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Information Brief

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TAXING THE INCOME OF MULTISTATE CORPORATIONS

Summary

- As a matter of federal constitutional law, the state may tax only that portion of a multistate corporation's income which is fairly attributable to Minnesota.

- Because this apportionment of corporate income is difficult to accomplish through separate accounting, states commonly rely on three factor apportionment formulas, based on the in-state share of the corporation's total property, payroll, and sales.

- The operation of this apportionment system is important, because the bulk of the corporate income tax is paid by multistate corporations and because the tax system affects business location decisions.

- Many multistate businesses operate in a multicorporate form--i.e., they operate through two or more corporations, commonly a parent and subsidiary corporation. In 1982 the Legislature modified the apportionment system by extending the three factor apportionment formulas to multicorporate, unitary businesses. This law, usually referred to as unitary taxation or combined reporting, determines the tax liability of multicorporate businesses, in effect, by applying the apportionment formula to the entire unitary business regardless of how that income is divided among each of the individual corporations comprising the business. The unitary apportionment system does not, however, apply to foreign subsidiaries.

Federal Law

The United States Constitution limits a state's power to tax multistate businesses to only that income which is fairly attributable to the taxing state. Permitting states unrestricted power to tax all the income of a multistate business could subject the business to double taxation of its income, since each state in which it does business could tax all its income. This outcome, the United States Supreme Court has held, would discourage the flow of interstate commerce in violation of the commerce clause of the U.S. Constitution.

Methods of Apportioning Corporate Income

As a result, the state corporate income tax must provide a mechanism for determining the share of a multistate corporation's income which is attributable to Minnesota. Traditionally this has been done in either of two ways: (1) separate accounting or (2) use of a formula to apportion income.

1. Separate Accounting

Separate accounting attempts to determine, using standard accounting techniques, the amount of profit generated by the in-state operations of a corporation. Thus, a corporation engaged in manufacturing could attempt to determine the value of the products produced in the state, the costs of its operations in the state, and the resulting profits. Since many of these transactions are simply transfers within the corporation, their valuation must be based on the accountant's or manager's judgment, rather than the market's measure of value.

Separate accounting is rarely used to apportion income under state corporate taxes for three reasons:

- Fairly valuing intracorporate transactions which are not made at arms length is extremely difficult. For example, the sales prices assigned by a corporation's manufacturing division for products delivered to its retailing division may not be reliable reflections of the true price of the product.
- Allocation of overhead and other general expenses--e.g., central management or advertising--must be done on an arbitrary basis.
- Using separate accounting is administratively burdensome and expensive for both corporations and the state.

Minnesota law permits the use of separate accounting only "if practicable" and when the apportionment formulas "will not properly reflect taxable net income assignable to the state." Minn. Stat. §290.19, subd. 1 (2)(b).

2. The Three Factor Apportionment Formulas

Because of the problems with separate accounting, all states rely principally upon apportionment formulas. These formulas apportion income based upon the proportions of the corporation's total tangible property, payroll, and sales that are located in the state. (Iowa, however, apportions income solely on the basis of sales.) The formulas are based on the notion that the location of a corporation's capital investment in tangible property, its employees (payroll), and sales are good indicators of the source of its profit or net income.

In Minnesota multistate corporations may select one of two apportionment formulas. The taxpayer has the option of using either formula and thus will use the formula which apportions less income to Minnesota. The two formulas are:

- The arithmetic formula which uses equal weights for each factor--

$$\text{Corporate Net Income} \times \left(.33 \frac{\text{MN payroll}}{\text{total payroll}} + .33 \frac{\text{MN sales}}{\text{total sales}} + .33 \frac{\text{MN property}}{\text{total property}} \right) = \text{Minnesota Taxable Income}$$

- The weighted formula which assigns a 70 percent weight to the sales factor and 15 percent weights to the property and payroll factors--

$$\text{Corporate Net Income} \times \left(.15 \frac{\text{MN payroll}}{\text{total payroll}} + .70 \frac{\text{MN sales}}{\text{total sales}} + .15 \frac{\text{MN property}}{\text{total property}} \right) = \text{Minnesota Taxable Income}$$

The Importance of the Apportionment System

1. The Significance for State Revenues

Apportionment formulas are important because most corporate taxes are paid by multistate corporations. In 1981 multistate corporations filed less than one-fourth of all corporate tax returns, but paid over two-thirds of the total corporate tax liability. The breakdown is displayed below.

	Number	Percent	Amount	Percent
100% MN Corporations	31,284	77.6%	$ 89,818,617	30.4%
Multi-State Corporations	9,023	22.4%	$206,047,620	69.6%
All Corporations	40,307	100.0%	$295,866,237	100.0%

2. The Apportionment Formula and Business Location Decisions

Minnesota uses its apportionment formulas to stimulate businesses to locate or expand in the state. The apportionment method reduces taxes for businesses with substantial facilities in Minnesota that sell a large proportion of their output outside the state. This is done through three mechanisms--the optional apportionment formulas, the destination sales rule, and the lack of a throwback rule. The goal is to stimulate businesses that sell their products in regional or national markets to locate their manufacturing facilities, warehouses, and processing plants in Minnesota.

- Optional Apportionment Formulas

  Most states use only the arithmetic formula. The Uniform Division of Income Tax for Tax Purposes Act ("uniform act"), a model law adopted by the American Law Institute and by nineteen states as part of the Multistate Tax Compact, also provides only for use of the arithmetic formula. Minnesota's optional, weighted formula provides lower taxes for corporations which have a larger share of their operations (property and payroll) in Minnesota but sell a large portion of their products outside the state. Because the formula weights sales more heavily, it apportions less income to Minnesota and reduces these corporations' taxes.

- Destination Sales

  In addition, the definition of the sales factor in Minnesota's apportionment formulas reduces taxes on businesses with large amounts of their sales outside of the state. The formulas determine the location of sales by reference to the purchaser's location, even if the taxpayer corporation ships the goods by common carrier from Minnesota. This feature, commonly called "destination sales," assigns more sales to other states thereby reducing the taxpayer's Minnesota tax.

- Throwback Rule

  Most states and the uniform act have a "throwback rule" to determine the location of sales. Under a throwback rule, if a sale is made in a state in which the taxpayer could not be subject to taxation, the sale is "thrown back" or included in the sales made in the state of origin. Throwback rules are designed to prevent the apportionment of income to states in which the corporation is not taxable. Minnesota does not employ a throwback rule in defining its sales factor.

Apportionment of the Income of Multicorporate, Unitary Businesses

The final, major feature of Minnesota's apportionment law is the unitary tax or the requirement of combined reporting, enacted by the Legislature in 1982 (effective July, 1981). Combined reporting extends the use of the three factor formula to multistate unitary businesses which operate in multi-corporate forms.

Many larger, multistate businesses operate in multi-corporate forms--i.e., the business consists of two or more separate corporations (usually a parent corporation which owns controlling interests in one or more subsidiary corporations). For example, an oil company may separately incorporate its drilling and exploration, refining, and retailing operations. Operating in multi-corporate form may be done for a variety of business, legal, or tax purposes. Since corporations are only legal fictions, a business's managers and stockholders may create as many separate corporations as they like simply by filing articles of incorporation and paying a filing fee. Some large businesses operate through numerous subsidiary corporations. For example, Mobil Oil Company has well over 200 subsidiaries.

Under Minnesota's corporate income tax law prior to 1981 each separate corporation was treated as an independent taxpayer. When a new corporation was created, a new taxpayer was also created. If the corporation did business in Minnesota and was therefore subject to the corporate tax, the three factor formula (using the individual corporation's property, payroll and sales) was applied to its net income to determine its tax liability. This was done without regard to the factors of the other corporate entities owned by the same business.

This system presented some multistate businesses with an opportunity to reduce their state corporate taxes by setting up multi-corporate structures and manipulating intracorporate pricing policies. To illustrate, a business may set up a multi-corporate structure whereby only one corporation does business in Minnesota (say a retailing operation), but it purchases substantial amounts of its goods and services from other corporations (say a manufacturing subsidiary) operated by the business. With this type of structure, only the retailing subsidiary is subject to the state income tax. However, the business's managers have the power to determine the profitability of the retailing subsidiary by setting the prices charged for the goods and services it purchases from the manufacturing subsidiary. These are essentially accounting or bookkeeping decisions which will allocate profit between the retailing and manufacturing subsidiaries but which do not affect the profitability of the overall business. By setting up separate, subsidiary corporations the business is in effect able to use separate accounting rather than formula apportionment.

The new combined reporting or unitary tax law extends the apportionment formula to these businesses. If a unitary business is operated in a multi-corporate form, its Minnesota tax will be determined by, in effect, ignoring the corporate structures in determining total net income and the apportionment factors.

Mechanically, each corporation doing business in Minnesota continues to file separate returns but uses (1) the total net income of the unitary business, (2) the individual corporation's Minnesota property, payroll, and sales as the numerator of the apportionment factors, and (3) the unitary business' total property, payroll and sales as the denominator of the factors. Each individual corporation will continue to retain the option of selecting either the arithmetic or the weighted apportionment formula.

Thus each corporation in the unitary business would pay tax based on the following formula:

$$\text{Unitary business's total net income} \times \frac{\text{separate corporation's factors}}{\text{unitary business's factors}}$$

The right side of the equation is determined using either of the apportionment formulas as described on page 3.

Adoption of the unitary tax was controversial. Many corporate and business interests objected to it on the grounds that subsidiaries doing business exclusively outside of Minnesota were genuinely more profitable than their Minnesota operations. For example, the major oil companies contend that their drilling and exploration operations (located outside Minnesota) are more profitable than their retailing or refining operations (located in Minnesota).

Concern was expressed that the definition of a unitary business was too open-ended and that the unitary tax would eliminate much of Minnesota favorable corporate tax treatment for large corporations with headquarters or other substantial facilities in Minnesota. A good deal of skepticism was also expressed regarding the estimated $65 million in increased collections for the 1982-83 biennium. In a subsequent forecast, the revenue estimate was reduced to $22 million, confirming this skepticism.

Minnesota's unitary tax does not apply to foreign subsidiaries. Application of combined reporting to foreign operations has generated the most controversy nationally. Corporations contend that risk levels and rates of return differ in foreign countries and as a result their proportionate share of property, payroll, and sales does not always accurately reflect the share of earnings contributed by foreign operations.