

MINNESOTA • REVENUE

CORPORATE FRANCHISE Foreign Operating Corporations Foreign Royalty Subtraction

March 15, 2007

	Yes	No
DOR Administrative Costs/Savings		X

Department of Revenue

Analysis of S.F. 763 (Moua) / H.F. 912 (Hornstein), Article 2

	Fund Impact			
	<u>F.Y. 2008</u>	<u>F.Y. 2009</u>	<u>F.Y. 2010</u>	<u>F.Y. 2011</u>
General Fund	\$142,000	\$102,000	\$98,000	\$96,000

Effective for tax years beginning after December 31, 2006.

EXPLANATION OF THE BILL

Current Law: Minnesota allows certain intercompany income of a unitary group to be classified as the income of a foreign operating corporation (FOC). Because FOC income receives a dividend received deduction, 20% of this income is subject to tax. In order to qualify for FOC status, a corporation must have 80% or more of the average of its property and payroll factors located outside the United States. Also, a corporation must have at least \$1 million of payroll and \$2 million of property located outside the U.S.

Under Minnesota law, corporations are allowed to claim a subtraction against their net income equal to 80% of intercompany foreign royalty income received from an FOC or a foreign corporation. The recipient corporation and the FOC or foreign corporation must be part of the same unitary business. Royalty income is defined as royalties, fees, or other like income.

Proposed Law: A corporation's FOC status would no longer be determined by its property and payroll factors. Instead FOC status would be determined by whether at least 80% of its gross income is from an active foreign business. The bill relies on definitions in the Internal Revenue Code to determine whether the income of an FOC is from foreign sources and to determine whether its income is attributable to the active conduct of a trade or business in a foreign country. Only foreign source income would be eligible for the dividend received deduction. Domestic source income would be ineligible for the dividend received deduction.

The bill adds an additional requirement to income receiving the foreign royalty subtraction. This income must be classified as income from foreign sources according to the Internal Revenue Code definitions.

REVENUE ANALYSIS DETAIL

- Article 2, sections 1 through 3 reduce the usage of the foreign operating corporation (FOC) tax regime and the foreign royalty subtraction.
- The revenue estimate is based on data from returns received by the Department of Revenue in calendar year 2005. Since the impact of the proposed law is not uniform across corporations, the effect of FOC changes varied amongst the approximately six hundred corporations with the largest amounts of FOC income. These corporations represent activity in about seventy unitary groups. Almost all of the revenue impact is concentrated in this group. Most of the total revenue gain was generated by changes to the FOC tax regime.
- The revenue gain from changes to the foreign royalty subtraction was estimated in a similar manner to that used to estimate changes the FOC tax regime.
- Growth in overall corporate tax collections as projected by the Department of Finance in the February 2007 forecast is used to project future revenue losses.
- All of tax year 2007 revenue loss is allocated to fiscal year 2008. Other tax years were allocated 30/70 to fiscal years.
- The estimates of current law against which the proposal is measured reflect the February 2007 forecast and include the prospective estimated impact of the June 2005 decision by the Minnesota Supreme Court in *Hutchinson Technology, Inc., vs. Commissioner of Revenue*.

Number of Taxpayers: About 3,000 corporations are affected by the bill.

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