DEPARTMENT OF REVENUE

INDIVIDUAL INCOME TAX
CORPORATE FRANCHISE TAX
Election to File as a C Corporation

	Yes	No
DOR Administrative Costs/Savings	X	

March 4, 2020

Department of Revenue
Analysis of H.F. 871 (Davids), As Proposed to be Amended (H0871DE1)

	Fund Impact			
	F.Y. 2020	**F.Y. 2021**	**F.Y. 2022**	**F.Y. 2023**
	(000's)			
General Fund	---------------Unknown---------------			

Effective beginning with tax year 2020.

EXPLANATION OF THE BILL

Current Law: Flow-through entities such as S corporations and partnerships do not pay state or federal income taxes directly. Their income is passed to shareholders, who report the income on their individual income tax returns. There is no election to allow a partnership, S corporation, or limited liability company to file and pay their tax liability as a C corporation.

Proposed Law: The bill creates an option that allows a partnership, S corporation, or limited liability company to elect to file and compute their tax liability as a corporation subject to the corporate franchise tax (termed a C-option corporation). When a taxpayer computes their tax liability as a corporation, its income would be apportioned to Minnesota. In addition, electing taxpayers would be required to use all corporate additions and subtractions. The tax rate would be at the highest individual rate, 9.85%. The corporate franchise tax rate is a flat 9.8%.

If the election is made by the majority owner of the qualifying entity (having more than 50% ownership interest), the election is binding on all of the owners of the entity. The election must be made by the date the return is due or the extended due date. The election is binding for the next four years, unless more than 50% of the ownership interest requests a revocation. If the election is revoked within four years, the entity may not file as a C-option corporation for the next four years. A shareholder's basis in the entity is not affected by the election to file as an C-Option corporation.

Shareholders of the qualifying entity may claim a subtraction on their individual income tax return equal to the amount of net income received from the entity. Net income cannot be less than zero.

REVENUE ANALYSIS DETAIL

- The number of qualifying entities that would elect to file as a C-option corporation is unknown.
- In tax year 2017, about 179,500 full-year resident returns reported income from an S corporation, partnership, or limited liability corporation.
- Of those, about 87,400 returns had state and local taxes over the deduction limit ($10,000 or $5,000 for married separate filers).

REVENUE ANALYSIS DETAIL (Cont.)

- About 30,100 of those returns had at least some income in the highest income tax bracket. Those are considered to be most likely to file as a C-option corporation, which would have all of its income taxed at the highest income tax rate.
- It is unknown how many of those taxpayers have more than 50% ownership in the qualifying entities.
- It is assumed that an entity would only file as a C-option corporation if the majority shareholders benefit from the election with a reduced combined federal and state tax liability.
- The effect on state tax revenue depends on the tax situation of the underlying shareholders, including the shareholder’s marginal tax rate and whether they are at the limit for state and local tax deductions.
- The election is binding on all shareholders, so minority shareholders could be hurt by the election even if the majority shareholders benefit.
- The election is binding for the next four tax years, unless revoked by a majority of shareholders. Taxpayers may not benefit from the election in the following years if their financial situation changes.

Minnesota Department of Revenue
Tax Research Division
https://www.revenue.state.mn.us/revenue-analyses

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