HOUSE RESEARCH

Bill Summary

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Version: As introduced

Authors: Hornstein and others

Subject: Tax provisions only (article 2)

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Overview

This summary describes only article 2 of the bill, which makes changes in the corporate franchise tax. These provisions make three changes related to the foreign source income provisions of the corporate franchise tax:

- The qualifying rules for "foreign operating corporations" (FOCs) are modified to require the corporation to derive 80 percent of its income from active foreign sources. This replaces the present law test that largely focuses on where the property and payroll of the corporation is located.
- Tax benefits accruing to FOCs and under the foreign royalty exclusion are denied to income from domestic sources, as defined under federal law.
- The commissioner of revenue is given expanded power to ignore transactions in computing a corporation's taxable income, if the transactions have no business purpose other than reducing taxes or if they lack economic substance.

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1 **Definition of foreign operating corporations.** Modifies the FOC definition to require that the entity either (1) have a valid 936 election (these are corporations qualifying under

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federal tax rules that provide an incentive for operating in Puerto Rico and other U.S. possessions) or (2) 80 percent or more of its income is foreign source, as defined by federal law, and is from the active conduct of a trade or business.

Present law's definition of an FOC contains four requirements that the entity:

- Be a domestic corporation that is part of a unitary group, one member of which is taxable in Minnesota
- Have 80% or more of its average property and payroll outside of the U.S. (excluding Puerto Rico or possessions) or be a 936 corporation
- Not be a Foreign Sales Corporation (a now obsolete federal tax provision that provided export incentives)
- Have $1 million in foreign payroll and $2 million in foreign property (the payroll requirement can also be satisfied by having $1 million of foreign contract work done).

Effective date: tax year 2007

2 **Additions for income for FOC operations.** Requires addition of the following items of income related to FOCs:

- Interest and intangible expenses paid to or incurred on behalf of an FOC by a member of the same unitary group - e.g., this would include payment of fees or royalties for the use of intangible properties held by the FOC, interest payments on loans made by the FOC to another member of the unitary group, payments made for the FOC, and so forth. The addition does not apply if the income is from foreign sources, as defined in federal law.

- Other interest and intangible income of an FOC (i.e., not paid to or received from a member of the unitary group) that is not from foreign sources, as defined by federal law.

- REIT (real estate investment trust) income of an FOC (it does not appear that the REIT needs to be a member of the unitary).

- Gains from the sale of U.S. real or personal property by the FOC.

These provisions are intended to prevent an FOC from receiving a tax benefit from domestic income from intangibles (e.g., intellectual property or financial transactions, such as loans), U.S. based capital gains, or REIT dividends. The law provides an FOC's income is taxed as a "deemed dividend received" by the unitary group. This income qualifies for the 80 percent dividend received deduction. This section would deny that treatment to these categories of income. The income would instead be included in the income of the unitary business. However, the apportionment factors of the FOC would not be reflected on the combined report.

Effective date: tax year 2007

3 **Foreign royalty subtraction.** Excludes domestic source income, as defined by federal law,

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from qualifying for the subtraction for foreign royalties. Present law provides recipients of royalty and similar payments from foreign corporations and FOCs a subtraction for 80 percent of these payments. The paying corporation must be part of the unitary business. Royalties often represent payments for use of intellectual property (patents, copyrights, trademarks, processes, and so forth) or similar payments. A typical situation would be a patent developed by the U.S. parent and licensed to a foreign subsidiary or FOC.

Effective date: tax year 2007

4 **Business purpose and economic substance test.** Authorizes the commissioner of revenue to determine the taxable income of a corporation without regard to transactions "whose primary business purpose is the avoidance of tax" or that have no "economic substance."

5 **Legislative intent.** States that section 0is intended to clarify the legislature's intent and does not change the law.