

The Ins and Outs of City Sales Tax

By Susan Naughton

Even in tight economic times, cities must tackle expensive projects such as updating the sewer system or making park and trail improvements. One option cities can explore for funding such necessary capital improvements is a sales and use tax.

Historically, city sales and use taxes have been rare. Before 1990, there were only three—in Minneapolis, Duluth, and Rochester. But due in part to decreasing state funding, cities are increasingly looking to local taxes as a way to fund capital improvements. As of January 2012, 27 cities were imposing a sales and use tax.

Four-step process. A city must follow four steps to impose a new sales and use tax as authorized by *Minnesota Statutes*, section 297A.99:

- **Step 1.** The city council must pass a resolution indicating its approval of the tax and stating (at a minimum) the:
 - Proposed tax rate.
 - Intended uses for the revenue.
 - Total amount of revenue to be raised.
 - Estimated length of time the tax will be in effect.
- **Step 2.** The city must submit the proposed tax to the voters as a referendum at a general election held at least 90 days after the resolution was passed. State law was adopted in 2011 to clarify that cities must first hold the referendum on the proposed tax before coming to the Legislature to seek its approval. State law was also adopted in 2011 that prohibits cities from advertising or spending funds to promote passage of the referendum.
- **Step 3.** The city must request—and the Legislature must approve—a special law authorizing the proposed tax.
- **Step 4.** The city must adopt an ordinance imposing the local tax and must notify the commissioner of the Department of Revenue at least 90 days before the first day of the calendar quarter on which the tax is to be imposed.

Typical capital improvements. Proceeds of a city sales and use tax must be dedicated exclusively to payment of a specific capital improvement designated at least 90 days before the referendum.

Generally, successful city sales and use taxes have funded capital improvements with regional significance, like those for:

- Convention or civic centers.
- Public safety.
- Transportation.
- Sewer and water.
- Parks and recreation.

The city of Hutchinson, for example, imposed a half-cent tax beginning in January 2012 to help pay for a new water plant and an expanded wastewater treatment plant.

Use tax requirement. A complementary use tax is required in all jurisdictions where a local sales tax has been imposed. This tax is imposed on the consumption or “use” of taxable items where no city sales tax was paid. The tax is imposed mainly on purchases by resident buyers from sellers located outside the taxing jurisdiction.

The use tax is intended to remove the disadvantage to local businesses from competition with businesses located outside the local taxing area that are not required to collect the local tax.

Exemptions. A city sales and use tax generally applies to the same tax base as the state sales and use tax. A taxable service is subject to the city tax if more than one-half of the service, based on the cost, is performed within the city.

There are three types of exempt sales:

- Purchases shipped outside the city for use in a trade or business outside the city.
- Purchases temporarily stored in the city before being shipped by common carrier for use outside the city.
- Purchases subject to the direct pay provisions for interstate motor vehicles.

Public notice. A city with a sales and use tax that maintains an official website

must display a link on its homepage to a notice about the local use tax. The notice must explain that residents and businesses in the city may owe a local use tax on purchases of goods and services made outside the city.

The notice must provide resources, including a link to any relevant Department of Revenue web page, to allow people to get information and forms to pay the tax. In addition, a city that provides and bills for utility services must include a similar notice at least once a year in a utility billing statement.

Collection. State law requires the commissioner of Revenue to collect local sales and use taxes, and provides that local taxes may be collected with the state sales and use tax. Local taxes are subject to the same penalties, interest, and mechanisms for enforcement as the state sales and use tax.

Zip codes are used to determine whether a delivery sale is subject to a local tax. The lowest combined tax rate applies if a zip code area includes more than one local tax rate. The state deducts its proportionate share of administrative costs from the collected tax revenue, and pays the tax proceeds to the city on at least a quarterly basis.

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