Franchise Tax is Eliminating Minnesota Jobs

By Ford Peterson © 2010[1]

The land of 10,000 taxes…

Minnesota is the home to many corporate giants. Honeywell, General Mills, the former Northwest Airlines, Medtronic, US Bank, 3-M, and many more, located their worldwide headquarters right here in our back yard. Many of these are home grown companies, some of which were started in a garage and grown to be multi-national giants of commerce. Many of these companies are staffed by Union workers making excellent wage rates. All companies doing business here pay homage to Minnesota in the form of the corporate franchise tax. It is my belief that this tax is the root cause for the attrition of jobs leaving Minnesota year-after-year. The quickest way to reverse the trend is to eliminate the tax and once again make Minnesota a tax haven for business.

You cannot understand this complex topic without understanding its far-reaching tentacles. What follows is a tutorial on Minnesota's franchise tax, as implemented through the Unitary method of allocating tax between states.

History of the Franchise Tax[2]

In 1967, the tax rate was raised to 11.33%. In 1971 it was raised to 12%. In 1981 the rate was reduced to 9% on the 1st $25,000 of income but remained at 12% for large corporations. The death blow to MN jobs came the same year when they also enacted the Unitary method of taxation. In 1987 they reduced the Unitary rate to 9.5% and started with federal taxable income. In 1990 the rate increased to 9.8% and a new fee (up to $5,000/year) was introduced.

In 2005 the legislature had the political will to address the hemorrhage of jobs, at least partially induced by the allocation formula, by passing some allocation reform. Beginning in 2007, the inter-state allocation weighting formula changed from 15% property, 15% payroll, and 70% sales, to 0% property, 0% payroll, and 100% sales, during an 8 year transition period ending in 2014.

The Department of Management and Budget estimated in February 2008 that the corporate franchise tax collections would be $1,034 million[2] for FY 2009. The actual collection for FY 2009 was just over $700 million[3] in 9.8% corporate franchise tax—almost 1/3 less than anticipated. That's still a lot of money in a state whose anticipated deficit is upwards of $8 Billion for 2010-2011. The real question is, how did the corporate franchise tax alter sales tax, income tax, and property tax, after the Unitary method drove tens of thousands of jobs from the state since imposing Unitary back in 1981? We may never know!

Understanding the malicious nature of this tax policy is complex. In this paper, I will attempt to explain the subtle factors leading up to the imposition of the Unitary method. While some steps were taken in 2005 to reduce the job killing effects by 2014, much of the damage has already been done. It is my opinion that the trendy exodus of jobs can only be corrected through the complete elimination of the franchise tax—even then the correction may take as many years to recover as it took for the damage to occur in the first place (possibly 30 years). While some might argue that this gives big business a 'free ride' on Minnesota's highways of commerce, it is clear that the propensity for these same big businesses to hire highly-paid Union workers is greater when disincentives for doing so are removed from the equation.

Who pays the Franchise Tax?

When it comes to corporate income tax, there are two types of corporations. An election can be made by certain shareholder groups to either be taxed at the corporate level (C-type), or the individual shareholder level (S-type, or pass-through entity).

S-type corporations pay no tax (other than fees). These are closely held pass-through corporations where the shareholders have agreed to add their allocated share of the company income to their personal tax return each year, and pay the tax personally. They pay the tax once whether they actually receive the money as a dividend or not. Dividends are deemed paid on the last day of the year (and effectively deducted from the corporation's income subject to MN tax) and taxed at the individual shareholder level.

C-type corporations are groups who either a) cannot, because of the number of shareholders, be S-Corps, or b) choose to pay the tax at the corporate level AND at the personal level when dividends are actually paid. Unlike S-Corps, a C-Corp is unable to effectively deduct the dividend payment from income subject to MN tax. So dividends are paid to shareholders out of 'after-tax' income. This introduces the notion of "double taxation." Income earned is therefore taxed once when the company makes the money, and taxed again at the individual level when the company pays out dividends from funds remaining after the franchise tax.

I'm oversimplifying the election by saying that corporations with few investors ('closely held' means less than 100 shareholders) made up of individuals and estates are eligible for S-Corporation treatment. Wall Street entities are excluded from electing S-Corp status because their shareholders number over 100 and often include other corporations, who are ineligible for S treatment. Suffice it to say, big companies are C-Corp and pay the double tax, and small companies are S-Corp and pay tax individually.

The franchise tax is imposed only on C-Corps. It is fair to say, large companies, large employers (often unionized employers) pay the franchise tax in MN. Small companies, and S-Corporations, pay only a filing fee between zero and up to $5,000 per year.

Minnesota Used to be a Tax Haven (Pre-Unitary tax)

Minnesota used to be an incubator for business. Small business could become large entities without the entanglement and overhead of a high state tax. MN was also the home to large employers. How can this be? Minnesota has taxed business for decades prior to the Unitary tax. Prior to 1981, Minnesota taxed each separate corporation doing business within the state. Only those doing business here were required to pay a tax to Minnesota. Practical application of tax policy encouraged a business to locate high overhead activities within our borders. How did this work? A national or multi-national corporation usually owns many individual corporations. An illustration is in order. For purpose of illustration, let's use an over-simplified example to understand.

XYZ Corporation of America, Inc. (parent)

XYZ of Minnesota, Inc. (100% owned subsidiary)
XYZ of California, Inc. (100% owned subsidiary)
XYZ of Florida, Inc. (100% owned subsidiary)

Only the parent's stock appears on the New York Stock Exchange (or comparable). Profits from the subsidiaries roll-up to the parent through inter-company transactions. Often times one subsidiary manufactures a product and sells it to the other wholly-owned subsidiaries located all over the world.

If any of these individual companies had property, payroll, or sales within MN, there would be "Nexus" to Minnesota imposing the franchise tax based on that subsidiary's income allocated by the property, payroll, and sales factors located within Minnesota. In any business, there is overhead associated with the operation of a facility and the staff to run it. When located in MN, this high overhead had Nexus with Minnesota, whereas the income did not.

In our example, let's assume the headquarters is located in MN, along with the primary factory. The other subsidiaries purchase product from the factory and conduct their activities in other states. Suppose that subsidiary manufactured thermostats (or food, or air travel, or medical devices, or magnetic media, etc.) and sell their products world-wide.

Pre-Unitary Example	Company Sales	In-State Sales	Cost of Goods	Wages	Expenses	Net Income	Property	% MN	Payroll	% MN	Sales	% MN
Minnesota Factory	60,000	30,000	25,000	31,500	32,000	1,500	10,000	100.0%	31,500	100.0%	90,000	33.3%
California Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
New York Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
Florida Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
Headquarters (MN)	-	-	-	500	200	(700)	500	100.0%	500	100.0%	-	100.0%
Total	60,000	120,000	85,000	36,500	33,700	24,800						

Allocation Factor	Factor	Weight	Total
Property	100.0%	15.0%	15.0%
Payroll	100.0%	15.0%	15.0%
Sales	33.3%	70.0%	23.3%
Allocated to MN		100.0%	53.3%

Separate MN Tax:	
Minnesota Income	1,500
Allocated to MN	53.3%
Taxable Income	800
Tax Rate	12.0%
Franchise Tax	96

The headquarters and manufacturing facilities, along with related payroll, are located in Minnesota. Clearly the factory has Nexus to MN because they are not only located here, they also sell products to Minnesotans. These two corporations, headquarters and the factory, have Nexus and were always required to file a franchise tax return. However, subsidiaries located outside Minnesota have no Nexus. They buy product from the factory subsidiary and sell it elsewhere, but they have no Nexus (property, payroll, sales) within the state. No Nexus? No tax return necessary—effectively insulating the non-Minnesota subsidiaries from MN tax. MN was a tax haven!

Let's further assume that each state consumes the same amount of product, for discussion let's say product gets sold in 4 different states and $30,000,000 per state. The MN factory would receive income from the other states in the form of products sold to the other out-of-state subsidiaries and from products sold to Minnesotans. 100% of the property, 100% of the payroll, and only 33% of the sales are located in MN. Using the standard 15% / 15% / 70% = 100% weighting implied an allocation percentage of 53.3%. The Headquarter facility actually lost money, because its net income was a loss. So the Headquarters paid no tax even though 100% of its operations were within MN (100% of $0 is $0). The factory earned $1,500,000 nationwide. $1.5M x 53.3% x 12% tax rate equaled $96,000 of MN franchise tax.

UNITARY METHOD OF ALLOCATING TAX TO MN (POST-UNITARY TAX)

In 1981, the Unitary method was introduced. Notwithstanding the many technical arguments for and against Unitary policy 'fairness' of allocation amongst the states, most companies find 'fairness' in paying less tax. The most notable argument for the Unitary method is that a company can easily 'game' the system to reduce their state tax burden—such as with favorable inter-company transactions, which have no shareholder consequence other than a reduction in state tax. The notion of gaming the system is perceived to be a good thing for shareholders and a bad thing for states.

Instead of considering each separate corporation and allocating the Nexus to MN based on property, payroll, and sales, the state demanded consideration of all the other corporations in the group—e.g. "Unitary."

Unitary Example	Company Sales	In-State Sales	Cost of Goods	Wages	Expenses	Net Income	Property	% MN	Payroll	% MN	MN Sales	% MN
Minnesota Factory	60,000	30,000	25,000	31,500	32,000	1,500	10,000	83.3%	31,500	86.3%	90,000	16.7%
California Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
New York Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
Florida Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
Headquarters (MN)	-	-	-	500	200	(700)	500	4.2%	500	1.4%	-	0.0%
Total	60,000	120,000	85,000	36,500	33,700	24,800	12,000	87.5%	36,500	87.7%	180,000	16.7%

Allocation Factor	Factor	Weight	Total
Property	87.5%	15.0%	13.1%
Payroll	87.7%	15.0%	13.2%
Sales	16.7%	70.0%	11.7%
Allocated to MN		100.0%	37.9%

MN Unitary Tax:		
Total Income	24,800	24,800
Allocated to MN	37.9%	37.9%
Taxable Income	9,410	9,410
Tax Rate	12.0%	9.8%
Franchise Tax	1,129	922

Let's use the same facts and circumstances, but impose the Unitary methodology. We now find that 87.5% of the property (primarily factory), 87.7% of the payroll (primarily factory and headquarters), and only 16.7% of sales, are located within Minnesota. Apply the 15% / 15% / 70% = 100% weighting and you have 37.9% allocated to MN. While 53% was allocated to the factory only income, 38% is now allocated to the whole company income. Instead of considering just the factory income, the entire national income acquires Nexus. Under the Unitary equation and current rates the same group of companies pays $922,000 of franchise tax to MN. Instead of $96K imposed when the rate was 12%, it is now $922K even though the rate is currently 9.8%. That's nearly a 10 fold increase in franchise tax! Ouch! I'll bet this got people's attention back in 1981 when the rate was even higher (12%)!

MN REVENUES (POST-UNITARY)

Is this to say the corporate collections increased 10X starting in 1981? No! This example is provided as a reasonable illustration to describe the tax imposed under Unitary versus separate accounting methods. In practice, national companies operate in all 50 states and around the world. This example company (for clarity of illustration) only operates in 4 states. National companies have factories in many states. So this is an oversimplification. But it serves to illustrate the following truisms:

1) Factory ***PROPERTY*** located in MN has caused a portion of national income to be allocated to MN, even though no income may be arriving from within MN borders. Since 1981, and until 2014, locating property outside of MN has provided (and will continue to provide) relief from MN taxation.
2) Headquarters and factory ***PAYROLL*** located in MN has caused a portion of national income to be allocated to MN, even though no income may be arriving from within MN borders. Since 1981, and until 2014, locating payroll outside of MN has provided (and will continue to provide) relief from MN taxation.
3) The factor weighting formula (15% to property; 15% to payroll, and 70% to sales, changing to 100% sales by 2014) has a significant impact on the allocation. A national company has had 27 years to adjust its business practices to legally avoid MN taxation by locating business reorganizations and expansions elsewhere. The legislature didn't recognize this to be a problem until 24 years of attrition had taken its toll on MN jobs. In 2005 the legislature voted to curtail the unfavorable practice and is changing the formula weighting over the next few years. By 2014 (33 years later) only MN sales will factor into the formula.

MN REVENUES (POST-2014)

So what happens to our fictitious company starting 2014?

Post 2013 Unitary	Company Sales	In-State Sales	Cost of Goods	Wages	Expenses	Net Income	Property	% MN	Payroll	% MN	MN Sales	% MN
Minnesota Factory	60,000	30,000	25,000	31,500	32,000	1,500	10,000	83.3%	31,500	86.3%	90,000	16.7%
California Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
New York Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
Florida Outlet	-	30,000	20,000	1,500	500	8,000	500	0.0%	1,500	0.0%	30,000	0.0%
Headquarters (MN)	-	-	-	500	200	(700)	500	4.2%	500	1.4%	-	0.0%
Total	60,000	120,000	85,000	36,500	33,700	24,800	12,000	87.5%	36,500	87.7%	180,000	16.7%

Allocation Factor	Factor	Weight	Total
Property	87.5%	0.0%	0.0%
Payroll	87.7%	0.0%	0.0%
Sales	16.7%	100.0%	16.7%
Allocated to MN		100.0%	16.7%

MN Unitary Tax:	
Total Income	24,800
Allocated to MN	16.7%
Taxable Income	4,133
Tax Rate	9.8%
Franchise Tax	405

Assuming the legislature and the Governor choose to keep the 9.8% tax rate, our little company will find some relief under the new "Sales Only" formula. The \$96K at 12% (taxed separately) ballooned to \$1,129K at 12% (under Unitary), then dropped to \$922K with the current 9.8% rate. The new "Sales Only" formula at 9.8% would induce a tax of \$405K. While this is a significant improvement, any company having already reconfigured their operations to a no-tax state[4] like, South Dakota, Washington, Wyoming, Utah, or even to a foreign country, would find no joy in re-locating high-overhead operations back to MN unless we make this a tax haven once again.

THE SOLUTION

So what's the solution? Economists generally believe apportionment formulas appear to be a tax on the factors[5]. Eliminate the franchise tax. Much (perhaps all) the damage has been done through almost 30 years of jobs attrition. If eliminated, future changes in home-grown business operations would not need to consider the tax disincentives associated with the franchise tax when considering the option of locating operations here in Minnesota. If Minnesota was a safe-harbor, more jobs would locate here. More jobs equates to more personal income tax collections, more sales tax, and more property tax. Sounds like a win-win-win situation. A win for business, taxpayers, and the state.

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