

CORPORATE INCOME TAX BACKGROUND

State rankings. In 2005 (the last data available), Minnesota ranked ninth highest in the nation in corporate income tax collections per capita (\$182) and eighth highest per \$1,000 of personal income (\$5.06). None of Minnesota's surrounding states had a higher corporate income tax burden. Michigan, with its single business tax or business activity tax, ranked eighth in corporate income tax collections per capita and seventh per \$1,000 of personal income.

Apportionment. An apportionment formula is used to calculate the amount of a corporation's total net income that is taxable in Minnesota. Three factors generally are used: the share of a company's property, payroll and sales attributable to Minnesota. These factors then are weighted to derive an apportionment percentage. In 2005, Minnesota adopted an eight-year phase-in of a sales-only apportionment formula beginning with tax year 2007. The table below shows the weights for the property, payroll and sales factors during the phase-in.

Tax Year	Property	Payroll	Sales
2006	12.5%	12.5%	75%
2007	11.0%	11.0%	78%
2008	9.5%	9.5%	81%
2009	8.0%	8.0%	84%
2010	6.5%	6.5%	87%
2011	5.0%	5.0%	90%
2012	3.5%	3.5%	93%
2013	2.0%	2.0%	96%
2014	0%	0%	100%

Nine states have sales-only apportionment formulas: Connecticut, Illinois, Iowa, Louisiana, Massachusetts, Missouri, Nebraska, Texas and Wisconsin. Michigan's single business tax uses a 90-percent sales weighting. Georgia (2008), New York (2008), and Oregon (2008) are phasing in an apportionment formula that is 100-percent weighted by sales.

Minnesota has a history of weighting sales more heavily than property and payroll. In 1939, manufacturers were given the option of average or weighted apportionment. Under the weighted apportionment approach, the sales factor was weighted 70 percent. In 1953, the weighted apportionment option was extended to all firms. It wasn't until the 1970s that other states began to change their apportionment formulas by placing a greater weight on sales. Recently, the trend, especially among Midwest states, has been to adopt a sales-only apportionment formula.

The impact of moving to a sales-only apportionment formula varies among businesses. Corporations that have significant amounts of property and payroll in Minnesota relative to the rest of the country and sell products nationally or worldwide benefit from such a change. These firms are companies that have their headquarters or a major facility in Minnesota. Some corporations with headquarters in other states might see an increased tax liability if a sales-only formula is adopted. For these firms, their percent of sales in Minnesota (i.e. their sales factor) is greater than the average of their property and payroll factors. The apportionment formula does not affect firms that do business totally within Minnesota.

Corporate tax structure. From 2003 to 2006, the Legislature proposed several changes to the corporate income tax structure, including a reduction in the dividend received deduction, elimination of the foreign royalty deduction, changing the definition of foreign operating corporation, and enacting a throwback rule. Each of these proposals would have had a negative impact on business's corporate income tax burden.

- **Dividend received deduction.** At present, Minnesota allows corporations to deduct 80 percent of the dividends they receive if the corporation owns 20 percent or more of the dividend payor. The deduction is 70 percent if the corporation owns less than 20 percent of the payor. In 2003, the

Legislature proposed reducing the 80-percent deduction to 56 percent and the 70-percent deduction to 49 percent. This would have increased corporate income tax revenues by approximately \$56 million during the FY 2004-2005 biennium.

The dividends received deduction mitigates the multiple taxation of income. Without a dividend received deduction, the dividend payor's net income is taxed at the national or international level and it is taxed again when the state taxes the parent company's net income. Even under Minnesota's current law, 20 percent of dividend income is subject to multiple taxation. Tax policy experts agree that multiple taxation of income should be avoided.

In addition, dividends from foreign corporations are only made possible by foreign sales, property and payroll. Since Minnesota does not include foreign sales, property and payroll in the apportionment formula, a deduction for dividends received is necessary to avoid taxing foreign income received by domestic corporations out of proportion to the corporation's contact with the state. Finally, 47 of 48 states that tax corporate income allow some type of income exclusion or deduction for dividends received. Idaho is the only state that does not allow the deduction; however, Idaho developed an alternate method to avoid multiple taxation of dividends.

- Foreign royalty deduction. Minnesota currently allows corporations to deduct 80 percent of the foreign royalties they receive if the payor is a member of the unitary group. In 2003, 2004 and 2005, the Legislature proposed eliminating the foreign royalty deduction. This would have increased corporate income tax revenue by \$45 million during the FY 2004-2005 biennium.

Since Minnesota uses a "waters edge" approach to unitary business taxation, foreign subsidiaries are not included in the domestic parent's unitary group. When management decides to have a foreign subsidiary pay royalties to the parent, income is recognized. However, these royalties are only made possible by foreign sales, property and payroll. Since Minnesota does not include foreign sales, property and payroll in the apportionment formula, a deduction for foreign royalties is necessary to avoid taxing foreign income received by domestic corporations out of proportion to the corporation's contact with the state.

In addition, foreign royalties are only made possible by hundreds of millions of dollars of research and development investment typically made in the United States. Corporations create high-paying jobs locally and generate foreign royalties by licensing the technology developed to foreign corporations. Changing the deductibility of foreign royalties could jeopardize this domestic R&D investment.

- Foreign operating corporations. Minnesota currently defines a foreign operating corporation (FOC) as an 80/20 corporation or a corporation that has in effect an election under Internal Revenue Code (IRC) section 936. An FOC must be part of the unitary business of a corporation which is a Minnesota taxpayer. In 2005, the Legislature changed the definition to require 80 percent or more of the FOC's property and payroll to be outside the United States and a minimum of \$2 million property and \$1 million payroll outside the United States. (IRC section 936 corporations are domestic corporations that have 75 percent or more of gross income from the active conduct of trade or business in Puerto Rico or the U.S. Virgin Islands.) All of the net income of an FOC is deemed to be paid as a dividend to the parent company, and the parent can deduct 80 percent of this dividend. From 2003 to 2006, the Legislature proposed several changes to the foreign operating corporation structure. The 2006 version would have increased corporate income tax revenue by more than \$200 million during the FY 2008-2009 biennium.

Foreign operating corporations were created to provide similar tax treatment between wholly owned foreign subsidiaries and wholly owned U.S. subsidiaries which contain mostly foreign operations. Prior to the creation of FOCs, domestic parent corporations that used 80/20 corporations to conduct foreign operations faced higher corporate income taxes than domestic corporations that used foreign subsidiaries to conduct their foreign operations. Income from 80/20 corporations was included in apportionable income when computing the Minnesota combined report and the foreign sales, property

and payroll used to generate the income were included in the apportionment formula. This resulted in multinational corporations paying taxes on foreign source income based only on the fact that they were using a U.S. legal entity (the 80/20 corporation). If instead, the domestic parent corporation had conducted the business through a foreign subsidiary, Minnesota would not have included the subsidiary in the combined report. Minnesota would have taxed the income when a dividend was paid and the state then would allow an 80-percent deduction for the dividend. The FOC law merely treats these two types of corporations in a similar manner.

In addition, 15 states besides Minnesota require a unitary combined corporate income tax return. Of those states, eight have 80/20 corporation laws similar to Minnesota's foreign operating corporation (Alaska, Arizona, Colorado, Illinois, Montana, New Hampshire, North Dakota and Utah). Indiana also has an 80/20 corporation law; however, it is not a unitary state. Alaska, Arizona, Colorado, Illinois, Indiana, Montana and New Hampshire exclude all income from the 80/20 company from taxation. North Dakota and Utah tax the income from 80/20 corporations, but also allow worldwide combined reporting so the foreign property, payroll and sales that help generate the income are included in the apportionment formula. Illinois excludes the income of an 80/20 company from taxation, but it requires corporations to add back interest and intangible expenses, therefore taxing some of the 80/20 company's income.

- **Throwback rule.** At present, Minnesota includes in the numerator of the apportionment formula only sales made to Minnesota customers. The Senate proposed adopting a throwback rule which would include sales made to customers in states where the corporation is not taxable in the numerator (*MN Sales* in the equation below). This would increase a company's apportionment percentage and therefore its corporate income tax liability.

$$\text{Apportionment \%} = \left[0.75 \times \frac{\text{MN Sales}}{\text{Total Sales}} + 0.125 \times \frac{\text{MN Property}}{\text{Total Property}} + 0.125 \times \frac{\text{MN Payroll}}{\text{Total Payroll}} \right]$$

A throwback rule would increase corporate income tax revenue by about \$18 million per year.

A throwback rule would reverse Minnesota's 65-year tradition of structuring its corporate franchise tax to encourage corporations to have their base of operation in Minnesota while selling to national and international markets. Minnesota achieves this goal by heavily weighting the sales factor of the apportionment formula and placing less emphasis on the amount of property and payroll a corporation has in the state. Minnesota currently weights the sales factor by 75 percent. This type of formula, compared to an equal weighted (33 1/3-percent sales weighting) or double weighted (50-percent sales factor weighting) formula reduces the corporate income tax burden of companies that have significant property and payroll in Minnesota and sell nationally or worldwide. Adding a throwback rule would negate this benefit.

In addition, a throwback rule would especially hurt small- and medium-sized businesses that are based in Minnesota and sell nationally. For corporate franchise tax purposes, these companies typically will not have nexus in many states in which they sell their goods and services. A throwback rule would significantly increase these company's sales factors and therefore their corporate income tax liability.

Corporate tax rate. Minnesota's corporate income tax rate is 9.8 percent. Only Iowa (12 percent), Pennsylvania (9.99 percent) and the District of Columbia (9.975 percent) have higher maximum rates. Minnesota also has a significant disparity between the rate it taxes C-corporations (9.8 percent) and the maximum rate it taxes S-corporations, partnerships and sole proprietors (7.85 percent). This differential provides an incentive for businesses to change their legal structure from a C-corporation to an S-corporation.

Capital gains exclusion. The 1999 session included a major debate over the definition of business and nonbusiness income. If a gain generated by the sale of an asset is determined to be business income, it

generally can be apportioned in part to Minnesota; however, if the gain is nonbusiness income, it is not apportioned, but rather, assigned to a specific state.

Prior to the 1998 Firstar and Hercules Minnesota Supreme Court decisions, the Minnesota Department of Revenue classified essentially all gains as apportionable business income. The court did not agree with the department's interpretation and stated that gains that are not generated through the ordinary course of business are nonbusiness income and cannot be apportioned in part to Minnesota.

The 1999 Legislature overturned these cases by, once again, classifying almost every gain as apportionable business income. Minnesota joined Iowa and Tennessee as the only states to have a statute that essentially fails to recognize nonbusiness income. This change increased the tax liability of Minnesota employers that have their headquarters in another state because more gains will be taxed in Minnesota than would have otherwise occurred. To address this concern, the Legislature adopted a credit for taxes paid to another state. The credit applies only to the tax on income or gains that were assigned to another state. Companies that face a tax increase because they must classify essentially all gains as business income are looking for ways to mitigate this situation. One potential solution is excluding from taxation a percentage of a company's capital gains.-

Corporate alternative minimum tax. The corporate alternative minimum tax (AMT) is paid if it exceeds the amount of the regular tax owed. It is paid by a small number of corporations but adds considerable complexity to the corporate income tax structure. In addition, over time, the AMT does not result in increased corporate tax collections, but rather, it changes the timing of corporate tax liability.