



# John James, former State Revenue Commissioner

## Broaden sales tax, cut income tax to respond to federal tax changes

A Minnesota Tax Policy Interview

*April 27, 2018*


### Present

John Adams, Steve Anderson, Helen Baer, Janis Clay (executive director), Pat Davies, Paul Gilje, John Hayden, John James, Ted Kolderie, Paul Ostrow (chair), Dana Schroeder (associate director), Clarence Shallbetter, T. Williams. By phone: Audrey Clay.

### Summary

Tax lawyer and former Minnesota Commissioner of Revenue John James calls the federal Tax Cuts and Jobs Act (TCJA) "an earthquake" in terms of individual income-tax structure, "nowhere more so than in Minnesota." He explains that Minnesota's income tax is heavily tied to the federal income tax and proposes a number of changes to the state tax system to adjust to the federal changes.

Overall, he proposes broadening the sales-tax base so everyone gets a state income-tax cut. He says broadening the sales-tax base to include clothing would produce \$389 million a year in additional sales-tax revenue. That revenue could be used to help ensure everyone gets an income-tax cut. An income-based credit could take away any issue of the sales tax being regressive, he says.

James proposes three major state income-tax-conformity bill possibilities, encompassing various levels of change and all aimed at simplifying Minnesota's tax system. He describes the three levels of change in this interview and goes into even more detail in his May 4, 2018, paper,  ["A Proposed Minnesota Response to the Federal Tax Cuts and Jobs Act."](#)

He says if his proposed Minnesota response to the TCJA is not politically feasible, the governor and the Legislature should significantly increase the state standard deduction and personal exemptions. The increase should be large enough to make the deduction and the exemptions combined roughly equal to or larger than the federal standard deduction, which was increased by the federal tax act.

Taking this step, James says, would reduce by hundreds of thousands the number of taxpayers who would need to compute Minnesota-only itemized deductions.

## Biography


John James is a tax and business lawyer with a history of developing law-change proposals, some of which have been enacted. He has spent time with three Minneapolis law firms and a CPA firm and has worked solo since 2007. He is former commissioner of the Minnesota Department of Revenue, serving in that post from 1987 to 1991. He was assistant commissioner from 1986 to 1987. While at the department, James created the Appeals Office, drafted and secured passage of major tax reform, and chaired the Multistate Tax Commission.

Upon leaving government in 1991, James co-founded what became the Public Strategies Group, a public-policy consulting firm with which he collaborated from time to time over the years. In 2011, James became a fellow with the Center for Policy Design to work with others to redesign multiple aspects of Minnesota's state and local governments. His emphasis is on the state-local fiscal system and the state-local government relationship. He recently created a framework for ending Minnesota's transportation-funding crisis.

James was deeply involved in two significant Minnesota public-policy designs outside the tax arena. In the 1970s, he helped design the Minnesota Interest on Lawyer Trust Accounts program. In the 1990s, he helped draft the Minnesota Limited Liability Company Act and secure support for it from the Department of Revenue, the Minnesota Legislature and the Internal Revenue Service.

James chairs the board of the Interest for Others Foundation and serves on the board of Minnesota Lakes and Rivers Advocates. He is a 1968 graduate of the University of Iowa and a 1974 graduate of Harvard Law School.

## Background

Continuing its focus on Minnesota's competitiveness, the Civic Caucus interviewed tax lawyer and former Minnesota Revenue Commissioner John James about his views on how Minnesota should respond to the major changes in the federal income tax resulting from the Tax Cuts and Jobs Act. James has written a paper explaining his proposed changes to Minnesota's tax system in response to the federal changes,  ["A Proposed Minnesota Response to the Federal Tax Cuts and Jobs Act."](#) He has sent this updated May 4, 2018, version of the paper to the governor, legislative leadership and other policy leaders.

## Discussion

**The federal Tax Cuts and Jobs Act (TCJA) is an earthquake in terms of individual income-tax structure and nowhere more so than in Minnesota.** Tax lawyer and former Minnesota Department of Revenue Commissioner John James said Minnesota's income tax is heavily tied to the federal income tax. Right now, James said, ours is tied to federal taxable income as of Dec. 16, 2016. "If we don't get a state tax bill-and that's supposedly a serious risk-that will still be the law and the 2019 tax season will be a nightmare," he said.

Years ago, James said, the Minnesota Supreme Court decided that for the state to just automatically conform to whatever Congress does would be an unconstitutional delegation of legislative power. "So every time the feds make a change, we have to look at it and say, 'Do we want to do this or not?'" he said. So every year the state Revenue Department has a federal conformity bill.

**There isn't a knowledgeable tax person in the state who doesn't think we have to have a tax bill.** James said without a bill, there will be an administrative disaster. "If we get to October and we don't have a solution, then we're in real trouble," he said.

Both the Republicans and the Democrats in the Legislature are trying to play to their bases, James said. "They're trying to minimize the impact by what they've done. But trying to preserve a status quo from which the federal government has retreated is not a good strategy for Minnesota."

He said if we keep the state income-tax revenue neutral, the upper middle class will get a tax increase. But the Legislature doesn't want to give anybody a tax increase. Legislators want to give tax cuts. "The obsessive focus on nobody getting a tax increase is a mistake from a public-policy point of view," he said.

**It no longer makes sense to tie the Minnesota income tax to Federal Taxable Income on the federal income-tax form, as we've done in the past.** "But tying to Federal Adjusted Gross Income (FAGI) from the federal income tax form is a very sensible thing to do," James said. Both the governor and the House and Senate have done that in their plans, he said. "They've got the basis for a compromise there."

**James said there are several key questions about how Minnesota should conform to the new federal tax law:**

1. James asked if he were right to be concerned about the following two things: (a) The loss of federal deductibility for state and local taxes for 30 percent of Minnesota filers-those filers who used to itemize on federal taxes but won't anymore because of the new, much larger federal standard deduction; and (b) Limiting the federal deduction for state and local taxes to \$10,000, impacting the five percent of Minnesota filers who will likely still itemize.

"Those two things are going to make supporting Minnesota state and local government more expensive for that 35 percent of Minnesotans, which is the higher income percentage of the population," James said. "Nobody's talking about that except me."

Because people will no longer get 25 percent or 30 percent deductions on their federal tax returns for state and local taxes, in some ways, they're paying 100 percent of those taxes, he said.

2. James asked if he were right or wrong to believe that it's questionable to expect 30 percent of Minnesota filers-those who will no longer itemize for federal taxes-to go through all the effort to itemize only for the state income tax. The savings for itemizing are "a pittance" on the state taxes. "Are people likely to resent this or not bother?" he said. They'll be paying more to their tax accountants, he noted.

In fairness to the governor and the Legislature, James said, they're trying to keep things close to what we've always had. "But these are the implications of that," he said. "Going through the hoops isn't going to be worth what it used to be."

**The big challenge is whether Minnesota can seize this opportunity to simplify the state income tax without hitting a large number of former itemizers with substantial tax increases.**

James said if we leave things as they are in the state income tax, people who had a large amount of deductions in the past will pay more in state income taxes, people who had an average amount of deductions will end up paying the same and people who had fewer deductions will pay less.

There are two ways to mitigate this problem, James said:

1. Use some of the current \$329 million surplus to provide tax relief, so the state could drop the income-tax rates. One interviewer noted that's a short-term solution.
2. Broaden the sales-tax base so everyone gets an income-tax cut. For example, if we broaden the sales-tax base to include clothing, that would produce \$389 million per year that could be used to help ensure that everyone gets an income-tax cut. An income-based credit could take away any issue of the sales tax being regressive.

The bipartisan State Budget Trends Study Commission, set up by the Legislature, said in its 2008 report that Minnesota should broaden its sales-tax base. But that was never done, James said. It would mean taxing things like clothing and services. "Minnesota's sales tax is on the narrow side among the states and our rate is on the high side," he said.

**If Minnesota would substantially broaden the sales-tax base, we could cut the state sales-tax rate from its current level of 6.875 percent to four percent and be revenue-neutral.** In 2011, through a grant from the Center for Policy Studies (now the Center for Policy Design), James undertook a study and produced an unpublished paper on redesigning the Minnesota tax system. His work brought him to that conclusion about the sales tax. He said if the state tax rate were lowered to five percent instead of four percent, "you'd be rolling in money."

"That's the kind of question Minnesota faces long term," James said. "But can't we get that done this year? That's the big challenge."

(Note: Total sales-tax rates in certain cities or counties that levy local sales taxes are higher than the state rate of 6.875 percent. For example, in Minneapolis, the total general sales-tax rate is 8.025 percent, while in St. Paul, it's 7.875 percent. The total tax rate is 7.525 percent in suburban Hennepin County and 7.375 percent in suburban Ramsey. There are also special entertainment, liquor and restaurant taxes in the downtown Minneapolis area.)

**If the Legislature wanted to maximize state revenue or make the tax system more stable, they'd have to be for expanding the sales-tax base.** James made that statement and said sales-tax base expansion is the last big thing the state can do. "The sales tax now produces nearly \$6 billion in revenue per year," he said. "A major base expansion without a rate cut could increase that by billions. But that would be stupid; a major base expansion would be accompanied by a major sales-tax rate cut. So, the additional revenue could range from zero to whatever amount the

Legislature decided was advisable. We need to focus on broadening the sales-tax base and reducing somewhat the role of income and property taxes.

**In 1967, the Citizens League proposed a sales tax at a rate that also would have applied to food and clothing.** An interviewer raised that point and said there could have been a credit to take care of any regressivity problem, but the Legislature chose instead to exempt food and clothing from the sales tax. He said the Democrats used to say that the income tax is good and the sales tax is bad.

"Dayton still thinks the sales tax is bad," James responded. "But a credit can take away the issue of the sales tax being regressive."

James said when he was Commissioner of Revenue 30 years ago, the state knew if the sales tax were expanded to clothing, it would be less regressive, because rich people buy more expensive clothing. He noted that the economy is moving more in the direction of services, but we don't levy a sales tax on most services.

An interviewer said he never understood the mantra that the sales tax is bad, since you can mute its effects through a family credit.

**The big conflict is business taxes vs. low- to moderate-income individual taxes.** This is what Governor Dayton and the Legislature are fighting about, James said.

"In his opening shot, Dayton is re-raising his big fight with the Legislature from last year," James said. He explained that Dayton reluctantly signed the tax bill last spring, even though it contained three cuts he didn't like: cuts in the estate tax, cuts in the cigarette tax and removal of the automatic inflator on the state business property tax. Dayton signed the bill because one of the provisions of the bill would have defunded the state Department of Revenue if he hadn't signed it. Then he defunded the Legislature by applying the line-item veto to their appropriation.

James said Dayton's current tax proposal has (1) reversed the three cuts he didn't like in order to get more money; (2) added a few more business reforms to get more money from business; (3) "sucked up" all the potential revenue from the foreign tax changes the federal TCJA made; and (4) expanded the working family credit and created a new personal and dependent credit.

"Dayton is socking it to the businesses and dumping all the money into the bottom end of the spectrum," James said. "He's taking a lot of risk."

The latest House and Senate tax proposal is not adopting these reforms, James said. "And it's not taking in all the revenue that might be produced from the federal foreign tax changes. They're cutting the rates in the two lowest individual tax brackets in stages and they're also cutting the corporate income-tax rate in stages."


But neither proposal does anything about the problem of the people who will have to itemize their deductions just for the state income taxes, James said.

**James proposes three major tax-conformity bill possibilities, applying the KISS (Keep It Simple, Stupid) principle:**

1. The "peck-on-the-cheek" approach.

- a. Start with federal adjusted gross income (FAGI) as the basis for the Minnesota income tax. The proposals from Dayton, the House and the Senate all do that, James said.
- b. Allow a deduction for health-insurance costs for all taxpayers not covered by an employer's health plan. That would mean, James said, that every Minnesotan who has health insurance gets it on a pre-tax basis.
- c. Allow a credit of somewhere between five and 10 percent of charitable contributions, up to a maximum contribution amount of 50 to 60 percent of FAGI.
- d. Enact an income-adjusted household credit or deduction. This would effectively replace the personal exemptions that Congress repealed and potentially the standard deduction, as well.
- e. Adjust all the income-tax rates slightly downward, so the net result is roughly revenue neutral as far as the individual income tax and the increased revenue from the recommended sales-tax broadening.
- f. Perhaps provide a deduction or credit for medical expenses deemed excessive—for example, in excess of 7.5 percent or 10 percent of FAGI.
- g. Consider retaining a deduction or credit for unreimbursed employee business expenses.

2. The "big-smooch" approach. This approach would include all the changes listed above under the "peck-on-the-cheek" approach, as well as the following:

- a. Eliminate a number of deductions from the Minnesota income tax to drive rates down and simplify tax-return preparation. (For a detailed list, see page 18 of  [James's May 4, 2018, paper](#).)
- b. Possibly convert the retained tax breaks to credits at a flat percentage of the amount of the item, which could enhance income-tax progressivity.

3. The "really big-smooch" approach. This approach would include the changes listed above under both the "peck-on-the-cheek" and the "big-smooch" approaches, as well as eliminating special Minnesota provisions that provide tax breaks. (For a detailed list, see pages 19 and 20 of James's paper.)

Doing that, James said, would expand the income-tax base, allowing Minnesota's income-tax rates to be as low as practicable and the individual income-tax return preparation process to be as simple as practicable.

**If those responses to the TCJA's structural earthquake are not politically feasible, significantly increase the state's standard deduction and personal exemptions.** Following this April 27, 2018, Civic Caucus interview, James added that recommendation to his May 4, 2018, paper. He wrote that making that increase would reduce by hundreds of thousands the number of taxpayers who need to compute Minnesota-only itemized deductions. If this is the action the governor and the Legislature take, James wrote, they should increase the state standard deduction and personal

exemptions so that combined, they are roughly equal to or even more than the increased federal standard deduction under the TCJA.

**Let's cut, slash and burn, and simplify and then have that be part of the political debate during the 2018 political campaign.** James made that statement in the interview and said if we could get enough of a reduction in the tax rate and a much simpler tax return, we could then discuss during the 2018 campaign whether instead we want to put back in all these deductions and credits and have the rate be higher.

"That kind of simplification is what we did with [former Governor Rudy] Perpich back in 1986 and 1987, when we went to using federal taxable income and created a short state income-tax form," James said. "Of course, in the ensuing three decades, it's gotten more complicated. You need the governor to want to do something and the Governor Dayton obviously doesn't want to do anything other than improve the lot of those toward the lower end of the income spectrum. That's a laudable goal, but the Republican majority in the Legislature wants just as much to give everyone, including corporations, a tax cut."

"Both sides," James continued, "are perfectly happy to stick Minnesotans with a much more complicated state income-tax return preparation process-the pain of which will not be felt until after this fall's election. They're also apparently perfectly happy to call the other's bluff on whether there will be a tax bill at all. It would be far better to simplify the income tax, ensuring that all individuals get a bit of a cut by slightly broadening the sales tax and providing a credit to avoid the regressivity problem. Then they could try to put their goodie baskets into a separate bill, upon which they would never agree, because their desires are in such conflict."

**Is the failure of the Legislature to move on this issue due to lack of legislators being informed about some critical issues or due to lack of political will?** An interviewer asked that question and James responded that it is mostly lack of political will. He stressed that between the Revenue Department and the legislative staffs, there is the brainpower to "tee up just about anything." He said most members of the Legislature are not experts on tax policy and those who are don't want to do anything major.

"The inertia on tax policy is just indescribable," James said. "They don't want to change anything, if they can help it, other than pass out some goodies here and there. And that's basically what they're doing. We have a theoretical opportunity to start dealing with some of this stuff. But they don't want to do it. It's complicated and there's no political will."

James said there are several problems with getting anything done in the Legislature: (1) It's deplorable that everything gets put a few large, omnibus bills; (2) Governor Dayton and the legislative leadership are not getting along well and now Dayton is trying to undo the three tax cuts he reluctantly signed into law last year; and (3) There is no appetite in the Legislature for taking a big-picture look at these things.


**What about the influence of lobbyists?** An interviewer asked that question, noting that places like the Mall of America would be hit if the state imposes the sales tax on clothing. James responded that the general interest isn't represented by anybody.

"One of the problems," he said, "is that the big business organizations have tended to be fearful of any broadening of bases or increasing any tax on anybody, because they basically think we're overtaxed. They would tend to oppose things and they have some lobbying clout. And the retailers, of course, would be apoplectic about taxing clothing."

"It's a hard sell to make major change in the tax system," James continued.

He noted that a partial solution to the Mall of America's objection to taxing clothing would be to grant an exemption from the sales tax if customers ship their clothing purchases back home out of state. "That would take away a lot of the pain," he said. "There's at least a partial solution to almost every problem."

**Will the U.S. Supreme Court overrule its 1992 *Quill* decision so that states could levy a sales tax on Internet sales, even if vendors do not have a physical presence in their states?** James asked that question and explained that in 1992, the Supreme Court ruled in *Quill Corp. v. North Dakota* that a business must have a physical presence in a state for that state to require it to collect sales taxes on Internet sales. However, the Court explicitly stated that Congress could overrule the decision through legislation.

Currently, the case of  *South Dakota v. Wayfair, Inc.*, is pending before the Supreme Court. South Dakota is looking for the Court to repeal the *Quill* decision. South Dakota is arguing that the state, along with many other states, has been robbed of billions of dollars as a result of the *Quill* decision.

"That's a big issue," James said. "Hopefully, the Supreme Court will do the right thing this time. It's mind-boggling to me that they would punt this to Congress again. But they might." He noted that Amazon is now charging sales taxes on Minnesota customers' purchases, since it now has a facility in Shakopee.

An interviewer asked how large the potential base is of Minnesota online sales that could, depending on the Supreme Court's decision, be subject to the Minnesota sales tax. James responded that the online sales that could be affected amount to hundreds of millions, if not over a billion, dollars. "More important than the lost sales-tax revenue is the competitive advantage over local retailers that the current situation gives online retailers," James said.

"That could affect the politics quite a bit," the interviewer said.

**James has proposed getting rid of the dedicated gas tax and instead taxing gas through the general state sales tax.** An interviewer commented that the transportation area is an ideal place for user taxes and that he doesn't think it's a good idea to move away from them.

James responded that trucks are a huge part of the problem of wear and tear on roads—more so than cars. He pointed out, though, that some cars don't even burn gas anymore. He said looking from an environmental standpoint, we could impose congestion pricing, tax parking downtown or put a tax on gas-guzzling vehicles. "We just don't have the guts to do it," he said. "I'm out there alone" on wanting to change the gas tax. He said most people believe we should go down that user-tax path.



Another interviewer proposed moving to a weight-distance tax, which would place more tax liability on trucks, but could still stick with the user-fee principle. "That would profoundly change the consumption patterns and maybe even the costs imposed on the system," the interviewer said.

"Maybe that's better," James said, "Maybe I ought to back off on the gas tax," which he has done in the latest version of his paper.

**Over the years, people have leaned on the tax system for tax credits, because they can't deal with these things on the spending side.** An interviewer made that comment and said, "Some things on the spending side are sacred and you cannot touch them," such as public education.

For example, the interviewer said, people who want more low-cost housing go after the credit side, because they won't get any money on the spending side.

James said tax deductions, credits and exclusions from tax are all tax expenditures and "they're huge." The interviewer commented, "People don't care about the tax expenditure side."

**What are we getting for what we're paying?** That's the important question to ask, an interviewer said. In education, we shovel more money into the existing system. In higher education, we have plenty of money. "But we don't get better outcomes," the interviewer said.