Minnesota Income Tax on Foreign Source Income

Policy Discussion Document

2005

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

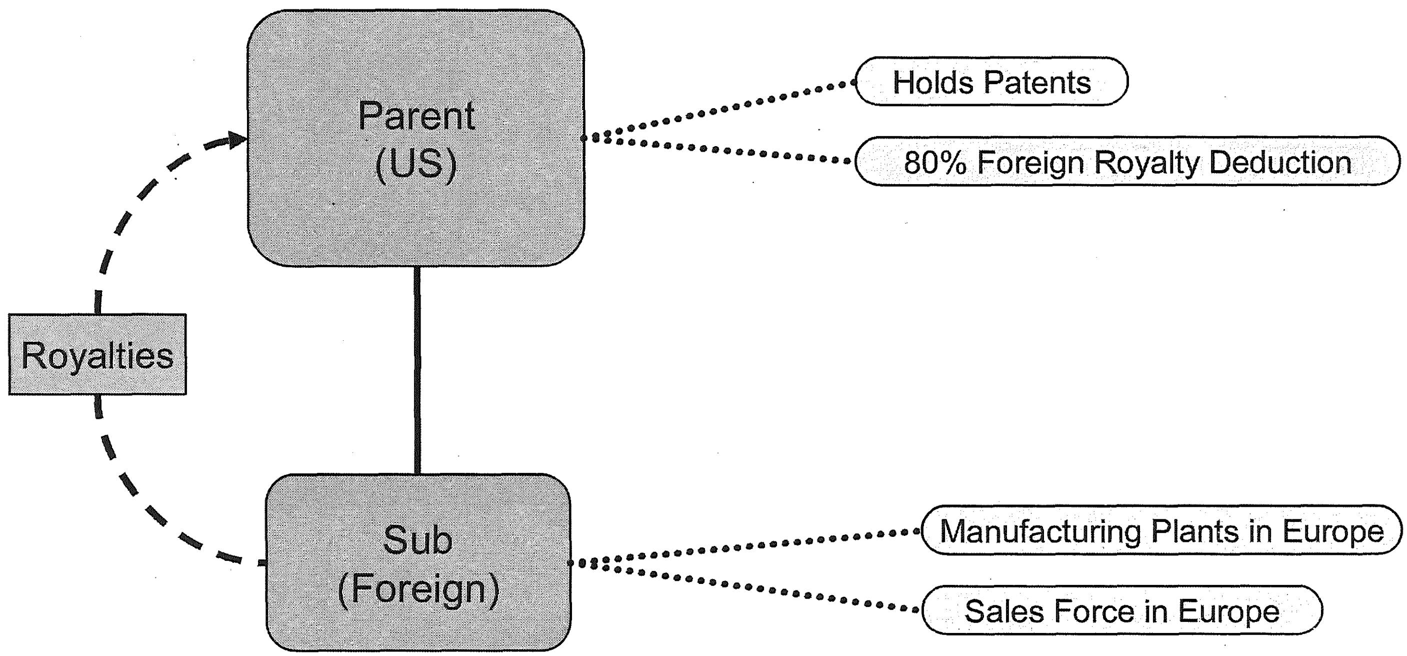
Minnesota Income Tax on Foreign Source Income

- 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



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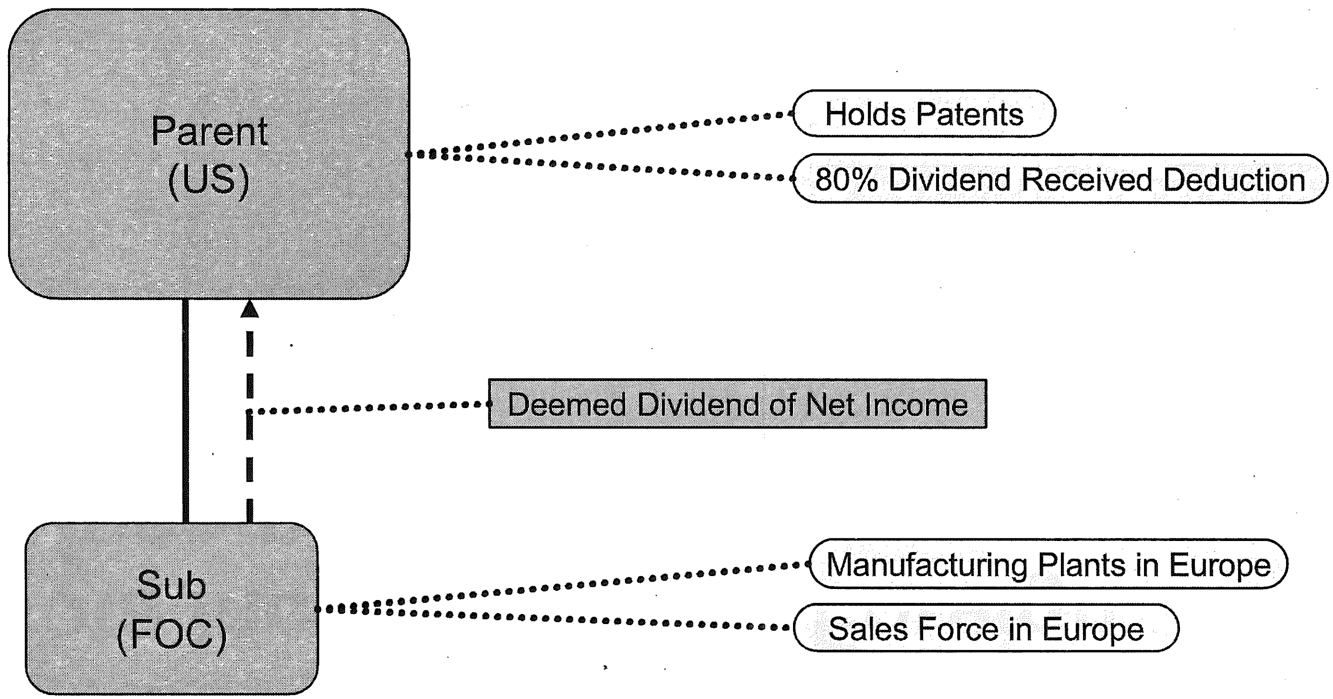

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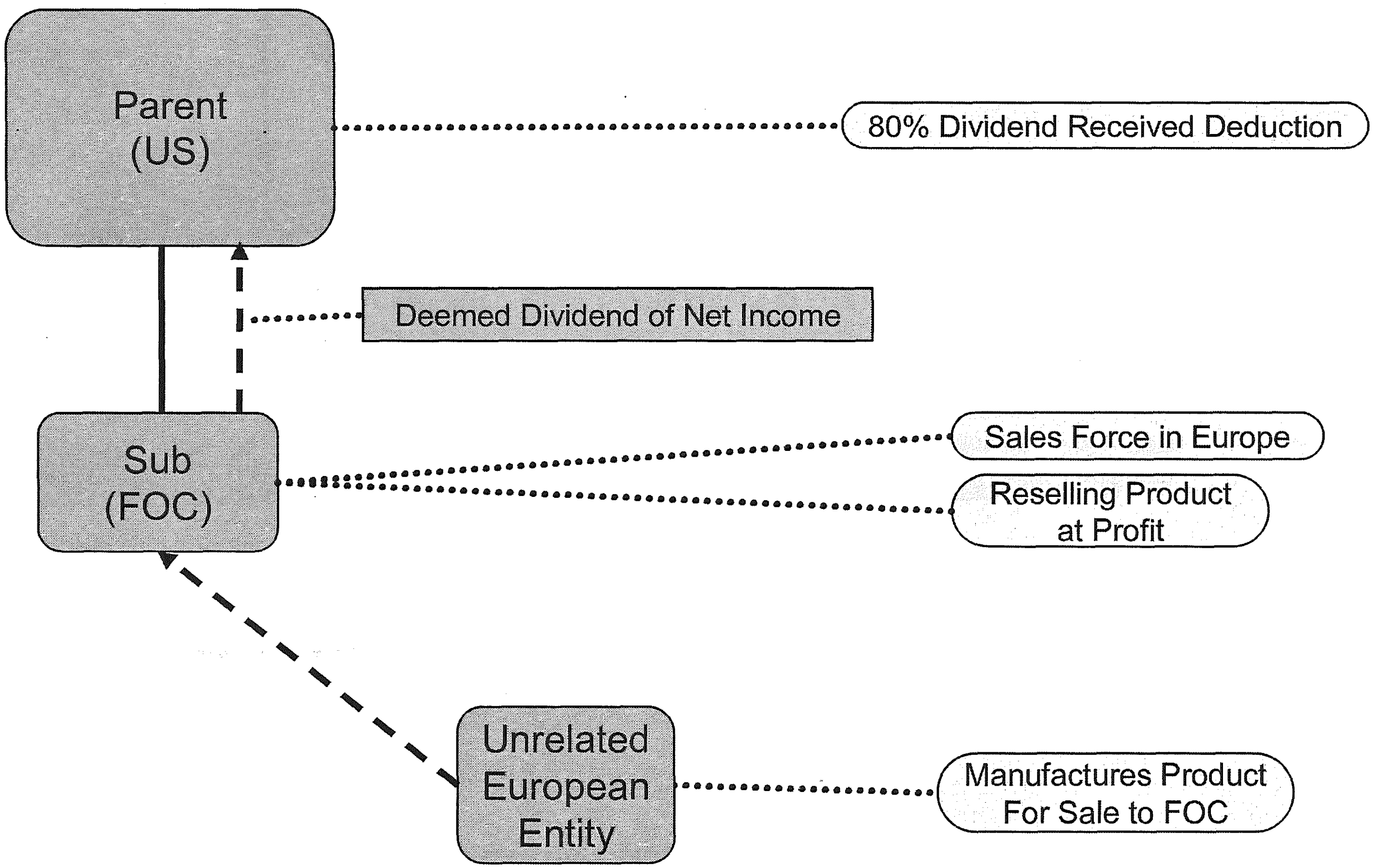

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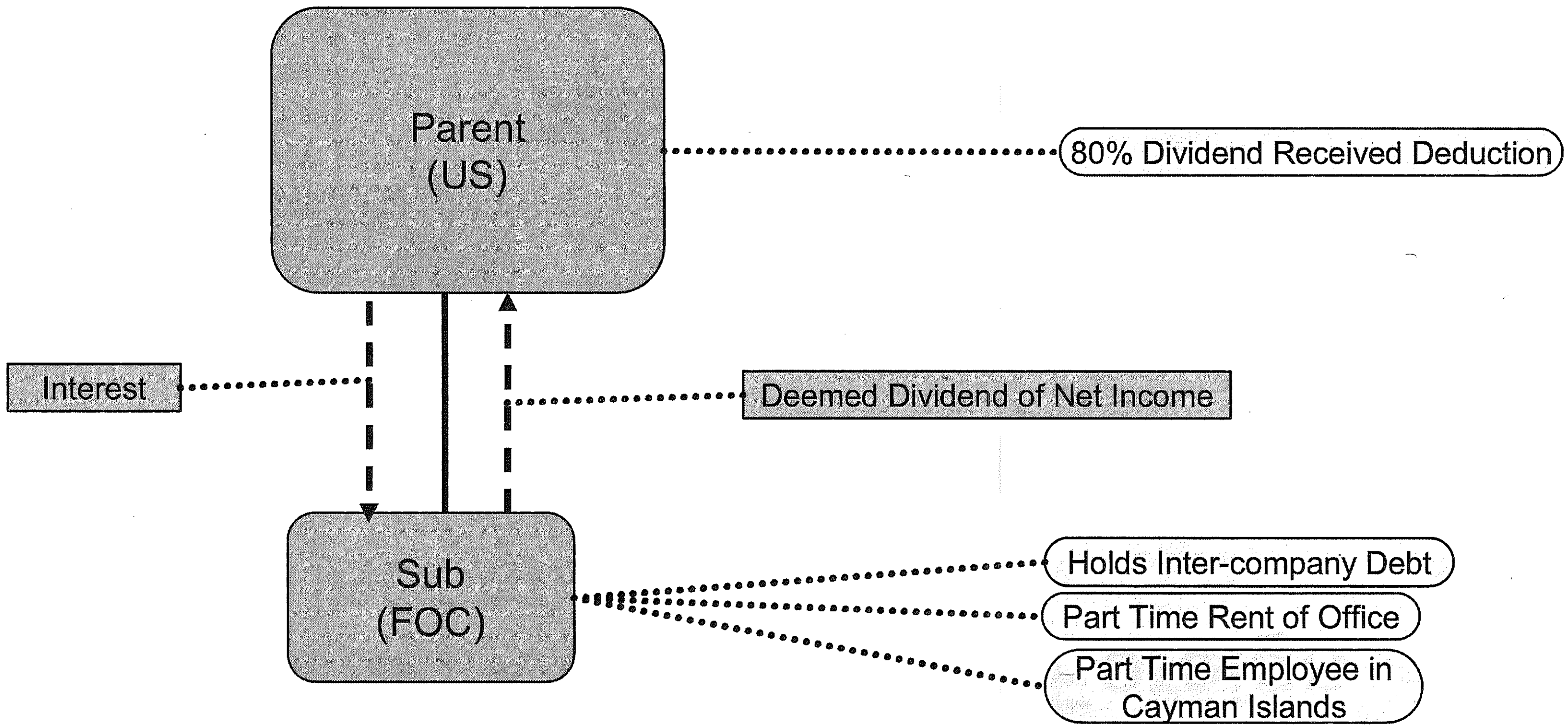

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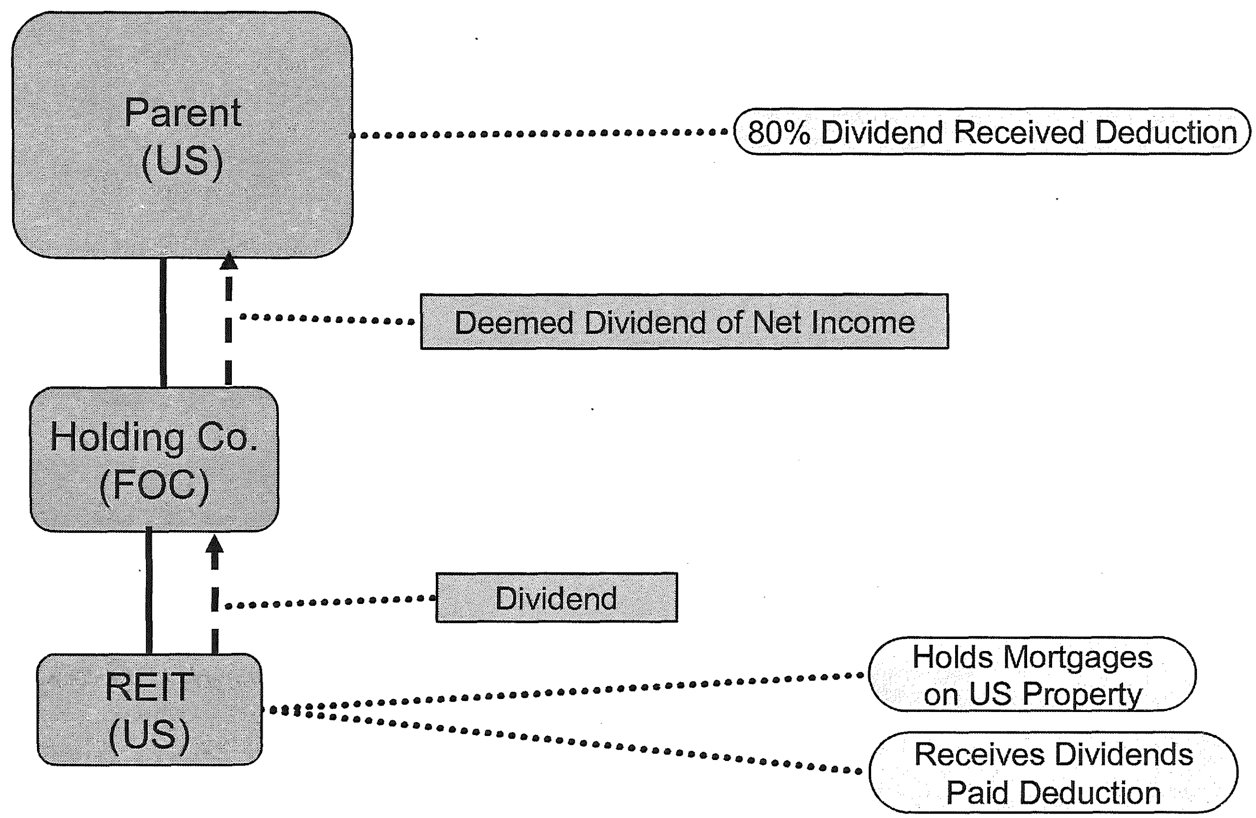

Minnesota Income Tax on Foreign Source Income

- 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

Top State Individual Income Tax Rates of 8% or Higher

This table shows the states that impose individual income tax rates equal to or greater than 8 percent for tax year 2004. The two columns to the far right indicate whether the state tax allows a deduction for federal income tax liability, because this affects the extent to which the statutory rate actually translates to a lower effective marginal tax rate. For states with an unlimited deduction of federal taxes (Minnesota had this system through 1986), each additional dollar of taxable income generates a deduction (the federal tax on that income) that reduces the statutory tax rate to a lower real rate. The far column assumes that the taxpayer is in the top federal tax bracket (35%) in making these computations. For taxpayers in lower federal brackets the state effective marginal rate would be higher.

States with Individual Income Tax Rates of 8% or More

State	Top Tax Rate	Income at which top rate begins to apply (married joint filers)	Deduction of federal income tax allowed?	Top rate after adjusting for federal income tax deduction*
California	9.3%	$78,266	No	9.3%
District of Columbia	9.3%	$30,000	No	9.3%
Iowa	8.98%	$55,080	Yes	5.837%
Hawaii	8.25%	$80,000	No	8.25%
Maine	8.5%	$33,950	No	8.5%
Montana	11.0%	$77,800	Yes	7.15%
North Carolina	8.25%	$200,000	No	8.25%
Oregon	9.0%	$12,700	Yes capped at $3,500	9.0%
Vermont	9.5%	$311,950	No	9.5%

* For taxpayer in top federal and state tax brackets
Source: Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States* (Jan. 2005).

House Research
3/16/2005