

Apportionment of Corporate Franchise Tax

Apportionment is constitutionally required

A state can constitutionally tax only the income of a multistate corporation that is “fairly apportioned” to the state. The reason for this requirement seems obvious: if a business operates in several states and each state could tax all of its income, the business could easily be subject to double taxation. Aside from being unfair, this would discourage a business from operating in multiple states; it would interfere with interstate commerce.

All states use formula apportionment

A state can apportion income using separate accounting or formula apportionment. Separate accounting traces income to the state where it was earned using standard accounting methods. Formula apportionment uses a proxy or rough measure to determine the in-state share of income (e.g., the percentage of the business’s in-state sales to its total sales). All states use some type of formula apportionment. Using separate accounting would be expensive, difficult to do, and subject to manipulation.

Minnesota uses a weighted three-factor formula

Minnesota uses a weighted three-factor formula of sales, property, and payroll, but is phasing in apportionment based only on sales (fully effective in tax year 2014). The formula for tax year 2011 weights sales at 90 percent, property at 5 percent, and payroll at 5 percent. The Minnesota percentage for each factor is multiplied by the weight, and the three factors are added to determine the Minnesota percentage of the corporation’s total income. Expressing this as a formula:

$$MN \text{ percent} = \left(0.9 * \frac{MnSales}{TotalSales} \right) + \left(0.05 * \frac{MnProperty}{TotalProperty} \right) + \left(0.05 * \frac{MnPayroll}{TotalPayroll} \right)$$

Sales are defined on a destination basis; that is, the location of the buyer generally determines whether the sale is a Minnesota sale. The property factor is the value of real and tangible personal property in Minnesota. Leased property is included; its value equals the lease payments multiplied by eight. Payroll is the amount paid to employees. The apportionment factors are also used to calculate the add-on minimum fee.

Special formulas apply to some industries

Special apportionment rules apply to some industries. Mail-order companies that have substantially all of their operations in Minnesota use a sales-only formula. A separate formula for financial institutions includes deposits and intangible property (e.g., receivables and loans), since these are important contributors to their profits.

No throwback rule applies

The Uniform Division of Income for Tax Purposes Act (adopted by a group of states) provides that sales to buyers in a state in which the corporation cannot be taxed and sales to the federal government are “thrown back.” Under a throwback rule, these sales are assigned to the seller’s location. Minnesota has not adopted a throwback rule. This favors businesses making sales from Minnesota to the federal government or to states where they can’t be taxed, since it reduces their Minnesota tax. Minnesota’s

apportionment formula does not affect the tax owed to another state, in any case.

Minnesota uses combined reporting for “complex” corporations

Special rules apply to complex corporations (i.e., those with multiple corporations, such as parent-subsidiary or brother-sister corporations). If these corporations are part of a “unitary business,” Minnesota requires them to file a combined report. Under combined reporting, each corporation in the unitary group calculates its tax using the total income of the unitary group and using its own factors as the numerator and the total group’s factors as the denominator. This method prevents most transactions among related corporations in the unitary group from affecting the tax liability of the group. In effect, the apportionment formula divides the unitary business’s income among the states without regard to how the business allocates the income among its various corporate entities. State corporate taxes that do not use this method allow corporations to artificially shift income (e.g., through “transfer pricing” among the related corporations) to states in which income is lightly taxed or is not taxed at all.

Formula apportionment has important economic effects

Public finance economists generally agree that apportionment formulas are a very important feature of state corporate taxes. They essentially make the tax the same as a tax directly on the factors. For example, the tax on the portion of income assigned using the sales factor is the same, in economic effect, as a sales tax. This affects both:

- the incidence of the tax (i.e., who bears the real burden of the tax); and
- the incentive effects of the tax (i.e., the impact of the tax on behavior).

Incidence effects vary by factor weights

Following conventional economic theory, the portion of the tax that is apportioned by sales will be a tax on consumption or consumers, similar to a sales tax. The portion on payroll is a tax on labor income and the portion on property falls on capital. (Caveat: Capital is mobile; it can move between states. In the long run, a state cannot increase the portion of the tax on capital much beyond the average imposed by other states. If it does, capital will flow to other states where higher rates of return are available.)

Minnesota is phasing in single sales apportionment to encourage in-state investment

Weighting sales more heavily generally encourages export businesses. Since sales are assigned to the buyer’s location and there is no throwback rule, export or non-Minnesota sales will reduce the amount of income taxable by Minnesota. Thus, increasing the weight for sales creates an incentive for companies to invest in Minnesota property or to hire more employees to sell products outside of Minnesota. The property and payroll factors, by contrast, would assign more income to Minnesota, increasing the tax, because the investment increases Minnesota property and payroll. It was following this logic that the legislature provided for a gradual shift of apportionment to relying only on sales. This change will be accomplished in eight annual steps between 2007 and 2014.

Other states are also adopting single sales apportionment

After the U.S. Supreme Court ruled sales-only apportionment was valid in 1978, many states increased their reliance on the sales factor because of these incentive effects.

For more information: Contact legislative analyst Joel Michael at joel.michael@house.mn. Also see the House Research publications [Single Sales Apportionment of Corporate Franchise Tax](#), October 2011, and [Corporate Franchise Taxation](#), October 2011.

The Research Department of the Minnesota House of Representatives is a nonpartisan office providing legislative, legal, and information services to the entire House.