Minnesota Income Tax on Foreign Source Income

Policy Discussion Document

2005

Agenda #1

Minnesota Income Tax on Foreign Source Income

HISTORY

- Unitary Taxation
  - Adopted by many states to avoid the manipulation of income between related entities to avoid state taxes
  - All income of related companies included in the tax base
  - Total income assigned to the state based on the group's payroll, property and sales within the state

Minnesota Income Tax on Foreign Source Income

- Formula

$$\frac{\text{MN Payroll}}{\text{Total Payroll}} + \frac{\text{MN Property}}{\text{Total Property}} + \frac{\text{MN Sales}}{\text{Total Sales}}$$

X

Total Income of Unitary Group

Minnesota Income Tax on Foreign Source Income

- Worldwide Unitary Taxation
  - Unitary taxation theory originally included all companies both domestic and foreign
  - International and Federal political pressure resulted in "waters-edge" application

Minnesota Income Tax on Foreign Source Income

- Impact of Water's Edge Unitary Taxation
  - Entities organized in foreign country excluded from tax base
  - Companies organized in United States with significant foreign operations included in tax base
  - Different tax treatment while operations looked very similar

Minnesota Income Tax on Foreign Source Income

- Minnesota's response to the issue raised by water's edge taxation
  - Foreign operating corporations
  - Foreign royalty subtraction

Minnesota Income Tax on Foreign Source Income

- Foreign Operating Corporations
  - Domestic corporation that is part of a unitary group
  - 80% of property and payroll in foreign jurisdiction
  - Income is deemed to be a dividend to the unitary group
  - Dividend is subject to 80% deduction – 20% of income is taxed

Minnesota Income Tax on Foreign Source Income

- Foreign Royalty Subtraction
  - 80% subtraction for "royalties, fees, or other like income" received from related foreign corporation or FOC
  - Goal was to include in income only an amount that was earned as a result of domestic activities
    - For example, royalties are earned as a result of domestic research and development expenditures
  - Separate goal to avoid disincentive for bringing money back to Minnesota

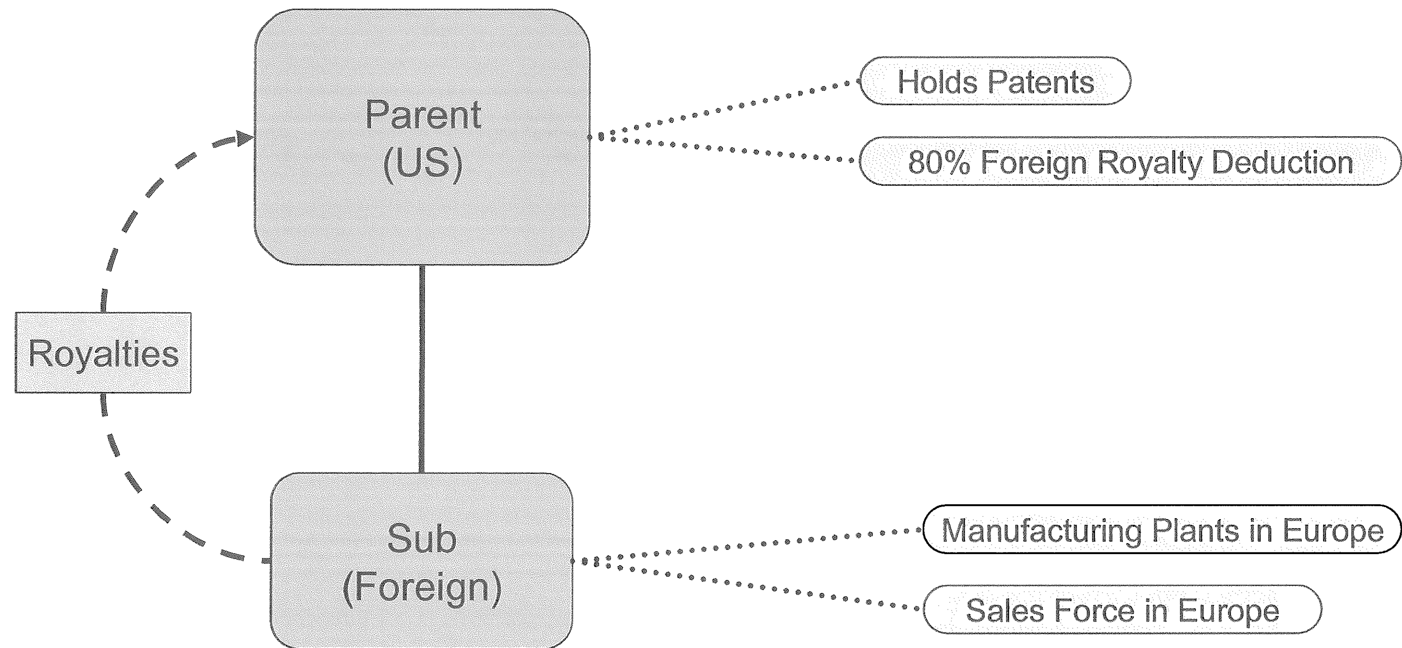
Minnesota Income Tax on Foreign Source Income

- Range of Uses of this Tax Structure
  - Full operations
    - May have foreign manufacturing operations, sales force
  - Contract manufacturing
    - Hire unrelated foreign entity to manufacture product that domestic company sells in international or domestic marketplace

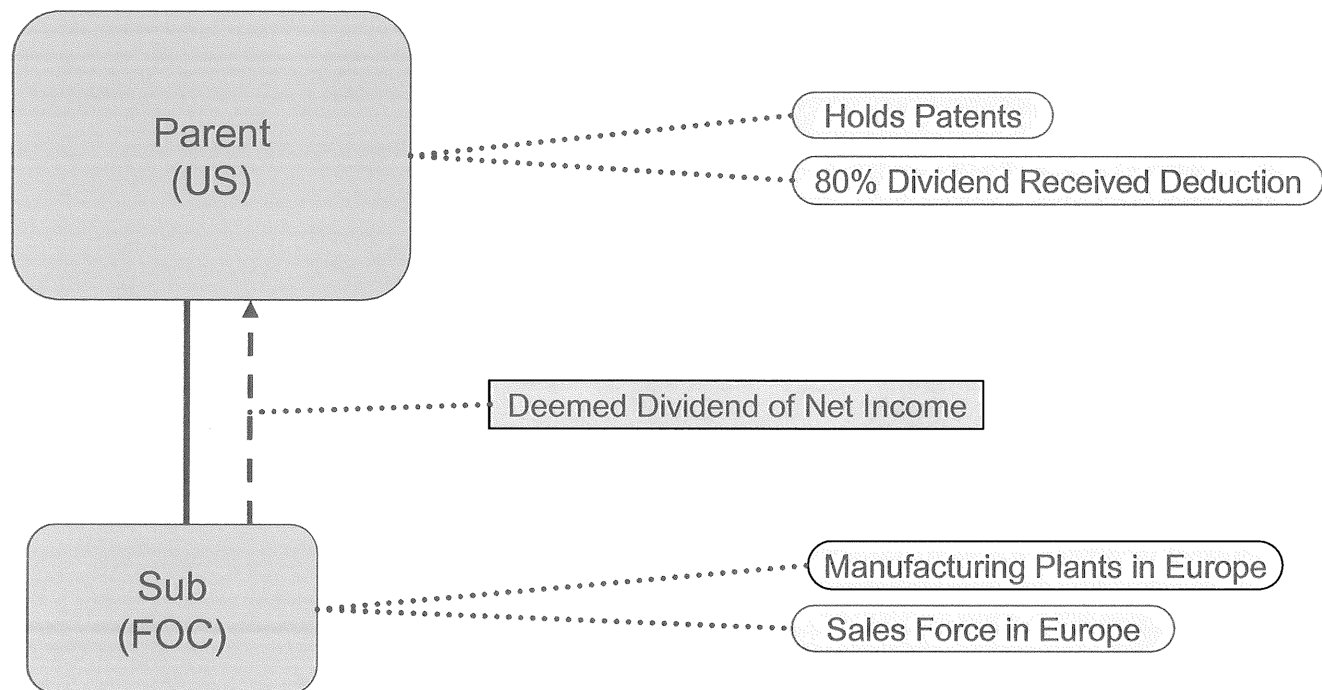
Minnesota Income Tax on Foreign Source Income

- Range of Uses of this Tax Structure (cont'd)
  - Sales/distribution
    - Retail companies have international distribution facilities and sales force
  - Maintenance of intangibles such as debt, intellectual property
    - All of above companies may have some of this
    - FOC may be formed to hold these intangibles – related income is subject to 80% exclusion whether income is generated from domestic or international sources

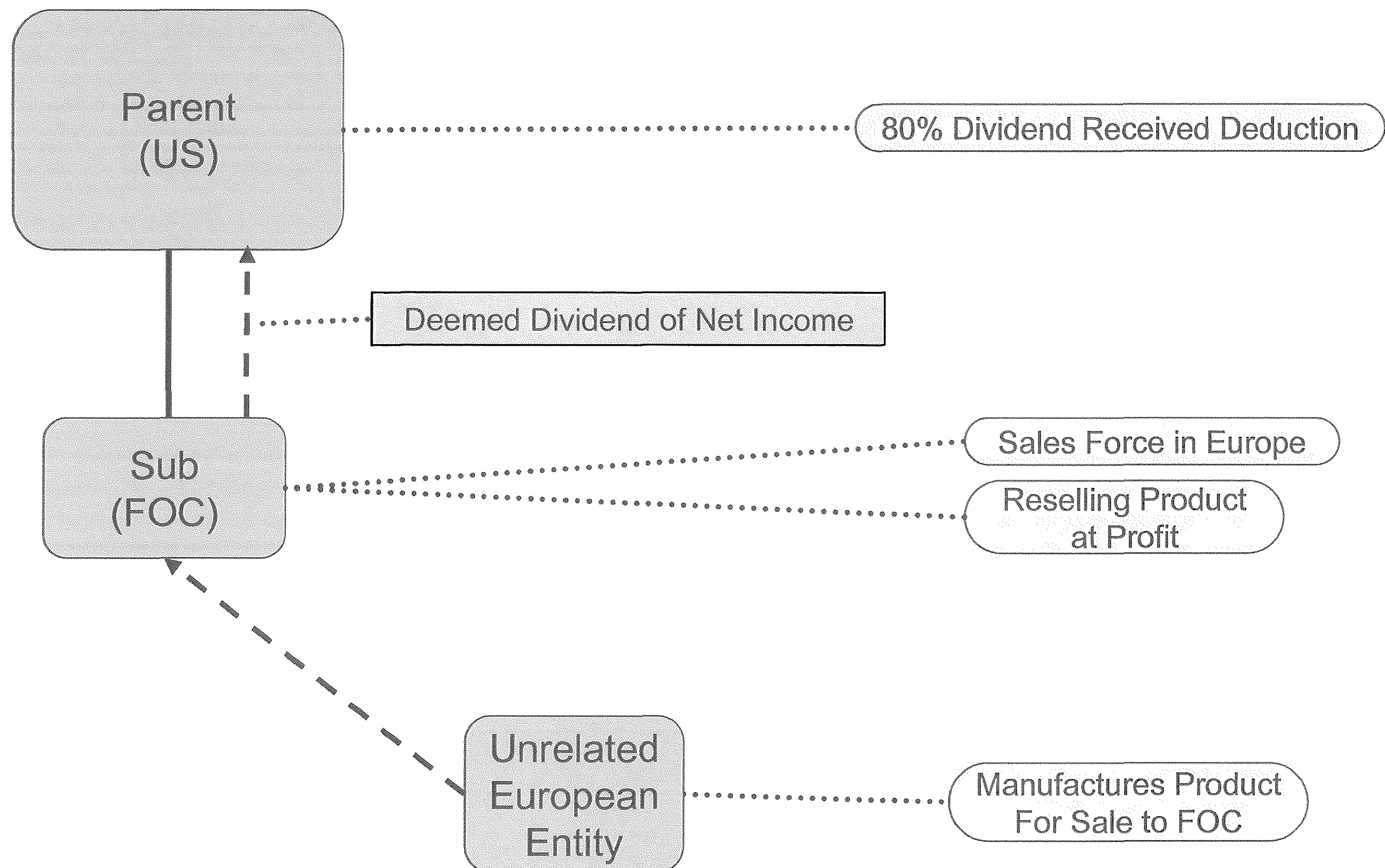
Minnesota Income Tax on Foreign Source Income



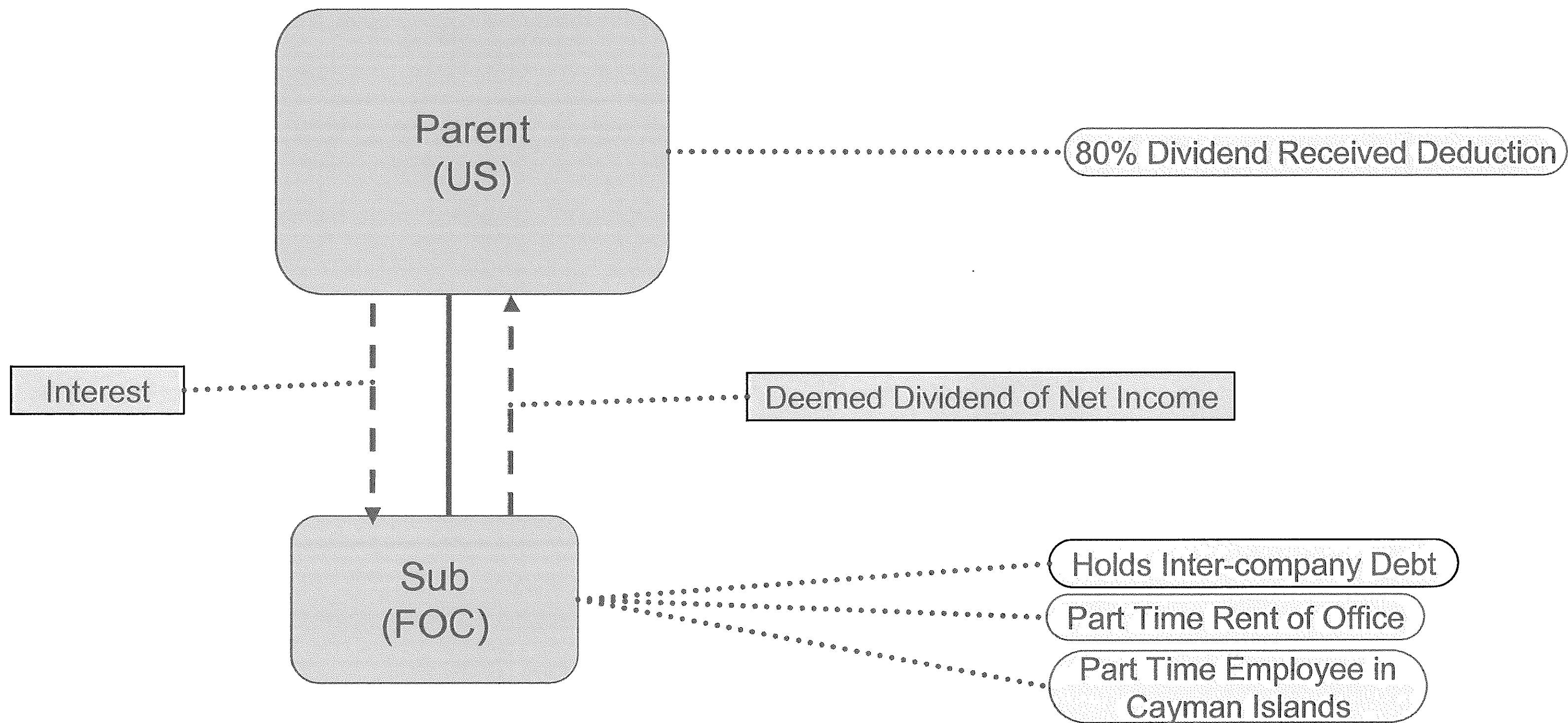
Minnesota Income Tax on Foreign Source Income



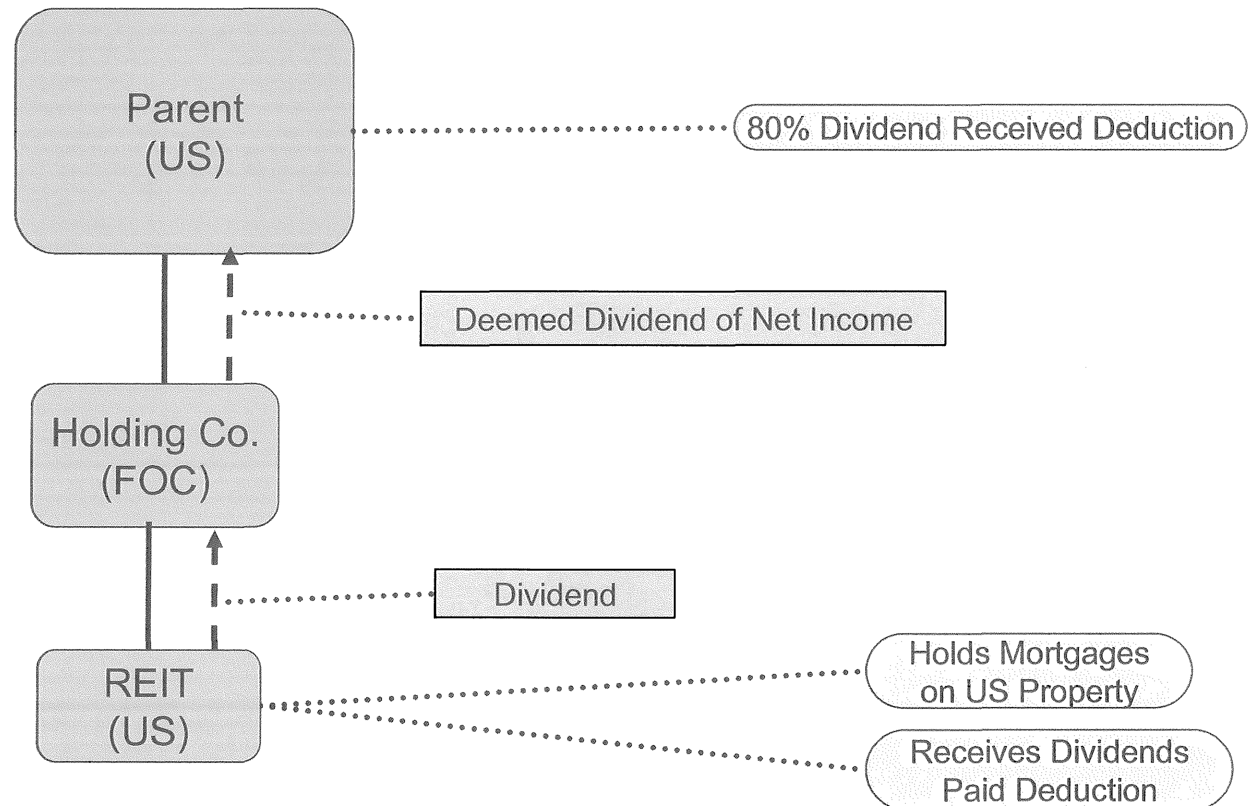
Minnesota Income Tax on Foreign Source Income



Minnesota Income Tax on Foreign Source Income



Minnesota Income Tax on Foreign Source Income



Minnesota Income Tax on Foreign Source Income

- Policy Issues for Discussion
  - Interest, royalties and other payments generated domestically by intangibles - should this income be excluded?
  - Maintenance of benefits with respect to true foreign source income

Minnesota Income Tax on Foreign Source Income

- Policy Issues for Discussion (cont'd)
  - Viability of unitary taxation
  - Clarity of law
  - Predictability of state revenues
  - Consistency of taxation between similarly situated taxpayers

Minnesota Income Tax on Foreign Source Income

- Possible Legislative Actions
  - Worldwide unitary reporting
  - Increase DOR's enforcement authority
    - Explicit language requiring economic substance/business purpose
    - Auditor training
  - Minimum requirement of foreign property and payroll – different levels have been recommended
  - Disallowance of deductions for payments of domestic company to FOC related to intangible assets
  - Disallowance of royalty subtraction and FOC benefits when income is generated domestically

Agenda #2

Senator Pogemiller introduced--

S.F. No. 1080: Referred to the Committee on Taxes.

1 A bill for an act

2 relating to taxation; corporate franchise; modifying
3 the definition of foreign operating corporations;
4 amending Minnesota Statutes 2004, sections 290.01,
5 subdivision 6b; 290.17, by adding a subdivision.

6 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:

7 Section 1. Minnesota Statutes 2004, section 290.01,
8 subdivision 6b, is amended to read:

9 Subd. 6b. [FOREIGN OPERATING CORPORATION.] The term
10 "foreign operating corporation," when applied to a corporation,
11 means a domestic corporation with the following characteristics:

12 (1) it is part of a unitary business at least one member of
13 which is taxable in this state;

14 (2) it is not a foreign sales corporation under section 922
15 of the Internal Revenue Code, as amended through December 31,
16 1999, for the taxable year; ~~and~~

17 (3) ~~either~~ (i) the average of the percentages of its
18 property and payrolls, including the pro rata share of its
19 unitary partnerships' property and payroll, assigned to
20 locations ~~inside~~ outside the United States ~~and-the-District-of~~
21 ~~Columbia,-excluding-the-commonwealth-of-Puerto-Rico-and~~
22 ~~possessions-of-the-United-States~~, where the United States
23 includes the District of Columbia and excludes the possessions
24 of the United States, as determined under section 290.191 or
25 290.20, is ~~20~~ 80 percent or ~~less~~ more; or (ii) it has in effect

1 a valid election under section 936 of the Internal Revenue Code;
2 and
3 (4) it has $1,000,000 of payroll and $2,000,000 of
4 property, as determined under section 290.191 or 290.20, that
5 are located outside of the United States. If the domestic
6 corporation does not have payroll as determined under section
7 290.191 or 290.20, but it or its partnerships have paid
8 $1,000,000 for work, performed directly for the domestic
9 corporation or the partnerships, outside of the United States,
10 then paragraph (3)(i) does not require payrolls to be included
11 in the average calculation.
12 [EFFECTIVE DATE.] This section is effective for taxable
13 years beginning after December 31, 2004.
14 Sec. 2. Minnesota Statutes 2002, section 290.17, is
15 amended by adding a subdivision to read:
16 Subd. 8. [FOREIGN OPERATING CORPORATIONS; COMMISSIONER'S
17 AUTHORITY.] (a) This subdivision applies to a unitary business
18 that includes a foreign operating corporation.
19 (b) The commissioner may disqualify a corporation as a
20 foreign operating corporation, if the commissioner finds that:
21 (1) there was no substantial independent business purpose,
22 other than the reduction of tax, for establishment of the
23 foreign operating corporation;
24 (2) the income of the foreign operating corporation, on a
25 multiyear basis, is primarily derived from or fairly
26 attributable to domestic operations or sources of the unitary
27 business; or
28 (3) a significant amount of inter-company transactions
29 involving the foreign operating corporation lack economic
30 substance or do not reflect market prices.
31 (c) The commissioner may disallow all or part of the
32 subtraction for royalties, fees, and like income under section
33 290.01, subdivision 19d, clause (10), or all or part of the
34 deduction for deemed dividends of the foreign operating
35 corporation under section 290.21, if the commissioner finds that
36 the income or transactions on which the deductions are based:

1 (1) lack economic substance or fail to reflect market
2 prices;
3 (2) have no substantial independent business purpose other
4 than the reduction of tax; or
5 (3) are derived from or fairly attributable to domestic
6 operations or sources.
7 [EFFECTIVE DATE.] This section is effective July 1, 2005.

CORPORATE FRANCHISE
Foreign Operating Corporations

April 20, 2005

	Yes	No
Separate Official Fiscal Note Requested		X
Fiscal Impact		
DOR Administrative Costs/Savings		X

Department of Revenue
Analysis of S.F. 1080 (Pogemiller)/ H.F. 1388 (Hornstein)

	Fund Impact			
	F.Y. 2006	F.Y. 2007	F.Y. 2008	F.Y. 2009
	(000's)			
General Fund	$1,800	$1,300	$900	$500

Changes to FOC requirements effective for tax years beginning after December 31, 2004.
Provisions related to the commissioner's authority effective July 1, 2005.

EXPLANATION OF THE BILL

Minnesota allows certain income of a unitary group to be classified as the income of a foreign operating corporation (FOC). This income is considered a deemed dividend, and up to 80% of this income may be claimed as a dividend received deduction. In effect, 20% of the deemed dividends from an FOC is subject to taxation.

The bill redefines an FOC. Under this new definition, a corporation with foreign operations will still be classified as an FOC. Current Minnesota law allows a corporation to be classified as an FOC if the average of its domestic property and payroll is 20% or less. Under the bill, the percent of foreign property and payroll must be 80% or more to qualify as an FOC. Also, the FOC must have at least $2 million of property and at least than $1 million of payroll located outside the United States.

In addition, the bill provides the Commissioner of Revenue the authority to disqualify a corporation as an FOC and to disallow the foreign royalty and fee subtraction provided that the source of the transaction is an FOC. The commissioner may use this authority in the following situations: transactions whose only purpose is tax reduction; the income of the FOC is fairly attributable to domestic operations or sources; or transactions without economic substance.

REVENUE ANALYSIS DETAIL

Change Qualifications for Foreign Operating Corporations

- The revenue estimates are based on data from returns received by the Department of Revenue in calendar year 2003.
- Annual percentage changes in overall corporate tax collections as projected by the Department of Finance in the February 2005 forecast are used to project future revenue gains.
- Runs of tax calculation programs against corporate data were used to calculate the revenue effect from changing the property and payroll qualifications that must be met in order to qualify as a FOC.
- It is assumed that the revenue gain would decrease over time as corporations make changes to meet the proposed requirements for an FOC.
- About 20-40 corporations will be affected by the bill.

Commissioner's Authority Related to Foreign Operating Corporations

- It is not known to what extent these provisions would result in additional revenue.

Source: Minnesota Department of Revenue
Tax Research Division
http://www.taxes.state.mn.us/taxes/legal_policy

sf1080(hf1388)_1/dkd

Agenda #3

Senator Pogemiller introduced--

S.F. No. 1082: Referred to the Committee on Taxes.

1 A bill for an act

2 relating to taxation; corporate franchise; modifying
3 the definition of foreign operating corporations;
4 repealing the subtraction for foreign royalties;
5 excluding certain intangible income from the deemed
6 dividend deduction for foreign operating corporation
7 income; amending Minnesota Statutes 2004, sections
8 290.01, subdivision 6b, 19d; 290.17, subdivision 4.

9 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:

10 Section 1. Minnesota Statutes 2004, section 290.01,
11 subdivision 6b, is amended to read:

12 Subd. 6b. [FOREIGN OPERATING CORPORATION.] The term
13 "foreign operating corporation," when applied to a corporation,
14 means a domestic corporation with the following characteristics:

15 (1) it is part of a unitary business at least one member of
16 which is taxable in this state;

17 (2) it is not a foreign sales corporation under section 922
18 of the Internal Revenue Code, as amended through December 31,
19 1999, for the taxable year; and

20 (3) either (i) the average of the percentages of its
21 property and payrolls assigned to locations ~~inside~~ outside the
22 United States ~~and the District of Columbia, excluding the~~
23 ~~commonwealth of Puerto Rico and possessions of the United~~
24 ~~States,~~ as determined under section 290.191 or 290.20, is ~~20~~ 80
25 percent or ~~less~~ greater and it has at least $2,000,000 of
26 property and $1,000,000 of payroll as determined under section
27 290.191 or 290.20; or (ii) it has in effect a valid election

1 under section 936 of the Internal Revenue Code.
2 **[EFFECTIVE DATE.]** This section is effective for taxable
3 years beginning after December 31, 2004.
4 Sec. 2. Minnesota Statutes 2004, section 290.01,
5 subdivision 19d, is amended to read:
6 Subd. 19d. [CORPORATIONS; MODIFICATIONS DECREASING FEDERAL
7 TAXABLE INCOME.] For corporations, there shall be subtracted
8 from federal taxable income after the increases provided in
9 subdivision 19c:
10 (1) the amount of foreign dividend gross-up added to gross
11 income for federal income tax purposes under section 78 of the
12 Internal Revenue Code;
13 (2) the amount of salary expense not allowed for federal
14 income tax purposes due to claiming the federal jobs credit
15 under section 51 of the Internal Revenue Code;
16 (3) any dividend (not including any distribution in
17 liquidation) paid within the taxable year by a national or state
18 bank to the United States, or to any instrumentality of the
19 United States exempt from federal income taxes, on the preferred
20 stock of the bank owned by the United States or the
21 instrumentality;
22 (4) amounts disallowed for intangible drilling costs due to
23 differences between this chapter and the Internal Revenue Code
24 in taxable years beginning before January 1, 1987, as follows:
25 (i) to the extent the disallowed costs are represented by
26 physical property, an amount equal to the allowance for
27 depreciation under Minnesota Statutes 1986, section 290.09,
28 subdivision 7, subject to the modifications contained in
29 subdivision 19e; and
30 (ii) to the extent the disallowed costs are not represented
31 by physical property, an amount equal to the allowance for cost
32 depletion under Minnesota Statutes 1986, section 290.09,
33 subdivision 8;
34 (5) the deduction for capital losses pursuant to sections
35 1211 and 1212 of the Internal Revenue Code, except that:
36 (i) for capital losses incurred in taxable years beginning

1 after December 31, 1986, capital loss carrybacks shall not be
2 allowed;
3 (ii) for capital losses incurred in taxable years beginning
4 after December 31, 1986, a capital loss carryover to each of the
5 15 taxable years succeeding the loss year shall be allowed;
6 (iii) for capital losses incurred in taxable years
7 beginning before January 1, 1987, a capital loss carryback to
8 each of the three taxable years preceding the loss year, subject
9 to the provisions of Minnesota Statutes 1986, section 290.16,
10 shall be allowed; and
11 (iv) for capital losses incurred in taxable years beginning
12 before January 1, 1987, a capital loss carryover to each of the
13 five taxable years succeeding the loss year to the extent such
14 loss was not used in a prior taxable year and subject to the
15 provisions of Minnesota Statutes 1986, section 290.16, shall be
16 allowed;
17 (6) an amount for interest and expenses relating to income
18 not taxable for federal income tax purposes, if (i) the income
19 is taxable under this chapter and (ii) the interest and expenses
20 were disallowed as deductions under the provisions of section
21 171(a)(2), 265 or 291 of the Internal Revenue Code in computing
22 federal taxable income;
23 (7) in the case of mines, oil and gas wells, other natural
24 deposits, and timber for which percentage depletion was
25 disallowed pursuant to subdivision 19c, clause (11), a
26 reasonable allowance for depletion based on actual cost. In the
27 case of leases the deduction must be apportioned between the
28 lessor and lessee in accordance with rules prescribed by the
29 commissioner. In the case of property held in trust, the
30 allowable deduction must be apportioned between the income
31 beneficiaries and the trustee in accordance with the pertinent
32 provisions of the trust, or if there is no provision in the
33 instrument, on the basis of the trust's income allocable to
34 each;
35 (8) for certified pollution control facilities placed in
36 service in a taxable year beginning before December 31, 1986,

1 and for which amortization deductions were elected under section
2 169 of the Internal Revenue Code of 1954, as amended through
3 December 31, 1985, an amount equal to the allowance for
4 depreciation under Minnesota Statutes 1986, section 290.09,
5 subdivision 7;

6 (9) amounts included in federal taxable income that are due
7 to refunds of income, excise, or franchise taxes based on net
8 income or related minimum taxes paid by the corporation to
9 Minnesota, another state, a political subdivision of another
10 state, the District of Columbia, or a foreign country or
11 possession of the United States to the extent that the taxes
12 were added to federal taxable income under section 290.01,
13 subdivision 19c, clause (1), in a prior taxable year;

14 (10) ~~80-percent-of-royalties,-fees,-or-other-like-income~~
15 ~~accrued-or-received-from-a-foreign-operating-corporation-or-a~~
16 ~~foreign-corporation-which-is-part-of-the-same-unitary-business~~
17 ~~as-the-receiving-corporation;~~

18 ~~(11)~~ income or gains from the business of mining as defined
19 in section 290.05, subdivision 1, clause (a), that are not
20 subject to Minnesota franchise tax;

21 ~~(12)~~ (11) the amount of handicap access expenditures in the
22 taxable year which are not allowed to be deducted or capitalized
23 under section 44(d)(7) of the Internal Revenue Code;

24 ~~(13)~~ (12) the amount of qualified research expenses not
25 allowed for federal income tax purposes under section 280C(c) of
26 the Internal Revenue Code, but only to the extent that the
27 amount exceeds the amount of the credit allowed under section
28 290.068;

29 ~~(14)~~ (13) the amount of salary expenses not allowed for
30 federal income tax purposes due to claiming the Indian
31 employment credit under section 45A(a) of the Internal Revenue
32 Code;

33 ~~(15)~~ (14) the amount of any refund of environmental taxes
34 paid under section 59A of the Internal Revenue Code;

35 ~~(16)~~ (15) for taxable years beginning before January 1,
36 2008, the amount of the federal small ethanol producer credit

1 allowed under section 40(a)(3) of the Internal Revenue Code
2 which is included in gross income under section 87 of the
3 Internal Revenue Code;
4 ~~(17)~~ (16) for a corporation whose foreign sales
5 corporation, as defined in section 922 of the Internal Revenue
6 Code, constituted a foreign operating corporation during any
7 taxable year ending before January 1, 1995, and a return was
8 filed by August 15, 1996, claiming the deduction under section
9 290.21, subdivision 4, for income received from the foreign
10 operating corporation, an amount equal to 1.23 multiplied by the
11 amount of income excluded under section 114 of the Internal
12 Revenue Code, provided the income is not income of a foreign
13 operating company;
14 ~~(18)~~ (17) any decrease in subpart F income, as defined in
15 section 952(a) of the Internal Revenue Code, for the taxable
16 year when subpart F income is calculated without regard to the
17 provisions of section 614 of Public Law 107-147; and
18 ~~(19)~~ (18) in each of the five tax years immediately
19 following the tax year in which an addition is required under
20 subdivision 19c, clause (16), an amount equal to one-fifth of
21 the delayed depreciation. For purposes of this clause, "delayed
22 depreciation" means the amount of the addition made by the
23 taxpayer under subdivision 19c, clause (16). The resulting
24 delayed depreciation cannot be less than zero.
25 **[EFFECTIVE DATE.]** This section is effective for taxable
26 years beginning after December 31, 2004.
27 Sec. 3. Minnesota Statutes 2004, section 290.17,
28 subdivision 4, is amended to read:
29 Subd. 4. [UNITARY BUSINESS PRINCIPLE.] (a) If a trade or
30 business conducted wholly within this state or partly within and
31 partly without this state is part of a unitary business, the
32 entire income of the unitary business is subject to
33 apportionment pursuant to section 290.191. Notwithstanding
34 subdivision 2, paragraph (c), none of the income of a unitary
35 business is considered to be derived from any particular source
36 and none may be allocated to a particular place except as

1 provided by the applicable apportionment formula. The
2 provisions of this subdivision do not apply to business income
3 subject to subdivision 5, income of an insurance company, or
4 income of an investment company determined under section 290.36.
5 (b) The term "unitary business" means business activities
6 or operations which result in a flow of value between them. The
7 term may be applied within a single legal entity or between
8 multiple entities and without regard to whether each entity is a
9 sole proprietorship, a corporation, a partnership or a trust.
10 (c) Unity is presumed whenever there is unity of ownership,
11 operation, and use, evidenced by centralized management or
12 executive force, centralized purchasing, advertising,
13 accounting, or other controlled interaction, but the absence of
14 these centralized activities will not necessarily evidence a
15 nonunitary business. Unity is also presumed when business
16 activities or operations are of mutual benefit, dependent upon
17 or contributory to one another, either individually or as a
18 group.
19 (d) Where a business operation conducted in Minnesota is
20 owned by a business entity that carries on business activity
21 outside the state different in kind from that conducted within
22 this state, and the other business is conducted entirely outside
23 the state, it is presumed that the two business operations are
24 unitary in nature, interrelated, connected, and interdependent
25 unless it can be shown to the contrary.
26 (e) Unity of ownership is not deemed to exist when a
27 corporation is involved unless that corporation is a member of a
28 group of two or more business entities and more than 50 percent
29 of the voting stock of each member of the group is directly or
30 indirectly owned by a common owner or by common owners, either
31 corporate or noncorporate, or by one or more of the member
32 corporations of the group. For this purpose, the term "voting
33 stock" shall include membership interests of mutual insurance
34 holding companies formed under section 60A.077.
35 (f) The net income and apportionment factors under section
36 290.191 or 290.20 of foreign corporations and other foreign

1 entities which are part of a unitary business shall not be
2 included in the net income or the apportionment factors of the
3 unitary business. A foreign corporation or other foreign entity
4 which is required to file a return under this chapter shall file
5 on a separate return basis. The net income and apportionment
6 factors under section 290.191 or 290.20 of foreign operating
7 corporations shall not be included in the net income or the
8 apportionment factors of the unitary business except as provided
9 in paragraph (g).
10 (g) The adjusted net income of a foreign operating
11 corporation shall be deemed to be paid as a dividend on the last
12 day of its taxable year to each shareholder thereof, in
1 proportion to each shareholder's ownership, with which such
14 corporation is engaged in a unitary business. Such deemed
15 dividend shall be treated as a dividend under section 290.21,
16 subdivision 4. <u>The dividends received deduction is not allowed</u>
17 <u>on dividends, interest, royalties, capital gains, or other like</u>
18 <u>income received by the foreign operating corporation.</u>
19 Dividends actually paid by a foreign operating corporation
20 to a corporate shareholder which is a member of the same unitary
21 business as the foreign operating corporation shall be
22 eliminated from the net income of the unitary business in
23 preparing a combined report for the unitary business. The
24 adjusted net income of a foreign operating corporation shall be
25 its net income adjusted as follows:
26 (1) any taxes paid or accrued to a foreign country, the
27 commonwealth of Puerto Rico, or a United States possession or
28 political subdivision of any of the foregoing shall be a
29 deduction; and
30 (2) the subtraction from federal taxable income for
31 payments received from foreign corporations or foreign operating
32 corporations under section 290.01, subdivision 19d, clause (10),
33 shall not be allowed.
34 If a foreign operating corporation incurs a net loss,
35 neither income nor deduction from that corporation shall be
36 included in determining the net income of the unitary business.

1 (h) For purposes of determining the net income of a unitary
2 business and the factors to be used in the apportionment of net
3 income pursuant to section 290.191 or 290.20, there must be
4 included only the income and apportionment factors of domestic
5 corporations or other domestic entities other than foreign
6 operating corporations that are determined to be part of the
7 unitary business pursuant to this subdivision, notwithstanding
8 that foreign corporations or other foreign entities might be
9 included in the unitary business.

10 (i) Deductions for expenses, interest, or taxes otherwise
11 allowable under this chapter that are connected with or
12 allocable against dividends, deemed dividends described in
13 paragraph (g), or royalties, fees, or other like income
14 described in section 290.01, subdivision 19d, clause (10), shall
15 not be disallowed.

16 (j) Each corporation or other entity, except a sole
17 proprietorship, that is part of a unitary business must file
18 combined reports as the commissioner determines. On the
19 reports, all intercompany transactions between entities included
20 pursuant to paragraph (h) must be eliminated and the entire net
21 income of the unitary business determined in accordance with
22 this subdivision is apportioned among the entities by using each
23 entity's Minnesota factors for apportionment purposes in the
24 numerators of the apportionment formula and the total factors
25 for apportionment purposes of all entities included pursuant to
26 paragraph (h) in the denominators of the apportionment formula.

27 (k) If a corporation has been divested from a unitary
28 business and is included in a combined report for a fractional
29 part of the common accounting period of the combined report:

30 (1) its income includable in the combined report is its
31 income incurred for that part of the year determined by
32 proration or separate accounting; and

33 (2) its sales, property, and payroll included in the
34 apportionment formula must be prorated or accounted for
35 separately.

36 **[EFFECTIVE DATE.]** This section is effective for taxable

1 years beginning after December 31, 2004.

CORPORATE FRANCHISE
Foreign Operating Corporations
Foreign Royalty Subtraction

April 20, 2005

	Yes	No
Separate Official Fiscal Note Requested		X
Fiscal Impact		
DOR Administrative Costs/Savings	X	

Department of Revenue
Analysis of S.F. 1082 (Pogemiller) / H.F. 1387(Hornstein)

	Fund Impact			
	F.Y. 2006	**F.Y. 2007**	**F.Y. 2008**	**F.Y. 2009**
		(000's)		
Foreign Operating Corporation Change	$63,300	$47,200	$47,300	$48,300
Repeal of Foreign Royalty Subtraction	$67,600	$50,400	$50,500	$51,600
Interaction	$1,200	$900	$900	$900
General Fund Total	$132,100	$98,500	$98,700	$100,800

Effective for tax years beginning after December 31, 2004.

EXPLANATION OF THE BILL

Corporate Franchise Tax – Foreign Operating Corporations

Minnesota allows certain income of a unitary group to be classified as the income of a foreign operating corporation (FOC). This income is considered a deemed dividend, and up to 80% of this income may be claimed as a dividend received deduction. In effect, 20% of the deemed dividends from an FOC is subject to taxation.

The bill redefines an FOC. Under this new definition, a corporation with foreign operations will still be classified as an FOC. Current Minnesota law allows a corporation to be classified as an FOC if the average of its domestic property and payroll is 20% or less. Under the bill, the percent of foreign property and payroll must be 80% or more to qualify as an FOC. Also, the FOC must have at least $2 million of property and at least than $1 million of payroll.

In addition, the bill disallows a dividend received deduction from an FOC if the deemed dividend includes dividends, interest, royalties, capital gains, or other like income (i.e. income other than income from ongoing operations).

EXPLANATION OF THE BILL (Continued)

Corporate Franchise Tax – Foreign Royalty Subtraction

Under Minnesota law, corporations are allowed a subtraction against their net income equal to 80% of foreign royalty income received from an FOC or a foreign corporation. Royalty income is defined as royalties, fees, or other like income. The foreign royalty subtraction would be repealed under this bill.

REVENUE ANALYSIS DETAIL

- The revenue estimates are based on data from returns received by the Department of Revenue in calendar year 2003.
- Growth in overall corporate tax collections as projected by the Department of Finance in the February 2005 forecast is used to project future revenue gains.
- Due to the tax year 2005 effective date, the tax year 2005 impact that would normally occur in fiscal year 2005 was shifted to fiscal year 2006. Generally, tax year impact is allocated 30%/ 70% to fiscal years.
- Compared to previous estimates, analysis of the most recent data indicates that a higher portion of FOC income would not be eligible for the dividend received deduction under this bill.
- Runs of tax calculation programs against corporate data were used to calculate the revenue effect from disallowing the foreign royalty subtraction and from disallowing the dividend received deduction if the FOC deemed dividend includes non-operating income such as dividends, interest, royalties and capital gains.
- About 1,600 corporations will be affected by the bill.

Source: Minnesota Department of Revenue
Tax Research Division
http://www.taxes.state.mn.us/taxes/legal_policy

sf1082(hf1387)_1/dkd

Corporate Tax History, Major changes 1981-2003 (from State Tax Handbook)

1981 - Unitary method of taxation enacted.
--Research Credit enacted.
--60% capital gain exclusion allowed.
--Rate reduced (from 12%) to 9% on first $25,000 of taxable income.

1982 --Research credit modified to 12.5% of qualifying expenses up to $2 million and 6.25% over $2 million.

1983 --Bunches of small credits enacted. Pollution control credit repealed.

1984 --Foreign source dividends and certain foreign source royalties exempted.
--Pollution control credits reinstated. Energy credit repealed.
--Minimum preference tax repealed.

1985 --Bunches of credits including pollution control, repealed.

1987 - Corp income tax and bank excise tax replaced with corporate franchise tax.
-- Tax based on FTI as starting point.
-- Conformed to TRA 86.
-- (Temporary) AMT enacted for 1989 (replaced in 1990 with modern AMT).
--Optional arithmetic average for apportionment repealed.
- Dividend received deduction and foreign source royalty deduction reduced.
- Technology transfer credit and small business assistance credits repealed.

1988 - Dividend received deduction changed.
- Deduction for 35% of foreign royalties repealed.
--Deduction enacted for foreign-source income (royalties, fees, and other like income) from a foreign operating corporation or a foreign corporation of 50% for 1989 and 1990, 80% thereafter.

1989 - UBIT enacted for business income of exempt corporations.
--Modern AMT enacted.
--Insurance company tax conformityupdated to current to IRC (rather than 1936 Federal Revenue Act). Selective insurance company exemptions enacted .
--Additional 20% dividend received deduction allowed in certain situations.

1990 --Rate increased from 9.0% to 9.8%, AMT rate cut from 7% to 5.8%. Minimum fee enacted.

1992 --LLC allowed (as partnerships).

1998 - Small corporations exempted from AMT.

1999 - Sales factor increased (effective 1-1-01) to 75% sales, 12.5% property, 12.5% payroll.
--Credit for taxes paid to another state allowed for certain situations.

2001 --Insurance companies exempted. S corporation banks exempted.

2003 --JOBZ exemptions enacted.

Foreign Operating Corporations

Presented at April 21, hearing of Senate Tax Committee

Agenda #4

What is an FOC

- A U.S. company with foreign operations is excluded from the MN unitary group
- 20% of its income is effectively taxed by Minnesota
- The entity must have less than 20% of its average property and payroll in the U.S.

Review of 1988 law

- Why the 1988 law?

  - the idea was to level the playing field between Minnesota companies and foreign competitors

  - the law was created to encourage homegrown companies to enter the increasingly global market place

How MN law differs from federal

- Controlled foreign corporation (CFC)
- Dividend income included in federal return
- Federal foreign tax credit
- MN allows a deduction for 80% of a dividend from CFCs

How MN law differs from federal

- Foreign Branch
- Federal domestic return includes income of a foreign branch
- MN taxes earnings of foreign branch
- An FOC is effectively subject to tax on 20% of its net income

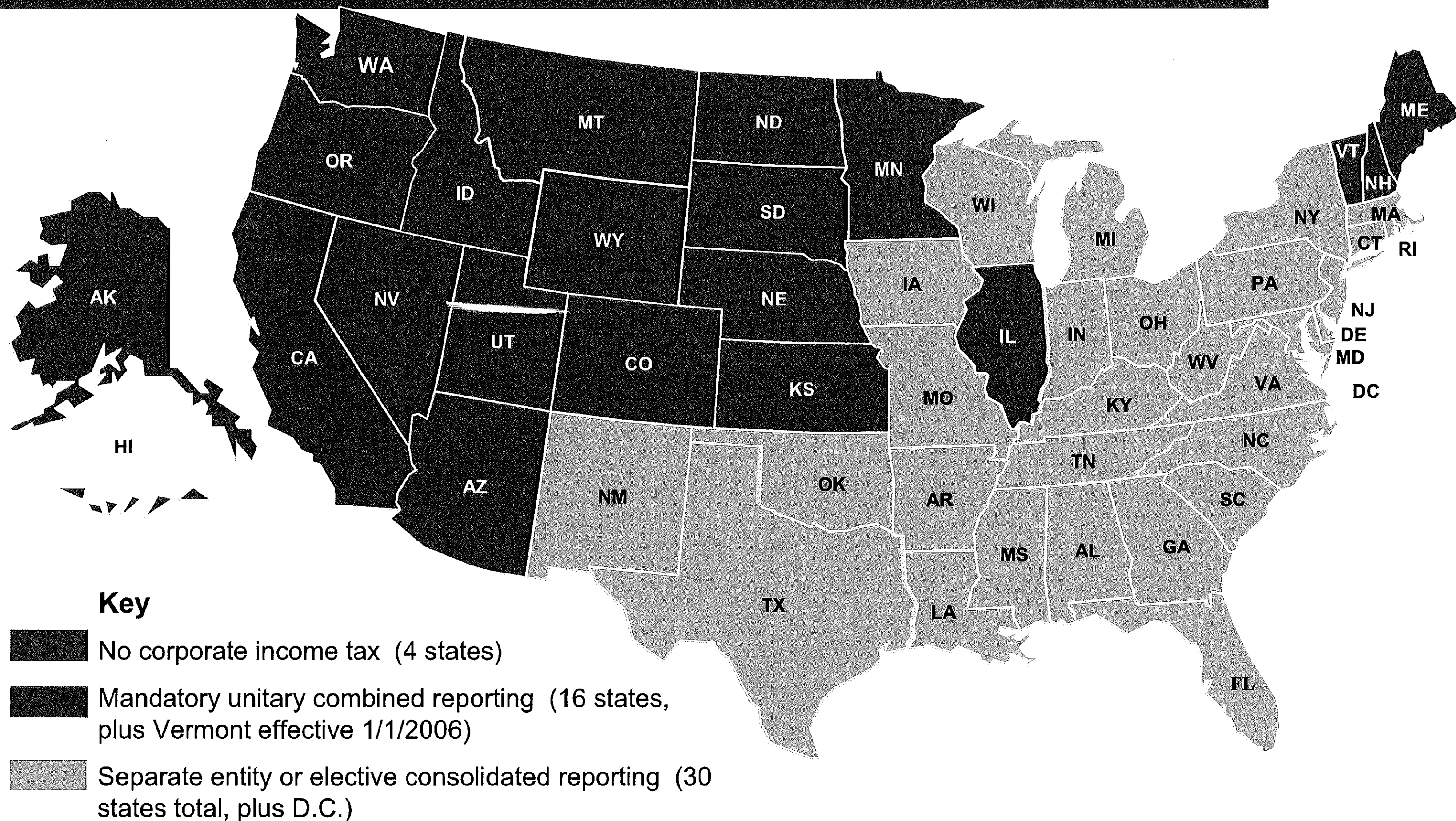
DOR defines the problem

- There are concerns that current law, as written, allows FOC status for companies that are neither “foreign nor operating”
- The DOR has suggested that organizations are using FOCs for tax planning
- The department has suggested that some corporations have taken traditional U.S. income and moved it into an FOC

DOR defines the problem cont.

- Corporate profits are up
- There has not been a drop in corporate tax collections, just a drop in collections relative to the forecast. These payments have been below projected levels
- Payments have been below projected levels in 2003 and the first 2 quarters of 2004
- DOR wants to clarify language; but believes there are legitimate uses of the FOC structure

State income tax – unitary vs separate company



Mandatory unitary states: worldwide vs. water's-edge

State [1] [1]	Mandatory Worldwide Filing	Mandatory Water's-Edge Filing	Can the Group Elect to file Water's-Edge or Worldwide	80/20 - FOCs are Excluded from the Unitary Group
ALASKA	NO	YES	NO	YES
ARIZONA	NO	YES	NO	YES
CALIFORNIA	YES	NO	YES	YES
COLORADO	YES	NO	NO	YES
HAWAII	NO	YES	NO	NO
IDAHO	YES	NO	YES	NO
ILLINOIS	YES	NO	NO	YES
KANSAS	NO	YES	NO	NO
MAINE	NO	YES	NO	NO
MINNESOTA	NO	YES	NO	YES
MONTANA	YES	NO	YES	YES
NEBRASKA	NO	YES	NO	NO

[1] Note that the above information is based in part on information from tax services such as CCH and/or BNA. For additional detail regarding each state's specific rules please see the state's statutes, regulations and/or case law.

Mandatory unitary states: worldwide vs. water's-edge (cont)

State [1]	Mandatory Worldwide Filing	Mandatory Water's-Edge Filing	Can the Group Elect to file Water's-Edge or Worldwide	80/20 - FOCs are Excluded from the Unitary Group
NEW HAMPSHIRE	NO	YES	NO	YES
NORTH DAKOTA	YES	NO	YES	YES
OREGON	NO	YES	NO	NO
UTAH	NO	YES	YES	YES
VERMONT (effective 1/1/06)	YES	NO	NO	YES

[1] Note that the above information is based in part on information from tax services such as CCH and/or BNA. For additional detail regarding each state's specific rules please see the state's statutes, regulations and/or case law.

Other states with similar FOC provisions to Minnesota

- Alaska
- Arizona
- Colorado
- Illinois
- Montana
- New Hampshire
- North Dakota
- Utah
- Vermont

How the FOC laws of other states differs from Minnesota

- Activity test is based on 80% or more outside the U.S. vs 20% or less within the U.S.
- Activity test includes property, payroll <u>and sales</u>
- Activity test is based on more than one tax year
- FOC must have 20% or less of its income from <u>U.S. sources</u> as determined under IRC § 861(c)
- Operations in U.S. territories (e.g. U.S. Virgin Islands) are not considered outside the U.S.
- The operations of a foreign entity which is disregarded for federal purposes is treated as if it were a division of an FOC, if that FOC is the sole member of the foreign entity

How the FOC laws of other states differs from Minnesota (cont)

- FOC can be taxed as a separate entity
- Dividends are taxable when received vs. a deemed dividend
- The income included from an FOC is based on net book income for financial statement purposes
- Percentage of dividend income from an FOC subject to tax
- Calculation of the amount of dividend income from an FOC that is taxable is based on the unitary group's apportionment factors, plus the FOC's apportionment factors
- In MN, FOC income is based on net book income as reported in financial statements

Downside to taxpayers of MN's FOC law

- Current year losses from an FOC cannot be carried forward to offset its future income
- Current year losses from an FOC cannot reduce the unitary group's income
- The unitary group's apportionment factors do not include the apportionment factors of an FOC

- 20% of FOC's income subject to tax no factor representation

- Whereas a foreign corporation's income is taxable only when it pays a dividend, an FOC's income is taxable when earned

Recent legislative activity – IL add back legislation

- Illinois enacted legislation requiring add back for related party transactions with 80/20 companies.
  - Effective for taxable years ending on or after December 31, 2004, individuals, corporations, trusts and partnerships must add back to federal taxable income any interest and intangible expenses paid to an "80/20" entity to the extent safe harbors do not apply.
  - Intangible expense includes:
    - expenses, losses and costs for or related to the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange or any other disposition of intangible property;
    - losses incurred, directly or indirectly, from factoring transactions or discounting transactions;
    - royalty, patent, technical or copyright fees;
    - licensing fees; and
    - other similar costs.

Recent legislative activity – IL safe harbor provisions

- The interest add back may not be required if:
  - The corresponding interest income is subject to tax in a foreign country or state: or
  - It can be established that
    - The 80/20, during the same taxable year, paid, accrued, or incurred the interest to a person that is not a related member; and
    - The transaction giving rise to the interest expense did not have as its principal purpose the avoidance of Illinois income tax and is paid pursuant to a contract that reflects arm's-length rates and terms:
  - It can be established that the interest paid, accrued, or incurred is at arm's-length and the principal purpose is not federal or Illinois income tax avoidance; or
  - The taxpayer can establish by clear and convincing evidence that the add back adjustments are unreasonable; or
  - The taxpayer and Director agree in writing to the application or use of an alternative apportionment method.

Recent legislative activity – IL safe harbor provisions (Cont)

- The intangible expense add back may not be required if:
  - The corresponding income from intangibles is subject to tax in a foreign country or state; or
  - It can be established with a preponderance of the evidence that:
    - The 80/20, during the same taxable year, paid, accrued, or incurred the interest to a person that is not a related member; and
    - The transaction giving rise to the interest expense did not have as its principal purpose the avoidance of Illinois income tax and is paid pursuant to a contract that reflects arm's-length rates and terms; or
  - The taxpayer can establish by clear and convincing evidence that the add back adjustments are unreasonable; or
  - The taxpayer and Director agree in writing to the application or use of an alternative apportionment method.

Recent legislative activity – VT unitary legislation adopted

- HB 784 was signed by Governor James Douglas on June 7, 2004. – Provisions effective tax years beginning on or after January 1, 2006.
  - Repeals current corporate income tax provisions that impose only the minimum tax on intangible holding companies
  - Adopts a unitary combined reporting for affiliated entities
- The legislation defines "affiliated group" as two or more corporations of which more than 50 percent of the voting stock of each member is directly or indirectly owned by a common owner or owners or by one or more of the member corporations, excluding overseas business organizations (*i.e.*, 80/20 corporations) and captive insurance companies.
- The legislation also:
  - double weights the sales factor, for taxable years beginning on or after January 1, 2006; and
  - reduces the maximum corporate income tax to 8.9 percent from 9.75 percent, for taxable years beginning on or after January 1, 2006, and to 8.5 percent, for tax years beginning on or after January 1, 2007

What has changed since 1988?

- How companies earn profits (manufacturing, technology, services, etc.)
- Where companies area doing business – there is a global presence for most organizations
- Single Member Limited Liability Companies (SMLLCs)
- Some companies have aggressively planned for state taxes
- Business is highly competitive

20

Contract manufacturing

- Widget Co. has two plants in the U.S.
- Widget Co. has five large customers in Europe
- In order to increase sales in Europe and decrease transportation cost of product to Europe, Widget Co. has increased its sales force in Europe as well as built a plant in the UK
- Widget Co. set up a U.S. Company – Widget UK to own the plant

Widget co. (cont)

- Widget UK contracts out all labor in the UK to a third party
- Widget UK meets the definition of an FOC with all property and payroll in the UK
- Minnesota taxes 20% of Widget UK's net income

Companies with Intangible Assets

- Cash management co.
- Cash Co. is part of a unitary business with 10 other members
- Cash Co. is a U.S. company
- Cash Co. operates as the bank for the unitary group. It makes daily cash sweeps from all bank accounts and provides all members with cash needs and invests all excess cash
- Cash Co. earns investment income from short-term and long-term investment of the consolidated group, including third-party investments and intercompany borrowing

Cash Co. (cont)

- Cash Co. has treasury people in MN and 20 sales people overseas
- The balance sheet of Cash Co. consists of investments, computers, and office fixtures and furniture of the two treasury people in MN and 20 sales people overseas
- Cash Co. has less than 20% of its property and payroll in the U.S, and therefore meets the definition of an FOC
- Minnesota taxes 20% of the income of Cash Co.

Companies with Intangible Assets Intellectual Properties company

- IP Co. is part of unitary business with Store Co.
- IP Co. is a U.S. company
- IP Co. was incorporated in 1985 to hold franchise rights of Store Co. – company owned locations and third-party franchises in both the U.S. and abroad
- Prior to 1998, IP Co. had not property or payroll
- In an effort to increase locations overseas, IP Co. hired 8 marketing representatives in Germany in 1998 to expand the business

IP Co. (cont)

- IP Co. pays Store Co. for services of the marketing representatives employed by Store Co. who are responsible for increasing franchise locations in the U.S.
- IP Co. has all of its property and payroll outside the U.S. and therefore, meets the definition of an FOC
- Minnesota taxes 20% of IP Co.

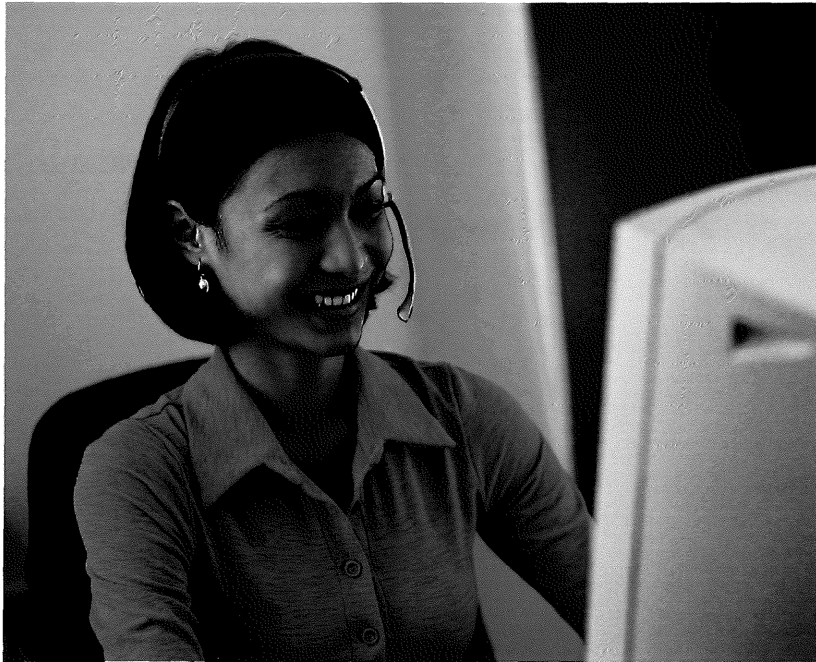
Zebra Technologies Corp.

- Zebra is a manufacturer
- Two subsidiaries were created to own, protect, and license trademarks, patents, and other intellectual property
- Subsidiaries had rented office space and a computer in Bermuda and one employee who was paid $600 per month by each company for services rendered in Bermuda
- Zebra had employees in the U.S. whose responsibility was to perform quality control of the intellectual property

Zebra Tech Corp (cont)

- The subsidiaries meet the definition of an FOC in Minnesota
- Therefore, 20% of the income is effectively taxes in Minnesota

Services Company



- IT company is a software developer
- IT company has a division that custom develops its software to meet its customers' needs
- Services-Asia is a 100%-owned subsidiary of IT company
- Services-Asia is a U.S. entity
- Services-Asia employs 5 U.S. employees that custom develop IT Company's software in Asia. 100% of their services are conducted in Asia

Services Co. (cont)

- The employees work from client location and have computers
- Services-Asia has all it property and payroll overseas and therefore qualifies as an FOC
- Minnesota taxes 20% of the net income of Services-Asia

Things that need to be considered when drafting legislation

- That the law can stand up against court battles
- Promote economic activity/growth in Minnesota
- Be clear and concise
- Make sure businesses know the playing field

Questions??

MNCPA FOC Task Force Members

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Dave Hoffman, Cargill

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Robert Ozmun, PricewaterhouseCoopers

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Agenda #5

CORPORATE FRANCHISE
INDIVIDUAL INCOME TAX
Foreign Operating Corporations
Foreign Royalty Subtraction
Deferred Compensation

April 20, 2005

	Yes	No
Separate Official Fiscal Note Requested		X
Fiscal Impact		
DOR Administrative Costs/Savings		X

Department of Revenue
Analysis of S.F. 254 (Berglin), Article 3 Only
Analysis Revised for February 2005 Forecast and Correction of Fiscal Year Allocation

	Fund Impact			
	F.Y. 2006	**F.Y. 2007**	**F.Y. 2008**	**F.Y. 2009**
		(000's)		
Foreign Operating Corporation Change	$63,300	$47,200	$47,300	$48,300
Repeal of Foreign Royalty Subtraction	$67,600	$50,400	$50,500	$51,600
Interaction	$1,200	$900	$900	$900
Corporate Franchise Tax	$132,100	$98,500	$98,700	$100,800
Individual Income Tax	$1,900	$2,000	$2,100	$2,300
General Fund Total	$134,000	$100,500	$100,800	$103,100

Effective for tax years beginning after December 31, 2004.

EXPLANATION OF THE BILL

Corporate Franchise Tax – Foreign Operating Corporations

Minnesota allows certain income of a unitary group to be classified as the income of a foreign operating corporation (FOC). This income is considered a deemed dividend, and up to 80% of this income may be claimed as a dividend received deduction. In effect, 20% of the deemed dividends from an FOC is subject to taxation.

The bill redefines an FOC. Under this new definition, a corporation with foreign operations will still be classified as an FOC. Current Minnesota law allows a corporation to be classified as an FOC if the average of its domestic property and payroll is 20% or less. Under the bill, the percent of foreign property and payroll must be 80% or more to qualify as an FOC. Also, the FOC must have at least $2 million of property and at least than $1 million of payroll.

In addition, the bill disallows a dividend received deduction from an FOC if the deemed dividend includes dividends, interest, royalties, or capital gains income (i.e. income other than income from ongoing operations).

EXPLANATION OF THE BILL (Continued)

Corporate Franchise Tax – Foreign Royalty Subtraction

Under Minnesota law, corporations are allowed a subtraction against their net income equal to 80% of foreign royalty income received from an FOC or a foreign corporation. Royalty income is defined as royalties, fees, or other like income. The foreign royalty subtraction would be repealed under this bill.

Individual Income Tax

Under current law, there is an exemption from the individual income tax for wage income that was earned while the taxpayer was a resident but is received in a year that the taxpayer was a nonresident for the full year. The bill would eliminate this exemption.

REVENUE ANALYSIS DETAIL

Corporate Franchise Tax Provisions

- The revenue estimates are based on data from returns received by the Department of Revenue in calendar year 2003.
- **For the revised estimates**, growth in overall corporate tax collections as projected by the Department of Finance in the February 2005 forecast is used to project future revenue gains.
- **For the revised estimates**, due to the tax year 2005 effective date, the tax year 2005 impact that would normally occur in fiscal year 2005 was shifted to fiscal year 2006. Generally, tax year impact is allocated 30%/ 70% to fiscal years.
- Compared to previous estimates, analysis of the most recent data indicates that a higher portion of FOC income would not be eligible for the dividend received deduction under this bill.
- Runs of tax calculation programs against corporate data were used to calculate the revenue effect from disallowing the foreign royalty subtraction and from disallowing the dividend received deduction if the FOC deemed dividend includes non-operating income such as dividends, interest, royalties and capital gains.
- About 1,600 corporations will be affected by the bill.

REVENUE ANALYSIS DETAIL (Continued)

Individual Income Tax Provision

- The estimates are based on information that was developed following the Minnesota Supreme Court decision in *Victor C. Benda v. James Girard in His Capacity as Commissioner of Revenue, et al.*
- Amended returns filed in response to the court case were the primary source of information, supplemented with a sample of 1997 individual income tax returns of nonresidents.
- Annual growth of 6% was assumed.

Source: Minnesota Department of Revenue
Tax Research Division
http://www.taxes.state.mn.us/taxes/legal_policy

sf0254_2/dkd