

## 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 multiple 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 single sales apportionment***

Since tax year 2014, Minnesota has apportioned income using “single sales” apportionment—i.e., the percentage that Minnesota sales comprise of total sales of the corporation is multiplied by total income to determine Minnesota-source income. Sales are defined on a destination basis; that is, the location of the buyer generally determines whether the sale is a Minnesota sale. Prior to tax year 2014, Minnesota like most states used three-factor apportionment, based on combination of the Minnesota percentage of property, payroll, and sales. Since the early 1950s, Minnesota has either allowed or mandated weighting sales more heavily before adopting single sales apportionment.

These apportionment rules also apply under the individual income tax—e.g., to pass-through entities—that operate in multiple states. Resident individuals, however, are subject to Minnesota tax on all of their income.

***Special rules apply to financial institutions***

Special rules apply to determine sales (receipts) for financial institutions and investment companies (e.g., companies operating or managing mutual funds).

***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-subsidary 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 its own factors as the numerator and the total group’s factors as the denominator. Under a 2013 change, sales made by domestic corporations that are part of the unitary group, but that do not have Minnesota nexus, must be included in the numerator of a corporation with nexus.

Combined reporting 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.

***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 similar, in economic effect, to 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 uses 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, using single sales apportionment 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 use of apportionment to relying only on sales.

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](mailto:joel.michael@house.mn). Also see the House Research publications [Single Sales Apportionment of Corporate Franchise Tax](#), June 2015, and [Corporate Franchise Taxation](#), June 2015.

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

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