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Minnesota Governor's Budget includes repeal of FOC regime, numerous corporate franchise and sales tax proposals

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Minnesota Governor Mark Dayton on February 15, 2011 released the outline of his biennial budget proposal, including a wide range of tax measures intended to help bridge the state's budget deficit, estimated at over $6 billion. While among the more controversial of the proposals are higher individual income tax rates and a temporary surtax, numerous corporate franchise tax, sales and use tax, and other miscellaneous tax proposals are of special concern to certain business taxpayers.

Corporate franchise tax

The proposed budget would repeal the current subtraction for 80% of royalties, fees or other like income accrued or received from a foreign operating corporation (FOC) or foreign corporation that is a part of the same unitary business as the receiving corporation, and would correspondingly repeal FOC treatment in Minnesota. According to the Governor's proposal, the change would result in all domestic and foreign royalties being treated "in a consistent manner," and there would be no disparity in the treatment of similarly situated sellers of tangible property to a FOC or foreign affiliate, for which there is no similar subtraction. The proposal cites the phase-in of single sales factor apportionment by 2014 as "address[ing] many of the competitive disadvantages that the royalties subtraction and FOC provisions were originally intended to address."

The proposed budget also would adopt statutory language "requiring that business transactions meet an economic substance test to be allowed in determining Minnesota taxable income in conformance with federal case law." The proposal intentionally would not refer to or

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incorporate the recent federal codification of economic substance, noting that "the recent Minnesota Supreme Court decision in *HMN Financial, Inc.* demonstrates the importance of adopting an economic substance standard that will apply to transactions only affecting the determination of Minnesota income." The change would be effective for taxable years ending after December 31, 2010. Interestingly, the proposal estimates a net fiscal impact for FY 2012 of only $100,000, climbing to $1 million in FY 2015 by "forclos[ing] the opportunity for businesses to structure themselves solely to avoid taxes."

Other corporate franchise tax proposals include, but are not limited to:

- Adoption of a "Finnigan" sourcing rule, effective for taxable years beginning after December 31, 2010. According to the proposal, "[w]hen sales to customers in Minnesota by a member of a unitary business are not included in the numerator of the sales factor, the net income of the unitary business allocated to Minnesota is understated."
- Repeal of the current exclusion for the net income and apportionment factors of foreign partnerships in calculating the net income and apportionment factor for a unitary business, effective for taxable years ending after December 31, 2011.
- Repeal the corporate franchise tax exemption for insurance companies, effective for taxable years ending after December 31, 2010.
- Exclude dividends received from a real estate investment trust (REIT) in calculating the deduction allowed to a corporation for dividends received from another corporation (DRD), effective for taxable years ending after December 31, 2011.
- General conformity to recent I.R.C. changes, but with specified decoupling such as from increased I.R.C. Sec. 179 expensing, bonus depreciation, and the exception under Subpart F for active financing.

Individual income tax

The Governor is recommending the creation of a new fourth income tax bracket, beginning at $150,000 taxable income for joint filers and $85,000 for single filers, of 10.95%, effective beginning with the 2011 tax year. Added to this would be a "temporary surtax" on income over $500,000 (regardless of filing status), of 3%, for tax years 2011 through 2013. (While not an income tax proposal, another proposal aimed at "upper income" taxpayers is a new statewide property tax levy on homes valued over $1 million.) Other proposed individual income tax changes include, but are not limited to, extending the income tax to persons who are present in the state for more than 60 days but less than 183 and who maintain an abode in the state for at least six months.

Sales and use tax

Among the more notable sales and use tax proposals, the Governor would amend the statutes for sales and use tax nexus to create a rebuttable presumption that a retailer maintains a place of business in the state if it enters into an agreement with a solicitor for the referral of Minnesota customers for a fee, and the retailer's gross receipts are at least $10,000 over a 12-month period. The proposal states that these provisions would be "similar to the approach adopted by the state of New York," and would be effective for sales and purchases made after June 30, 2011.

The Governor also proposes to expand the sales tax "to charges for access and use of remote access (web-based) software maintained by the seller or a third-party," effective July 1, 2011. Such "remote access" models may be referred to as software as a service (SaaS), application service provider (ASP), or cloud computing.

Among other changes, the proposal would provide an exemption for ring tones; expand the definition of "direct satellite service" to include digital video recorder (DVR) services and programming services requiring subscriber interaction, such as pay-per-view; and tax the full amount charged for lodging services by "accommodations intermediaries," including any reservation or similar ancillary services that are part of the transaction.

Miscellaneous tax measures

There is a variety of other miscellaneous tax measures, many intended to raise revenue, in the Governor's proposed budget. Notable items include a 1% car rental tax increase, with revenue dedicated to "Minnesota tourism marketing and promotion." As with analysis of increased income tax burdens falling on other than the general populace (high wage earners), the proposal notes that "[t]he impact [of the increased car tax] would be that most of the new tourism marketing revenue would come primarily from out of state visitors."

PwC observes

"Governor Mark Dayton's budget is in line with his campaign proposals, and generally should not come as a surprise," observes Sue Haffield, State and Local Tax Partner with PwC in Minneapolis. "Further, many of these corporate franchise tax measures have been proposed in prior years by Democratic-Farmer-Labor (DFL) legislators, and similar stand-alone legislation has already been introduced this year. Had the DFL maintained its control of the state legislature in November 2010, we would have a clearer picture of the changes facing taxpayers. Because of the Republican take-over of both houses of the legislature, however, the picture is considerably muddied. While most of the attention will go to the rate increases and similar proposals aimed at upper-income earners -- echoing similar debates in Washington over the extension of the 'Bush tax cuts' -- stakeholders on a variety of corporate franchise tax and sales and use tax issues will need to make their voices heard to avoid being swept into the ultimate budget solution. As with prior years, where there was a Republican governor and DFL-controlled legislature, this year's budget is likely to be a hard-fought and drawn-out affair, where the Governor's proposals are merely the opening salvo."

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