

5/11/92

STATE OF MINNESOTA
DEPARTMENT OF REVENUE

In the Matter of the Proposed Adoption of
Permanent Rules for the Apportionment of
Income of Air Carriers

STATEMENT OF NEED
AND REASONABLENESS

A Notice of Intent to Solicit Outside Opinion regarding the Proposed Rules Governing Franchise Tax Apportionment of Business Income of Interstate Air Carriers was published in the State Register on August 13, 1990. The notice specifically mentioned this rule and invited interested persons to submit comments or suggestions orally or in writing to the Department by October 15, 1990. The Air Transport Association of America commented in writing and orally.

IMPACT ON SMALL BUSINESS.

The impact of this rule on small business has been considered. The proposed rule is not expected to place any additional financial or administrative burden on small business. Corporate franchise tax reporting requirements are mandatory under Minnesota Statutes, chapter 290, so they cannot be made less stringent by a rule. The proposed rule does not impose any additional reporting requirements or deadlines on small businesses beyond those already in required by statute. The proposed rule does not establish any performance standards. The proposed rule does not add any reporting burden in addition to those already required by statute. If a small business air carrier is affected by the rule, the rule will not create a competitive advantage for either large or small businesses. There are no new reporting requirements, filing fees, or compliance requirements in the rule. The proposed rule does apply to small business air carriers but,

The Legislative Committee
Review Administrative Rules

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it is not expected to impact them qualitatively or quantitatively, economic, or otherwise.

Subpart 1. **General statement.** Minnesota Statutes 1990, section 290.02 imposes a franchise tax on corporate taxpayers who exercise their franchise to engage in contacts with the State of Minnesota. The tax is measured by taxable income and the alternative minimum tax base. Taxable income is defined by Minnesota Statutes 1990, section 290.01, subdivision 19, with the additions and subtractions specified in subdivisions 19c and 19d.

Minnesota Statutes 1990, section 290.191, subdivision 1 provides that the net income of a trade or business carried on partly within and partly without Minnesota must be apportioned according to the rules set out in the statute. The basic apportionment formula is the total of 70 percent of the ratio of sales made within this state, 15 percent of the ratio of tangible property within this state, and 15 percent of the ratio of payroll paid or incurred within this state. There is a special apportionment formula for financial institutions in subdivision 3 and another special formula for the mail order business in subdivision 4. However, there is no special formula for the air carriers. The methods prescribed by Minnesota Statutes 1990, section 290.191 are presumed to fairly reflect the taxpayer's taxable net income assignable to Minnesota. Minnesota Statutes section 290.20, subdivision 1. This section further states that if the methods set forth in Minnesota Statutes 1990, 290.191 do not fairly reflect taxable net income allocable to this state, the commissioner may require another method that fairly reflects Minnesota taxable net income.

The United States Supreme Court has stated the two components of fairness under the Constitution in Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 169, 103 S.Ct. 2933, 2942 as:

1. Internal consistency. "The formula if applied in every jurisdiction, it would result in no more than all the unitary business income being taxed."

2. External consistency. "The factor or factors must actually reflect a reasonable sense of how income is generated." (Emphasis added.) At 468 U.S. 183, 103 S.Ct. 2949, the Court stated:

"The three-factor formula used by California has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated."

Minnesota has sought under the corporate franchise tax to tax corporations to the extent constitutionally possible. Although an apportionment formula must be fair, it need not be exact. In NCR Corporation v. Commissioner of Revenue, 438 N.W.2d 86 (Minn. 1989), the Court, speaking of apportionment, stated at 438 N.W.2d 91:

"However, a state need not show that its statute results in the precise allocation of income resulting from activities of the taxpayer occurring within its jurisdiction."

The proposed rule attempts to fairly apportion income of air carriers. The rule recognizes that while air carriers derive income from carrying passengers, freight, and mail, some component of income is attributable to the situs of an air carrier's ground bases. That air carriers generate income by carrying passengers and freight from one point to another over distance is axiomatic. In general, although exceptions do exist, the revenue derived by an air carrier is related to the distance traveled and that is evident in the normal pricing of airline tickets. Air carriers earn nothing if nothing is transported. The miles traveled should therefore form a part of any formula designed to fairly apportion

income of airlines. Revenue miles is a principal measurement of an airline's operations. Because of this dual nature of the income earning activity of air carriers, it is necessary to bifurcate the formula to apportion income fairly. The proposed rule, following Container Corporation, attempts to reflect a reasonable sense of how income is generated by air carriers. The proposed rule does this while also following the constitutionally approved three-factor formula.

The proposed rule uses a standard airline measure of income, revenue ton miles, in conjunction with the three-factor formula. By joining the apportionment formula that follows the statutory method of apportionment, and the industry measure of income, no more than all of the unitary income of the business will be taxed. Other states have arrived at the same apportionment method and impose their franchise tax on airlines on the basis of mileage and situs elements.

For example, California, in Cal. Admin. Code, Title 18, section 25137-7(1991) apportions flight payroll of airline companies on the basis of the ratio of time the aircraft spends in the state performing services to total time spent in performing services. It determines the sales factor numerator by weighting the ratio of time aircraft spend in that state to total air time, by aircraft type and weighting the ratio of arrivals and departures in that state to total arrivals and departures.

Colorado arrives at a property factor numerator by including aircraft based on the weighted ratio of Colorado air miles to total air miles, plus the weighted ratio of Colorado arrivals and departures to total arrivals and departures. Flight payroll and sales are included in the Colorado numerator using the same percentage derived, for apportioning aircraft. 1 Colo. Code Regs. section 201-2(1982).

Ohio weights the ratio of air miles in Ohio to total air miles and Ohio arrivals and departures to total arrivals and departures and applies them in each of the three factors. The ratios are applied to aircraft ready for flight to arrive at a property factor numerator, flight personnel to calculate a payroll factor numerator, and to gross receipts from passenger and freight revenue to arrive at a sales factor numerator. Ohio Admin. Code section 5703-05-09(1989).

Each of these rules was promulgated to apportion income of an airline company using the three-factor formula.

Subp. 2. **Definitions.**

A. "Air carrier" is a reasonable definition because it follows the commonly accepted definition of the industry which is the subject of the rule. Not all corporations which hold themselves out as "airlines" meet the definition of air carrier as used in the proposed rule, so use of another term was necessary to avoid confusion.

B. "Aircraft" is a reasonable definition because it generally defines devices that are or may be operated by air carriers to produce revenue.

C. "Cargo ton mile" is defined in accordance with the generally accepted usage in the airline industry. It is reasonable to use a standard definition which will be understood and can readily be applied in calculating activity of an air carrier in this state.

D. "Departure" is defined to follow the commonly understood usage both within the airline industry and generally.

E. "Airport-to-airport mileage" is a reasonable definition because it sets forth a standard measurement which will approximate mileage of flights in service for the purpose of apportionment. More precise measurements can be made, but would require actual tracking of each flight. Measurement on the basis of actual flights would impose a heavy administrative burden on airline companies. It would require plotting and measuring each

change in course during the flight path of each revenue flight in service.

F. "Fixed property and payroll" is a necessary definition, for it classifies all property and payroll which is not subject to treatment as flight property and payroll because of the mobile nature of the property and payroll.

G. "Fleet type" is reasonable because it is the standard definition in the industry and necessary because each series of aircraft may have different passenger capacities and values.

H. "Flight in revenue service" is a required definition because it limits the apportionment measures to revenue producing activity, excluding maintenance and testing activity.

I. "Flight payroll" reasonably defines compensation paid to those persons whose job performance is not tied to a fixed situs and whose service is required in flight to produce revenue for the paid carriage of passengers, cargo, and mail.

J. "Flight property" is defined as aircraft and spare parts which may be subject to repair or rebuilding and repeated placement in an aircraft. Spare parts which cannot be used repeatedly after repair or rebuilding are not defined as rotating spare parts and are not included in flight property.

K. "Mail ton mile" is reasonable as defined by the rule because it follows both the industry standard for measurement and follows common sense definition. It is used to compute the receipts factor.

L. "Minnesota cargo ton mile", as defined, is the result of two other defined terms.

M. "Minnesota departures", as defined, is a logical usage following the definition of "departures" above.

N. "Minnesota plane miles" clearly defines plane miles which are attributed to Minnesota to apportion income under this formula. The definition is necessary to obtain a plane mile ratio for apportionment. The Minnesota plane miles approximates the actual mileage flown by an aircraft in Minnesota, using U. S. Department of Transportation mileage. The mileage is computed on

an airport of origination-airport of destination basis (city pair basis), using U. S. Department of Transportation airport to airport mileage. Minnesota distances are measured utilizing standard aviation maps to accurately arrive at the distance that each flight travels in Minnesota. The Global Navigation and Planning Chart is produced by the U. S. Defense Mapping Agency, is the standard chart used by air carriers and is available to air carriers and the public at flight shops. The Global Navigation and Planning Charts are great circle projections which measure flight miles. Other charts which show airports and are equally accurate are acceptable. Standard projections do not measure flight miles, but measure flat miles, not compensating for the curvature of the earth. Airport-to-border distances measured using charts of this accuracy will be uniform, and both the air carriers and Department of Revenue can compute distance based on these charts.

O. "Minnesota mail ton mile", as defined, is the result of two other defined terms.

P. "Minnesota passenger ton mile", as defined, is the result of two other defined terms.

Q. "Passenger ton mile" is reasonable as defined for the rule because it follows both the industry standards and is a common sense definition. It is used to calculate the receipts factor.

R. "Minnesota plane mile ratio" is a necessary definition because it is applied to flight property and flight payroll to determine what portion of that property and payroll is includable in the numerator to obtain an apportionment percentage.

S. "Plane miles" defines mileage which is includable in the denominator to obtain the plane mile ratio. It is necessary to have an approximate standard mileage because actual flight mileage would have to be kept on each flight to get more accurate mileage. The administrative burden of keeping actual mileage for each flight in an airline system is excessive, as the Air Transport Association carriers flew approximately 7,000,000 flight segments (legs between take-offs and landings) in 1990.

Subp. 3. **Formula.** This subpart is necessary because companies who are primarily in the airline business may have other divisions or subsidiaries which are not in the airline business. This subpart states that those divisions or subsidiaries are subject to taxation in the same manner as any similar business not owned by airline companies.

Subp. 4. **Property factor.** This subpart necessarily divides property into two categories, property without a fixed situs and property with a fixed situs. In the rule this property is called flight property and fixed property respectively. It is also reasonable that property which does not have a fixed situs be apportioned to the various states where it is used in determining the property factor. The method in the rule that apportions flight property to Minnesota for the property factor is the application of the Minnesota plane mile ratio. The Minnesota plane mile ratio is a ratio derived from mileage flown in income producing flight. The Minnesota plane mile ratio is, therefore, an appropriate method of assigning income producing flight property in this factor. It is reasonable to assign all property with a fixed situs to the state of situs while determining the property factor.

The rental capitalization rate is the statutory rate, as set forth in Minnesota Statutes, section 290.191, subdivision 10(e). The rule follows legislative judgment on a proper rental capitalization rate.

Subp. 5. **Payroll factor.** This subpart reasonably situs fixed payroll at a fixed location following the precepts set forth in the statute. The income of flight personnel is earned ratably while in service over the airline company's system. It is reasonable then to attribute to Minnesota that portion of flight payroll that is earned in Minnesota. This is accomplished in the

rule by multiplying total flight payroll by the Minnesota plane mile ratio.

Subp. 6. **Receipts factor.** The receipts factor recognizes that two components are necessary for an air carrier to earn income. One part is the location from which flights originate and terminate. The second part is the performance of the transportation service between those locations. The rule gives weight to each component of the income producing activities of an airline company. The denominator includes all receipts from paid transportation. The numerator adds income from the two component parts to arrive at the receipts factor for apportionment.

The first component, in subpart 6B(1), of the rule, allocates receipts to Minnesota using the mileage component of the income producing activities. Each segment of income produced by flight activity is separately multiplied by the ton mileage ratio arrived at for that income activity. Thus passenger, cargo, and mail revenue is apportioned to the Minnesota numerator on the basis of Minnesota passenger, cargo, and mail revenue ton miles to total passenger, cargo and mail revenue ton miles. The receipts generated are multiplied by the receipt producing mileage to accurately measure Minnesota receipts derived from flight activity.

The second component, in subpart 6(B)(2) allocates receipts to Minnesota using the ground component of the income producing activities. It is not appropriate to measure receipts from situs based activities by revenue ton miles. Revenue ton miles measure performance of the service giving rise to the receipts over the routes flown. The more accurate measure for situs based performance of a service is the ratio of Minnesota departures to total departures. This ratio applied to total revenue measures the situs based economic activities for inclusion of situs based receipts in the numerator of the receipts factor. It is used in this rule.

SEK:caw:snr:airline1-2/4/92:04/29/92

LCRAR



Legislative Commission

to Review Administrative Rules

Representative Peter Rodosovich
Chair

Senator Phil Riveness
Vice Chair

55 State Office Building
St. Paul, Minnesota 55155-1201
Telephone 612/296-1143

Maryanne V. Hruby, Director

June 2, 1992

Stephen E. Krenkel
Minnesota Department of Revenue
Appeals, Legal Services, and
Criminal Investigation Division
10 River Park Plaza
Mail Station 2220
St. Paul, Minnesota 55146-2220

Dear Mr. Krenkel:

I write to request a copy of the Department of Revenue's Statement of Need and Reasonableness (SONAR) for recently published rules relating to taxation; income; and air carriers.

As you may know, Minnesota Statutes, sections 14.131 and 14.23 now require state agencies to provide copies of SONAR's to the LCRAR when they become available for public review.

If you have not already done so, please send a copy of the SONAR for these proposed rules to:

✓ The Legislative Commission to Review Administrative Rules
Maryanne Hruby, Director
55 State Office Building
St. Paul, Minnesota 55155

Please contact me at 296-1143 if you have any questions.

Thank you.

Sincerely,

A handwritten signature in cursive script that reads "Michele Swanson".

Michele Swanson
Commission Secretary





STATE OF MINNESOTA

DEPARTMENT OF REVENUE

June 5, 1992

Michelle Swanson, Commission Secretary
Legislative Commission to Review Administrative Rules
55 State Office Building
St. Paul, Minnesota 55155-1143

Dear Ms. Swanson:

Enclosed is a copy of the Statement of Need and Reasonableness (SONAR) for the published rule relating to taxation, income, and air carriers. I have also sent a copy to Maryanne Hruby, Director of the LCRAR, as you requested in your letter of June 2, 1992.

Please excuse my overlooking this requirement. If you have any questions, call be at 296-1902 Extension 135.

Thank you.

Sincerely,

A handwritten signature in black ink, appearing to read "Stephen E. Krenkel".

Stephen E. Krenkel, Attorney
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SEK:caw:gc-1:swanson-06/05