

Minnesota Department of Revenue

Revenue Notice # 26-01: Corporate Franchise Income Tax – Minnesota Taxable Income – Foreign Corporate Filers

Introduction

For a foreign corporate filer that files federal Form 1120-F, there are circumstances when line 1a of Form M4I, Income Calculation, will not equal the income amount on the corresponding line on federal Form 1120-F.¹ Line 1a of Form M4I, Income Calculation, lists the federal taxable income before net operating loss (“NOL”) deduction and special deductions. The test the *Internal Revenue Code* uses to establish when a foreign corporation is subject to its jurisdiction to tax – which can involve establishment of an “effective connection” with the conduct of a trade or business within the United States – is different from the test Minnesota uses to establish its jurisdiction to tax which involves constitutional nexus and can result in a different calculation of taxable income.

This Revenue Notice discusses two common examples of when this occurs. One example is when sections 864(c) and 882 of the *Internal Revenue Code* exempt income of a foreign corporate filer for federal income tax purposes but does not do so for Minnesota income tax purposes (the “not effectively connected” example). The other example is when a foreign tax treaty exempts income of the foreign corporate filer for federal income tax purposes but not for Minnesota income tax purposes (the “foreign treaty” example).

Background

A. Federal income taxation of foreign corporations.

Section 11 of the *Internal Revenue Code* imposes federal income tax on domestic corporations using one method, and on foreign corporations using another method.

Domestic Corporations: For domestic corporations, federal income tax is generally “imposed for each taxable year on the taxable income of every corporation.” *Internal Revenue Code* section 11(a). The “taxable income” referenced in section 11(a) is defined in *Internal Revenue Code* section 63. A domestic corporation’s “taxable income” means, for federal purposes, “gross income minus the deductions allowed by this chapter (other than the standard deduction).” *Internal Revenue Code* section 63. “Gross income,” for federal purposes, is generally defined as “all income from whatever source derived.” *Internal Revenue Code* section 61.

Foreign Corporations: The method used for imposing federal income taxes on foreign corporations is different than domestic corporations, as described in section 11(d) of the *Internal Revenue Code*. Section 11(d) provides that “[i]n the case of a foreign corporation, the taxes

¹ A foreign corporate filer’s federal taxable income before NOL deduction and special deductions appears on Line 29, Section II of the federal 2024 Form 1120-F.

imposed by subsection (a) and section 55 shall apply only as provided by section 882.” Generally, section 882(b) imposes federal income tax on a foreign corporation’s:

- (1) gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and
- (2) gross income which is effectively connected with the conduct of a trade or business within the United States.

Section 864(c)(4)(B) of the *Internal Revenue Code* provides, generally, that income, gain, or loss from sources outside the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a foreign corporation “if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable.”

As a result, if a foreign corporation does not have gross income in connection with a trade or business within the United States fitting the definitions in paragraphs (1) and (2) of section 882(b) of the *Internal Revenue Code*, then it is not subject to federal income tax.

B. Minnesota income taxation of foreign corporations.

Minnesota income tax law differs from federal income tax law in that it does not adopt the federal definitions of “gross income” in *Internal Revenue Code* section 882(b).

1. Minnesota’s jurisdiction to tax income of foreign corporations.

Under Minnesota income tax law, a “corporation” is defined as including, among other things, “every entity which is a corporation under section 7701(a)(3)” of the Internal Revenue Code. *Minnesota Statutes*, section 290.01, subdivision 4. Sections 7701(a)(3)(4) and (5) of the *Internal Revenue Code* provide that the term “corporation” includes both “domestic corporations” and “foreign corporations.” The same is true under Minnesota income tax law. *See Minnesota Statutes*, section 290.01, subdivisions 4, 5 and 5a (“corporation” includes both “domestic corporations” and “foreign corporations”).

As a general matter, Minnesota has jurisdiction to impose its income tax on foreign corporations when they have income allocable to Minnesota due to their contacts with the state:

Except as provided in section 290.015, corporations are subject to the return filing requirements and to tax as provided in this chapter if the corporation so exercises its franchise as to engage in such contacts with this state as to cause part of the income of the corporation to be:

- (1) allocable to this state under section 290.17, 290.191, 290.20, or 290.36.

Minnesota Statutes, section 290.014, subdivision 5(1).

Unlike *Internal Revenue Code* section 882(b), Minnesota imposes no requirement that a foreign corporate filer be “effectively connected” with the conduct of a trade or business within the United States (or within Minnesota) to impose the corporate franchise income tax.

2. The definitions of income applicable to foreign corporations under Minnesota tax law.

Minnesota Statutes, section 290.02 imposes the corporate franchise income tax on “the corporations’ taxable income and alternative minimum taxable income for the taxable year for which the tax is imposed, computed in the manner and at the rates provided in this chapter.” “Taxable income” for corporations is defined in *Minnesota Statutes*, section 290.01, subdivision 29(2) (“taxable net income less [certain deductions]”).

“Taxable net income” for corporations means “the part of net income that is allocable to Minnesota by assignment or apportionment under one or more of Sections 290.17, 290.191, 290.20, and 290.36.” *Minnesota Statutes*, section 290.01, subd 22(3).

“Net income” means for corporations “the federal taxable income, as defined in section 63 of the *Internal Revenue Code* of 1986, as amended through the date named in this subdivision, incorporating the federal effective dates of changes to the Internal Revenue Code and any elections made by the taxpayer in accordance with the Internal Revenue Code in determining federal taxable income for federal income tax purposes, and with the modifications provided in sections 290.0131 to 290.0136.” *Minnesota Statutes*, section 290.01, subdivision 19(a).

Under *Internal Revenue Code* section 63(a), federal “‘taxable income’ means gross income minus the deductions allowed by this chapter (other than the standard deduction).”

Minnesota imposes the corporate franchise income tax on corporations that “engage in contacts with this state that produce gross income attributable to sources within this state.” *Minnesota Statutes*, section 290.02.

“Gross income” means “the gross income as defined in section 61 of the Internal Revenue Code of 1986, as amended through the date named in subdivision 19 for the applicable taxable year, plus any additional items of income taxable under this chapter but not taxable under the Internal Revenue Code, less any items included in federal gross income but of a character exempt from state income tax under the laws of the United States.” *Minnesota Statutes*, section 290.01, subdivision 20.

Accordingly, when the term “gross income” is used with respect to a foreign corporate filer in Minnesota's corporate franchise income tax laws, it includes: 1) “all income from whatever

source derived,” and 2) “any additional items of income taxable under this chapter but not taxable under the Internal Revenue Code.”

Department Position

The test the federal government uses to establish when a foreign corporation is subject to its jurisdiction to tax – which can involve establishment of an “effective connection” – is different from the test Minnesota uses to establish its jurisdiction to tax which involves constitutional nexus.² This can lead to a different calculation of Minnesota taxable income. Below the Department describes two common examples of when this occurs.

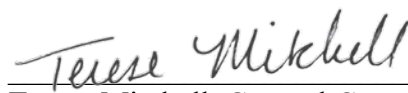
A. The “not effectively connected” example.

In this example, the foreign corporate filer does not have any effectively connected income (“ECI”) to report on federal Form 1120-F. The filer also does not have any physical presence in the United States (e.g., an office or other fixed place of business) but makes sales in Minnesota producing income for purposes of *Internal Revenue Code* sections 61 and 63. In this situation, the filer must enter its federal taxable income, as defined in section 63 of the *Internal Revenue Code*, on line 1a of Minnesota Form M4I, Income Calculation – without consideration of whether it has ECI. The Department’s position is that the filer must complete Schedule REC, Reconciliation, to explain the difference between line 1a on Minnesota Form M4I, Income Calculation, and the line on Form 1120-F showing its federal taxable income before NOL deduction and special deductions, and attach Schedule REC to its Form M4I.

B. The “foreign treaty” example.

In this example, the foreign corporate filer is exempt from paying federal income tax because of a tax treaty signed by the United States. The Department’s position is that a treaty that provides that a taxpayer’s income and gains are exempt from federal income taxes imposed by the *Internal Revenue Code*, but specifies that subnational (e.g., state) taxation is not included in the exemptions provided in the treaty, does not define, alter, or exempt income from the *Internal Revenue Code* definition of federal taxable income, which is the basis for determining Minnesota taxable income. In this situation, the federal treaty does not apply to Minnesota income taxation, and the foreign corporate filer must file a pro forma federal Form 1120 to calculate Minnesota taxable income.

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² See *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 433 and 443 (1980) (describing contacts sufficient to impose a state’s income tax as “sufficient nexus” for purposes of the Due Process Clause and “substantial nexus” for purposes of the Commerce Clause).