a vendor files for a refund with the Department of Revenue and submits a detailed schedule reflecting the tax periods covered in the claim, the vendor receives interest back to when the payment was remitted. If the refund claim submitted does not include a detailed schedule reflecting the tax periods covered in the claim, interest is computed from the date the claim was filed. This recommendation would come closest to matching the amount of interest that would be paid if the vendor filed for the refund on behalf of the purchaser. The Department of Revenue estimates this recommendation has a minimal cost.

VIII. Reinstate the Former Exemption of Isolated and Occasional Sales of Property Used In a Trade or Business and Make All Otherwise Taxable Sales by Brokers, Agents and Auctioneers Who Are Regularly Engaged in Those Businesses Subject to the Sales Tax

The council recommends that the Legislature reinstate the former exemption for isolated and occasional sales of tangible personal property used in a trade or business. In conjunction, the council recommends that the Legislature make all sales by brokers, agents and auctioneers who are regularly engaged in those businesses subject to the sales tax to the same extent the items sold would be subject to sales tax if sold at a retail store.

The 1991 repeal of the isolated and occasional sales exemption for property used in a trade or business has created a number of compliance problems. A significant number of taxpayers, usually not obliged to collect sales tax, are unaware of their obligation to collect tax on sales of items used in their trade or business. In addition, the current law's exemptions of such sales when they are done in conjunction with the sales of substantially all the assets of the business or when they meet certain federal statutory standards relating to tax free reorganizations or transfers between members of controlled groups further complicates compliance. Reinstatement of the exemption would eliminate the problem. At the same time, making all sales by brokers, agents and auctioneers who are regularly engaged in those businesses subject to the sales tax (to the same extent the items sold would be subject to sales tax if sold at a retail store) would fill one of the "loopholes" addressed by the repeal of the isolated and occasional sales exemption for property used in a trade or business.

The Department of Revenue's preliminary estimates of the combined impact of these recommendations are a revenue gain of \$12.1 million in FY 1998 and \$12.5 million in FY 1999.

IX. Exempt Clothing Repairs and Alterations

The council recommends that the Legislature exempt clothing repair and alterations from the sales and use tax.

Sales of clothing are exempt from the sales tax. It makes little sense to tax the repair or alteration of clothing when the sales of new clothing--the manufacture of which involves near identical labor inputs in terms of sewing, hemming, etc.--are exempt or when the tax can be legally "evaded" by including an unstated but standard alteration charge in the sales price of all clothing articles that would frequently be subject to alteration, e.g. men's suits.

The Department of Revenue estimates this recommendation would cost \$800,000 in FY 1998 and \$900,000 in FY 1999.

X. Make the Sales Tax and the Use Tax More Complementary

The council recommends that the Legislature amend the statutes to apply the sales tax and the use tax in the same manner regardless of whether goods are purchased from an in-state or out-of-state vendor. In addition, the council recommends that the Legislature give the commissioner clear authority to issue direct pay permits to taxpayers other than common carriers engaged in interstate commerce and clarify that the tax due under the permit is a use tax. Finally, the council recommends that the Legislature amend existing statutory exemptions to clarify that sales tax exemptions also apply to the use tax.

Making the sales tax and use tax more complementary or applicable in the same manner regardless of whether goods are purchased from an in-state or out-of-state vendor would require making changes "1a" and "1b" below.

1a) Eliminate the use tax processing exemption.

Minnesota Statutes, Section 297A.25, subdivision 9 (the exemption for materials used or consumed for production of tangible personal property for ultimate sale at retail) achieves the same objective as the use tax processing exemption -- to avoid taxing goods brought into the state for processing. So, it is a source of confusion to provide a redundant, separate intermediate processing exemption for the use tax.

1b) Amend the temporary storage exemption in Minnesota Statutes, Section 297A.01, subdivision 7 by narrowing eligibility to only those goods temporarily in storage at a public warehouse while in transit with a common carrier and only resident in Minnesota while in the course of interstate commerce.

The use tax may be applied without a constitutional impediment when a taxpayer and ultimate consumer either (a) brings goods into Minnesota purchased elsewhere or (b)

takes possession in Minnesota of goods to which the title passed in another state. Double taxation is not an issue since, to the extent that such goods have already been subject to a sales tax in the state of purchase, the taxpayer will receive a credit against any Minnesota use tax liability and, to the extent that such goods will be subject to use tax in another state where the goods will be ultimately used, the taxpayer will receive a credit for the Minnesota use tax that was paid. To pass constitutional muster, the state need exempt only those goods brought into the state for temporary storage in a public warehouse while such goods are in transit with a common carrier and only temporarily resident in Minnesota while in the course of interstate commerce. This change is projected to raise \$1 million of additional revenue annually.

2) Provide statutory authorization for direct pay permittees other than common carriers engaged in interstate commerce, and clarify that direct pay permittees' liability is a use tax liability.

Currently Minnesota Statutes, Section 297A.211 authorizes only common carriers engaged in interstate commerce to directly remit use tax (instead of paying sales tax at the time of purchase). The Department of Revenue, however, does allow other permitted taxpayers to directly remit sales *or* use tax instead of paying the sales tax at the time of purchase, despite the absence of explicit statutory authority to do so. The council recommends amending the statute to authorize this long standing administrative practice.

Furthermore, the council recommends the status of the tax paid by direct pay permittees--under both the existing statutory authorization for interstate common carriers under Minnesota Statutes Section 297A.211 and the recommended statutory authorization for other direct pay permittees--be clarified so that it is clear that the tax liability that accrues to a direct pay permittee is a use tax liability. For those cities with local sales taxes but no local use taxes such as St. Paul or Mankato, the law would be changed so that the local sales tax would still accrue on those goods or services used or consumed in the taxing city if the council's recommendation II under "Legislative Recommendations With No Effect on State Revenues" is not enacted.

3) Amend Existing Statutory Exemptions to Clarify that Sales Tax Exemptions Also Apply to the Use Tax.

Many current exemptions only refer to the sales tax. In the absence of literal authorization for a use tax exemption, the Department of Revenue administers the exemptions as if the legislature meant to exempt from use tax any item that is exempt from sales tax. The council recommends that the statute be amended to be consistent with the manner in which it is being administered—that is, that exemptions apply to the use tax as well as to the sales tax.

XI. Clarify the Taxation of Health Care Products

The Council recommends the Legislature make the following changes to the exemption provided for medicines and medical products:

- (1) Broaden the language exempting analgesic products to include new over-the-counter analgesics approved by the Federal Drug Administration.
- (2) Change the statute to provide an exemption for "legend drugs" in place of the current "prescribed drugs."
- (3) Define medical supplies and clarify that medical supplies purchased by a health care provider for treatment of a person while a patient or resident are exempt from sales tax.
- (4) Include definitions for therapeutic, prosthetic and orthopedic devices in statute.

The reasons for the recommendations follow:

1. Analgesics. The first recommendation will add the flexibility needed to keep up with changes in the industry and provide the exemption intended by the original legislation. The statute specifically exempts analgesics consisting principally (determined by weight of all ingredients) of acetaminophen, acetylsalicylic acid, ibuprofen, or a combination thereof. This exempts aspirin and aspirin substitutes such as Tylenol and Advil. Aleve and Orudis KT are two new analgesic products that are not exempt under this provision because the principal ingredients in these products, naproxen (Aleve) and ketoprofen (Orudis KT), are not included in the exemption even though the products serve the same purpose as other exempt medicines.

2. Legend drugs. Currently the sale of prescribed drugs, prescribed medicine and insulin, intended for use, internal or external, in the cure, mitigation, treatment or prevention of illness or disease in human beings is exempt. This exemption raises questions about the definition of the word "prescribed" and whether diagnostic activities are part of the "cure, mitigation, treatment or prevention of illness or disease." It also creates inconsistency between the Minnesota Care tax and the sales tax.

The changes suggested will create consistency between the Minnesota Care tax and the sales tax and codify current practice. This change will exempt some items such as contraceptives that are currently taxable.

3. Medical supplies. The department has administratively allowed an exemption from sales tax for medical supplies purchased by doctors and clinics for patient use. This exemption has been allowed since 1987 when state government became taxable. The

rationale is that since Medical Assistance pays for the health costs for low income persons, taxing these items would increase the costs of health care which would decrease the value of Medical Assistance dollars. The council recommends that the Legislature codify this administrative exemption in the statute.

4. Therapeutic, prosthetic and orthopedic devices. The proposal would add definitions for the terms therapeutic devices, and prosthetic and orthopedic devices to the statute. Definitions for therapeutic and prosthetic devices are currently found only in Rule 8130.4800. This would also include a definition for orthopedic devices. Although orthopedic devices are not currently defined in the rule, they are included in the exemption as prosthetic devices.

The Department of Revenue estimates these recommendation in total would cost \$900,000 in FY 1998 and \$1 million in FY 1999.

XII. Food products

The Council recommends that the Legislature adopt statutory language to create consistency in taxing food products.

Furnishing, preparing, or serving of food, meals or drinks for consideration is a taxable sale. The law further clarifies that heated food or drinks, sandwiches prepared by the retailer, single sales of prepackaged ice cream or ice milk novelties prepared by the retailer, hand-prepared or dispensed ice cream or ice milk products including cones, sundaes, and snow cones, soft drinks and other beverages prepared or served by the retailer, gum, ice, all food sold in vending machines, party trays prepared by the retailer, and all meals and single servings of packaged snack food, single cans or bottles of pop, sold in restaurants and bars are taxable.

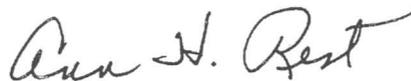
The statutory language creates confusion and inconsistencies in taxing food products. Certain food products, such as salads, are taxable when sold in a restaurant, but exempt when sold in a grocery store deli section even though in both situations the salad is prepared by the retailer and ready for immediate consumption.

The council makes no specific recommendations on how to resolve this issue but optional clarifications would include:

- Taxing all food and drinks that are sold to be consumed on the retailer's premises - "Premises" would be defined as the total space and facilities made available for use by the retailer (including buildings, grounds, and parking lots made available or that are available for use by the retailer).
- Taxing all food sold on grounds that require an admission charge - All food sold for consumption on such premises would be presumed taxable.

- Applying the sales tax to sales of all ice cream and bakery products that were sold in single or individual servings - Prepackaged, multiple-serving packages and bulk containers would be exempt.
- Applying the sales tax to all soft drinks and beverages except dairy products, fruit juices and certain bottled water.

The Department of Revenue estimates these recommendation in total would raise additional revenue of \$3.2 million in FY 1998 and \$3.3 million in FY 1999.



Representative Ann H. Rest
Chair, Sales Tax Advisory Council