Minnesota enacted a $443 million tax reduction bill last month (HF 1777) that made several changes to sales tax, estate and gift taxes, and income taxes. The bill passed by a wide margin in both chambers and was promptly signed by Governor Mark Dayton. The tax cuts are expected to save taxpayers just over $443 million during the 2014-15 fiscal year and $956 million in 2015-16.

Most anticipated was the repeal of several controversial sales taxes on business inputs that were enacted last year, including:

- Sales tax on warehousing and storage services. This tax would have gone into effect on April 1, 2014 if it hadn't been repealed.
- Sales tax on repair and maintenance of electronic equipment, commercial equipment, and farm equipment. The repeal was effective April 1, 2014, but not retroactive. Transactions made between July 1, 2013 and March 31, 2014 are subject to sales tax.
- Sales tax on telecommunications equipment. Similar to the repair and maintenance tax, the repeal was effective April 1 of this year, but repeal was not retroactive.

We criticized these when they were passed last year because applying the sales tax to business inputs causes tax pyramiding and differing effective tax rates for different businesses. That can cause firms to vertically integrate for tax reasons, resulting in costly economic distortions. Getting rid of sales tax on business inputs is a smart move.

HF 1777 also makes changes to the taxation of capital equipment purchases, expanding the sales tax exemption for these items (another good move). But it also delays the "up-front sales tax exemption" for capital equipment from September 1, 2014 to July 1, 2015. Previously, capital equipment purchasers or renters would pay sales tax at time of sale and then request a refund. After July 1 of next year, these transactions will be exempt from the sales tax when they are purchased. (Note that this was supposed to go into effect on September 1 of this year, but the tax package delayed this.) Forcing buyers to file for a refund later adds unnecessarily complexity to the tax code and wastes resources on compliance and administration. It would be better for Minnesota to move to "up front" exemptions immediately.

In addition, the tax package increases the state's estate tax exemption from $1 million to $2 million over five years and repeals the state gift tax enacted last year. Though coupling the estate tax exemption with the federal exemption of $5.25 million would have been better (something that Maryland and New York did this year), this is a good start. Minnesota estate tax rates are also slightly adjusted (though the top rate of 16 percent didn't change).

Prior to the enactment of the American Taxpayer Relief Act (ATRA) at the federal level, Minnesota did a fairly good job of coupling state income calculation with federal income calculation (see Table 2 of this Special Report). ATRA contained changes to how taxable income is calculated for federal taxes. HF 1777 updates several of the state's laws to match what occurred federally under the ATRA, making Minnesota income more closely mirror federal taxable income.

Conforming income calculation to the federal code makes sense, since taxpayers pay both state and federal taxes. But there is a bit of a trade-off here: though Minnesota's state income tax code adopted exclusions from income that exist at the federal level, it also duplicated many deductions, credits, and other politically expedient federal carve-outs, which carve away at the state's tax base. Minnesota already has high income tax rates (last year lawmakers there retroactively added another top income tax bracket, moving the top rate to 9.85 percent). Further chipping away at the tax base only exacerbates this problem.

The major state individual income tax provisions adopted this year are summarized in the following table. (Minnesota's Department of Revenue put together a summary here, details of which are reproduced below.)

Individual Income Tax Provision	Details
Child and Dependent Care Credit	Credit is calculated based on $2,400 of qualifying expenses for one child ($4,800 for two); credit amounts to 30 percent of these. Credit begins to phase out at $10,000.
Mortgage Interest Premiums Deduction	Available to individuals with income less than $110,000.
Higher Education Tuition and Fees Deduction	Up to $4,000 is deductible; available to individuals with income less than $80,000.
Student Loan Interest Deduction	Up to $2,500 is deductible; available to individuals with income less than $75,000.
Education Savings Account Distribution Exclusion	K-12 education expenses paid for by Coverdell Education Savings account distributions can be excluded from income; available to individuals with income less than $110,000.
Exclusion for Certain Employer-Provided Assistance	Certain college or post-secondary education expenses (up to $5,250), adoption expenses (up to $12,970), and transit expenses (up to $245/month) paid for by the taxpayer's employer can be excluded from income. Available to individuals with income less than $234,580.
Exclusion for Tax-Free IRA Distributions Spent on Charitable Contributions	Up to $100,000 can be excluded; available to individuals 70 ½ and older (no income eligibility requirement).
Educator Expenses Deduction	Up to $250 can be deducted; available to K-12 school teachers and employees that purchases school supplies out of pocket.

Other minor changes	Minnesota now allows for exclusion of National Health Corps Scholarships and certain mortgage debt forgiveness amounts, in addition to expanding certain aspects of charitable contributions deductions.

Other individual income tax provisions included in HF 1777:

- Elimination of the marriage penalty by increasing standard deduction for married-filing-jointly taxpayers (now double the single standard deduction).
- Expansion of the refundable Working Family Credit (married joint filers now eligible). Taxpayers earning up to $47,000 are eligible.
- Expansion of the Angel Investment Credit.
- Increase in amount that can to be put into Education Savings Accounts.

All in all, this year's tax package has some positive elements--namely, the repeal of sales tax on certain business inputs, the higher estate tax exemption, and the repeal of the state's gift tax. Even though the income tax changes are expected to cut taxes by a large amount, this isn't real individual income tax reform because it doesn't repeal the retroactive income tax increases enacted last year and it carves away at the base. Pairing state income calculation to federal income calculation can have simplification benefits, but it doesn't trump Minnesota's high rates. Instead, lawmakers should consolidate brackets and lower the top rate.