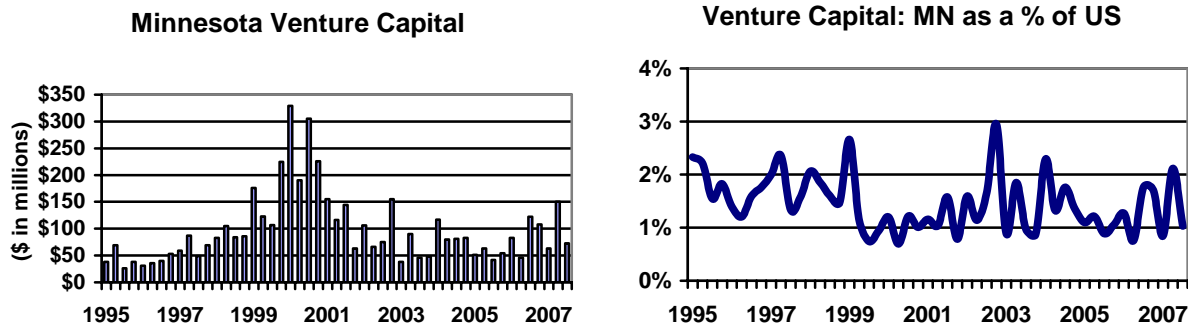


PERSONAL INCOME TAX BACKGROUND

The personal income tax, and the capital gains tax especially, is a business issue for several reasons. First, according to a study released in 2005 by Associated Oregon Industries Foundation, Minnesota has the eighth highest tax rate for capital gains in the nation. The study concludes that high taxes on capital gains inhibit venture capital investment. That investment helps spur small business growth and keep entrepreneurs working, investing and employing people.

The two graphs below from PricewaterhouseCoopers Money Tree Survey show Minnesota's total venture capital investment and the state's share of the national venture capital investment.



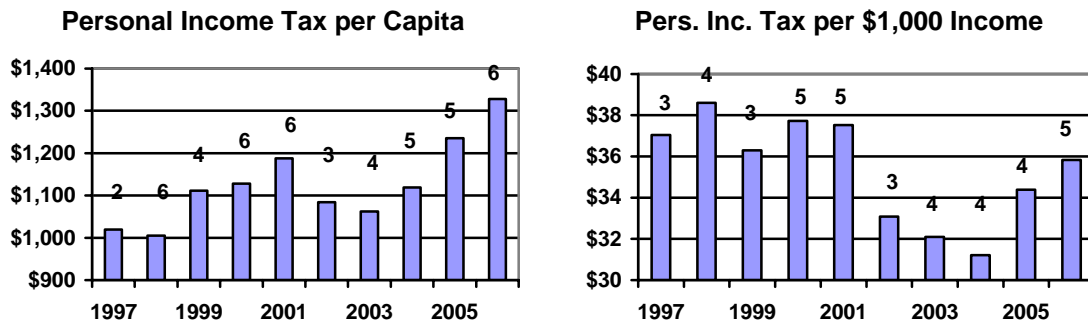
Minnesota taxes capital gains at the same rates as ordinary income so Minnesota's top rate is 7.85 percent. However, a significant number of states, including all of our surrounding states, provide some type of preferential treatment for capital gains. According to the Small Business and Entrepreneurship Council, in 2005, Iowa's top capital gains tax rate is 7.633 percent, North Dakota's is 5.54 percent, South Dakota does not tax capital gains, and Wisconsin's top rate is 2.7 percent. The average and median top rate for states that tax capital gains is almost 6 percent which would be a 24-percent reduction in Minnesota's current top rate.

Second, a significant and growing number of businesses flow their business income through a personal rather than a corporate income tax return. In 1994, there were almost 48,000 personal returns filed with income derived from S-corporations, 30,000 personal returns with income from partnerships and approximately 326,000 personal returns with income from sole proprietorships (anyone filing a Schedule C). In that same year, approximately 53,000 corporate tax returns were filed. By 2002, the number of personal returns with income derived from S-corporations more than doubled to 101,000 while the number of returns filed by C-corporations stayed essentially flat at 54,000. Thus, the vast majority of business taxpayers filed a personal and not a corporate tax return.

The trend of businesses flowing income through personal returns has accelerated during the past 15 years. This has occurred because, for many businesses, changes to the federal income tax code have made S-corporations, limited liability companies and partnerships more attractive corporate structures than C-corporations. In addition, Minnesota provides an incentive for such a change by taxing C-corporations at a 9.8-percent rate, significantly above its highest marginal tax rate for the personal income tax of 7.85 percent.

Third, Minnesota is losing more high-income people than it is attracting. According to the Internal Revenue Service, between 1998 and 1999, Minnesota lost more than \$170 million of income due to migration. The largest net dollar losses were individuals moving to Florida and Arizona. Minnesota also lost income to South Dakota, North Carolina, Colorado and Nevada. Florida, Nevada and South Dakota do not have personal income taxes. Personal income taxes per \$1,000 of income in Arizona ranked 40th highest, in Colorado ranked 31st highest and in North Carolina's ranked fifth highest. Minnesota's high personal income tax rates are likely to be one factor in the loss of this income.

State rankings. Minnesota has historically ranked among the highest in the nation with respect to the personal income tax. In 2006, the last data available, Minnesota ranked sixth highest in personal income tax per capita (\$1328) and fifth highest per \$1,000 of income (\$35.83). None of our surrounding states had income tax collections that ranked in the top 10. The graphs below show Minnesota's personal income tax collections per capita and per \$1,000 of income from 1997 to 2004. (Minnesota's national ranking appears above the bar.) Despite significant personal income tax rate reductions in 1999 and 2000, Minnesota's competitive position hasn't improved.



These rankings tell only part of the story because taxpayers in different income groups or with different filing status face varying tax burdens. The table on the next page compares personal income tax burden by income level and filing status using the Minnesota Taxpayers Association's most recent comparison report. As the table shows, Minnesota's personal income tax does a good job of shielding taxpayers up to \$20,000 of gross income; however, once income rises above that level, taxpayers face much higher tax burdens.

**2003 Minnesota Personal Income Tax:
Preliminary Tax and National Ranking by Gross Income and Filing Status**

FAGI	Married Joint Filers		Head of Household		Single	
	Tax	Rank	Tax	Rank	Tax	Rank
\$10,000	(\$815)	39 th	(\$637)	39 th	\$97	22 nd
\$20,000	(\$1,472)	42 nd	(\$177)	40 th	\$655	19 th
\$35,000	\$714	26 th	\$1,174	22 nd	\$1,598	14 th
\$50,000	\$1,491	21 st	\$2,010	17 th	\$2,430	11 th
\$75,000	\$3,063	19 th	\$3,624	12 th	\$4,103	9 th
\$100,000	\$4,567	18 th	\$5,269	12 th	\$5,997	7 th
\$250,000	\$15,910	10 th	--	--	\$17,850	9 th

FAGI = Federal Adjusted Gross Income
Rankings: 1 = highest; 42 = lowest.

Source: Minnesota Taxpayers Association

In 2005, the Legislature considered an increase in personal income tax rates. A new fourth bracket for high-income individuals with a rate of 10.65 percent was proposed to help balance the budget. In addition, there was a proposal to increase the 7.85-percent rate to 8.0 percent to address problems with the alternative minimum tax. Neither rate increase became law. The Department of Revenue estimated that 42,000 S-corporation shareholders would be in the new fourth bracket. Many more small businesses would have been affected by proposed increase in the 7.85-percent rate. Accordingly, these tax increases would have had a significant impact on the competitiveness of Minnesota's small businesses.

In 2007, the Minnesota House proposed the creation of a new fourth bracket at 9 percent for married-joint filers at \$400,000 of income (\$226,000 for individuals). This new bracket would have affected 9,500

Minnesota residents with small business income, and consequently increased their taxes by \$86 million/year. Similarly, in 2007 the Minnesota Senate proposed creating a new fourth bracket at 9.7 percent for married-joint filers at \$250,000 of income (\$141,000 for individuals). This proposal would have negatively impacted 29,800 Minnesota residents with small business income and raised their taxes an additional \$183 million/year. The House proposal would have elevated Minnesota to the third highest income tax rate in the nation. Correspondingly, the Senate proposal would have elevated Minnesota to the highest income tax rate in the country.

In 2006, the Legislature modified the alternative minimum tax (AMT) by increasing and indexing the exemption amount. According to a House Research analysis of the change, the number of AMT filers should drop from approximately 45,000 to 8,000 because of this change. There are still a few issues with respect to the AMT, namely, conformity to the federal AMT tax base, a marriage penalty and home mortgage deduction issues.

Growth and Justice Study: In 2004, the Growth and Justice think tank studied Minnesota's tax system and made recommendations to improve its progressivity and competitiveness. Its recommendations consisted of two restructuring proposals both of which increased personal income taxes and decreased business taxes. The first proposal had the following components:

- Use federal adjusted gross income as the starting point for the Minnesota return rather than federal taxable income.
- Increase the top marginal rate to 9.5 percent.
- Eliminate the corporate income tax.
- Eliminate the sales tax on most business purchases.
- Create a business activity tax with a rate of 2.5 percent.
- Broaden the sales tax to consumer services, untaxed goods and clothing and reduce the rate to 4.2 percent.

The personal income tax changes of the first proposal raised about \$375 million which in turn were used to reduce business taxes by the same amount. Using adjusted gross income as the starting point for Minnesota personal income taxes increases taxes on upper-income Minnesotans and decreases taxes for those at lower incomes.

The second proposal is a more modest one. Its components are:

- Create a new top bracket for the personal income tax of 9 percent for married joint filers with income over \$150,000.
- Tax municipal bond interest.
- Cap itemized deductions at \$100,000.
- Broaden the sales tax to include most consumer services except health care and lower the rate to 5.3 percent.
- Reduce the corporate income tax rate to 9.5 percent.

The personal income tax changes of the second proposal also raised about \$375 million which again was used to reduce business taxes. This proposal increases taxes on upper-income Minnesotans but does not reduce personal income taxes on lower-income earners.