

Minnesota bill proposes significant corporate income, sales and use, and other tax changes

February 20, 2013

In brief

Minnesota Senate File 552 (S.F. 552) was introduced on February 18, 2013. The bill incorporates many of the provisions of Governor Mark Dayton's proposed 2014-15 budget. A companion bill, H.F. 677 was also introduced on February 18.

Minnesota taxpayers should be aware of the significant tax changes proposed by this legislation, including: reducing the corporate franchise tax rate, repealing foreign operating corporation provisions, including certain foreign entity income and apportionment attributes, reducing the sales tax rate, expanding the sales tax base to most services, expanding the commissioner's adjustment powers to allow for the disallowance of transactions without economic substance, implementing a noneconomic substance understatement penalty, and other tax changes. [[Minnesota Senate Bill S.F. 552](#), for our summary of the governor's 2014-15 budget proposal, [click here](#)]

In detail

Corporate income and franchise taxes

Unless otherwise noted, the following corporate income and franchise tax proposals under the legislation would be effective for taxable years beginning after December 31, 2012.

Rate reduction

The legislation would reduce Minnesota's corporate franchise tax from 9.8% to 8.4%.

Repeal of foreign operating corporation provisions

Under current law, a foreign operating corporation (FOC)

generally includes a domestic corporation, in a unitary relationship with a Minnesota taxpayer, with at least 80% of its gross income derived from active foreign business income. FOCs are not required to file a Minnesota return and may not file as members of a unitary group. Special rules applicable to FOCs include: (1) deemed dividends of a FOC are added to a taxpayer's federal taxable income, subject to certain reductions; and (2) royalties, fees, or other like income received from a FOC are generally subject to an 80% deduction.

The legislation provides that FOCs would no longer be excluded from filing a Minnesota return or from filing as members of a unitary group. Provisions regarding FOCs would be repealed, including the deemed dividend provision and the 80% royalty deduction (presumably because FOCs would file as members of a unitary group).

In addition to eliminating the royalty deduction for FOCs, the legislation would also repeal the royalty deduction from any other foreign corporation (currently at 80%).

Income and apportionment of foreign flow-through entities

Under current law, Minnesota carves out the income and apportionment factors of foreign corporations and other foreign entities from the unitary group. The legislation would provide that the income and apportionment factors of a foreign entity would flow to its *unitary* domestic owner for purposes of calculating net income and apportionment factors of a unitary business to the extent the income is included in federal taxable income. Specifically, the language states:

"income and apportionment factors of a foreign corporation, foreign partnership, or other foreign entity, that is included in the federal taxable income, as defined in section 63 of the Internal Revenue Code as amended through the date named in section 290.01, subdivision 19, of a domestic corporation, domestic entity, or individual, must be included in determining net income and the factors to be used in the apportionment of net income pursuant to section 290.191 or 290.20."

A *non-unitary* foreign entity would file on a separate basis, if it is required to file a Minnesota return.

Finnigan sales factor sourcing

Under current law, Minnesota is a *Joyce* sales factor sourcing state. The legislation would provide that "[a]ll sales of the unitary business made within [Minnesota] . . . must be included on the combined report" of a member with nexus with Minnesota.

Dividends from a REIT

Under current law, Minnesota generally provides for a dividends received deduction of either 70% or 80% depending on the ownership percentage in the subsidiary. The

legislation would provide that dividends from a real estate investment trust do not qualify for the deduction.

Individual income tax

Effective for tax years beginning after December 31, 2012, the legislation would expand Minnesota's existing three personal income tax brackets, and would create a new 4th tier income tax bracket at a rate of 9.85% for joint married filers with income over \$250,000 and for unmarried individuals with income over \$150,000.

Commercial-industrial property tax inflation adjustment

Under current law, Minnesota applies an annual inflation adjustment regarding the property tax amount applied against commercial-industrial property.

For taxes payable in 2014 and 2015, the legislation would suspend the inflation adjustment. For taxes payable in 2016 and later, the inflation adjustment would resume at half the rate as under current law.

Sales and use taxes

Sales tax rate reduction

Effective January 1, 2014, the legislation would reduce the combined sales and use tax rate from 6.875% to 5.5%.

Capital equipment exemption

Under current law, capital equipment is exempt from sales tax. However, the tax must be imposed and collected, and then taxpayers must apply for a refund.

Effective July 1, 2015, the legislation would repeal all capital equipment refund provisions and create an upfront exemption for the sale or lease of capital equipment (including machinery and equipment used for

manufacturing, fabricating, mining, or refining).

Expanded sales tax base

Effective January 1, 2014, the legislation would subject the sale of the following products and services to the sales and use tax, either by making them explicitly subject to tax or by removing exemptions:

- all services are taxable except those explicitly exempt (among the services that would become taxable are accounting, legal, management consulting, engineering, and architectural services)
- custom computer software, whether delivered electronically, by load and leave, or otherwise
- the right to access and use remote computer software
- specified digital goods and certain other digital products
- over-the-counter drugs
- publications and publication materials
- advertising services and materials
- clothing items over \$100
- certain admissions to selling events such as trade shows

Explicitly exempt services include the following:

- bank services, brokerage, and investment counseling provided to a person other than a natural person
- construction labor
- education services
- health care and medical services
- government public services
- real estate services

- social assistance services
- waste management services
- certain services provided to veterans groups and nonprofit groups.

The legislation provides that a retail sale includes "any sale of a service in the normal course of business as defined . . . and a sale of a service is not considered a sale for resale. This includes the sale of custom computer software, information services, and data processing services."

Click-through nexus

Effective January 1, 2014, the legislation provides that a retailer would be presumed to have sales tax nexus with Minnesota if the retailer "enters into an agreement with a resident under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet Web site, or otherwise, to the seller." The total gross receipts from sales to referred Minnesota customers must be at least \$10,000 in a 12-month period.

The above presumption may be rebutted by proof that the resident with whom the retailer has an agreement did not engage in any solicitation in the state on behalf of

the retailer that would satisfy the nexus requirements of the US Constitution during the 12-month period in question.

Economic substance and enhanced penalties

Economic substance

Effective for taxable years beginning after December 31, 2012, the legislation would provide the commissioner with the power to "disallow the tax effects of a transaction that does not have economic substance." To overcome the commissioner's disallowance, a taxpayer must prove by clear and convincing evidence that the transaction in question has economic substance.

A transaction would be treated as having economic substance only if: (1) the transaction changes in a meaningful way, apart from tax effects, the taxpayer's economic position; and (2) the taxpayer has a substantial purpose, apart from tax effects, for entering into the transaction.

Noneconomic substance transaction understatement penalty

Effective for taxable years beginning after December 31, 2012, the legislation would impose a penalty on

transactions disallowed due to the absence of economic substance, as described above. The penalty is either 20% (if disclosed) or 40% (if not disclosed) of the noneconomic substance transaction understatement.

The takeaway

The expansion of the sales tax base to include most services represents a broad shift in policy and may result in an overall increase in tax to businesses purchasing previously exempt services. Furthermore, it is unclear how a sale of a service for resale will be treated or how certain services received at multiple locations will be sourced. It also appears that a sale for resale exemption for services is generally precluded. Taxpayers should analyze how the legislation will affect their business including the impact on their current sales and use tax compliance process.

The legislation would also effectively reverse the Minnesota Supreme Court decision in *Manpower, Inc. v Commissioner of Revenue* (Minn. Supreme Court, No. A-06-468, December 7, 2006), which held that foreign 'check the box' entities are excludable from Minnesota taxable income.

Let's talk

We will closely monitor this legislation and report on any significant developments. If you have any questions regarding this legislation, please contact:

State and local tax services

Sue Haffield
Partner, *Minneapolis*
+1 (612) 596-4842
susan.haffield@us.pwc.com

Gina Ceola
Director, *Minneapolis*
+1 (612) 596-4827
gina.ceola@us.pwc.com

Michael Santoro
Director, *Chicago*
+1 (312) 298-2917
michael.v.santoro@us.pwc.com