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Corporate Franchise Tax: Foreign Source Income Provisions

The 2013 Legislature repealed the special foreign source income provisions under the corporate franchise tax. Laws 2013, ch. 143, art. 8. As a result, the discussion in this publication is now only of historical interest and does not apply after tax year 2012.

What is an FOC?

Prior to their repeal in 2013, foreign operating corporations (FOCs) qualified for special tax treatment under the corporate franchise tax. To be an FOC, a corporation was required to:

- Be a domestic corporation that was part of a unitary group, one member of which is taxable in Minnesota;
- Derive 80 percent or more of its gross income from active foreign business income.

What tax benefits were provided to FOCs?

In broad terms, 80 percent of an FOC's income was exempt as "deemed dividends." The FOC's income was allocated to its shareholders and "deemed" to be a dividend that qualified for the dividend-received deduction; under Minnesota law dividends received by a corporation qualify for an 80 percent deduction.

What tax benefits were provided for foreign royalty and similar payments?

When an FOC or a foreign corporation paid royalties and fees to another entity in a unitary business, the receiving corporation was allowed to subtract 80 percent of these amounts if the FOC is part of its unitary business. This was referred to as the foreign royalty subtraction or deduction (often referred to by its acronym, FRD). It did not apply to income derived from U.S. sources as defined under the federal tax law. The 2013 Legislature also repealed the FRD.

Thus, under these two provisions, 80 percent of a unitary business's foreign source income that either flowed through an FOC or a foreign corporation was exempt from tax.

How much did the repeal increase state revenues?

The Department of Revenue (DOR) estimated that the 2013 legislation repealing the FOC and FRD provisions will increase state corporate franchise tax revenues by about $98 million per fiscal year. About 80 percent of this revenue was attributed to repeal of the foreign royalty subtraction or deduction.

When were the FOC provisions adopted?

The FOC provisions were adopted by the 1988 Legislature and remained largely unchanged until the 2008 Legislature based the definition of FOCs on the income sources of the corporation (i.e., requiring 80 percent of its income to be from a foreign source). Prior to that, the test was based on the location of the corporation's property and payroll factors.

What is the policy rationale for FOCs?

The FOC provisions were a response to the adoption of combined reporting apportionment in the early 1980s. Supporters argued that they were necessary to appropriately tax foreign operations under Minnesota's "water's edge"

combined reporting system. This method excludes foreign corporations from the unitary group, while including foreign operations of domestic corporations. As a result, tax is deferred on the income of foreign subsidiaries or affiliates until it is "repatriated" or paid to a domestic corporation. If the income is paid as a dividend, only 20 percent of it is taxed. By contrast, income from foreign operations of other domestic corporations is fully taxed immediately.

The FOC and foreign royalty provisions had two primary policy purposes:

- They allowed foreign operations of domestic corporations to qualify for about the same state tax treatment as foreign corporations by satisfying the FOC rules.
- They provided "factor relief" for nondividend income paid by foreign corporations and FOCs. When a foreign subsidiary or FOC makes royalty or similar payments to a U.S. corporation, this income is fully taxable; the apportionment formula does not take into account the foreign sales, payroll, and property that helped generate the income because these corporations and their factors are not included in the combined report. The royalty subtraction excluded 80 percent of this income to adjust for the absence of the foreign and FOC factors in the apportionment formula.

What was the rationale for the 2008 legislative changes and the repeal of the foreign source income provisions?

In the late 1990s, DOR and legislators became concerned that some corporations were abusing the FOC provisions by shifting income from domestic operations into FOCs. (The literal language of the provisions allowed this, because the FOC definition then considered only the location of tangible property and employees.) Corporations typically did this by assigning intangible property to their FOCs. The income (royalties, fees, interest, and so forth) received for use of the intangibles could be from domestic sources and still qualify for the 80 percent discount on taxes.

The 2008 legislation foreclosed these possibilities by requiring an FOC's income to be derived 80 percent from foreign sources under federal tax rules. However, this did not fully eliminate the possibilities for abuse. Federal definitions of foreign versus domestic income also depend upon accurate transfer pricing. Federal tax officials have expressed concerns regarding their ability to prevent taxpayers from recharacterizing or artificially shifting income to foreign countries with lower tax rates through transfer pricing practices. This type of federal tax avoidance or evasion can also affect Minnesota tax liability.

The adoption of 100 percent sales apportionment (effective for tax year 2014) means, in practical effect, that the location of employees and property no longer affects a multinational corporation's Minnesota tax liability. Given this and the continuing potential for distortion through transfer pricing practices, the legislature considered that the foreign source income provisions were no longer necessary—either to accurately measure the Minnesota tax base or to make the state an attractive location for multinational corporations.

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