

Minnesota's New Approach to Taxing Foreign Income Is Unfair and Unwise

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In this article, the authors examine how Minnesota's new approach to taxing foreign-source income is unfair to U.S. multinationals, uncompetitive with other states, and likely violates the commerce clause based on U.S. Supreme Court precedents concerning discrimination, fair apportionment, and foreign commerce.

Executive Summary

In May Minnesota adopted a new statutory approach to taxing foreign-source income that vastly expands the amount of that income in the corporate income tax base.¹ Before the legislation, Minnesota included 20 percent of foreign

¹The authors thank Lauryn Lamp, a Council On State Taxation summer legal intern, for her assistance with the research and charts for this article.

dividends and subpart F income² in its corporate income tax base.³ Under the new legislation, Minnesota for the first time subjected global intangible low-taxed income to its tax base, taxing 50 percent of GILTI. It also increased the inclusion of foreign dividends and subpart F income to 50 percent.⁴ The significant increase of the corporate income tax base was done without providing any factor representation in the apportionment formula for the foreign sales that produced the foreign-source income.

Minnesota's new approach to taxing foreign-source income makes it an outlier, particularly among the largest 25 states by population in the nation. The approach is unfair to U.S. multinationals, uncompetitive with other states, and likely violates the commerce clause under U.S. Supreme Court precedents related to discrimination, fair apportionment, and foreign commerce.⁵

Minnesota is the only state among the top 25 most populous states that includes 50 percent of GILTI, foreign dividends, and subpart F income in its corporate income tax base — essentially taxing half of foreign-source income on either a current or deferred basis. Moreover, it is the only one of

²Subpart F income is a category of foreign-source income historically taxed on a current, not deferred, basis under IRC sections 951 and 952. For controlled foreign corporations, subpart F income is generally a small portion of foreign-source income and typically includes "movable"- or "passive investment"-type income. See IRS, "Subpart F Overview" (Sept. 3, 2014).

³See Minn. Statutes 2022, section 290.21, subdivision 4. For dividends received by a corporation owning less than 20 percent of stock of another corporation, 30 percent of the dividend was in the tax base before the law change, which is effective beginning with tax year 2023.

⁴For dividends received by a corporation owning less than 20 percent of the stock of another corporation, 60 percent of the dividend is now in the tax base.

⁵See later discussion in the section, "The New Minnesota Approach Likely Violates the Commerce Clause."

the top 25 states that taxes more than 5 percent of foreign-source income and fails to provide foreign factor representation for that income.⁶ (See table.)

Indeed, the new approach to taxing foreign-source income makes Minnesota not only an anomaly among the states but also an outlier regarding the federal tax scheme. The federal government taxes 50 percent of GILTI, 100 percent of the smaller category of subpart F income, and generally none of the residual category of foreign dividends.⁷ The federal government allows taxpayers to use a credit for foreign taxes paid on GILTI and subpart F income to offset those income inclusions. By contrast, Minnesota neither allows the foreign tax credit to be applied against foreign-source income nor provides any foreign factor representation to ensure that the portion of GILTI, subpart F, or foreign dividends in the tax base is fairly and constitutionally limited to Minnesota's apportioned share.⁸

Minnesota's New Approach From A Multistate Perspective

On May 24, Minnesota Gov. Tim Walz (D-FL) signed a major tax bill, H.F. 1938, that contains several significant changes to both corporate and personal income tax laws. Among the most controversial legislative provisions is the new approach to taxing foreign-source income that

vastly expands the amount of this income in the corporate income tax base.⁹ While the effect of Minnesota's tax law change to dividends encompassed both dividends from non-unitary domestic subsidiaries and from foreign subsidiaries, this article focuses on the latter category because the former is generally insignificant in a water's-edge combined group. Before the legislation, Minnesota included 20 percent of foreign dividends and subpart F income in its corporate income tax base.¹⁰ Under the new legislation, the state added GILTI to its tax base, taxing 50 percent of it as a dividend.¹¹ It also increased its tax base inclusion of foreign dividends and subpart F income to 50 percent of such income.¹²

To provide a multistate perspective on Minnesota's new approach to taxing foreign-source income, the best comparison is with the other large-population states. Minnesota is the 22nd largest state by population (see table) and ranks sixth in a *U.S. News & World Report* story on the *Fortune* 1,000 list of revenue-generating businesses that have their corporate headquarters in a given state.¹³

⁶ Foreign factor representation refers to the inclusion in the apportionment formula of the factors that contribute to the production of the foreign-source income in the corporate income tax base. Minnesota uses a single-sales-factor apportionment formula. Therefore, foreign factor representation would entail including the foreign sales that contribute to the production of GILTI, subpart F, or foreign dividends in the denominator of the sales factor. In general, no foreign sales would be in the numerator of the sales factor because the income from the foreign sales is not Minnesota-sourced.

⁷ Under the 2017 Tax Cuts and Jobs Act, the federal government moved away from generally taxing 100 percent of foreign dividends (on a deferred basis) to taxing 50 percent of GILTI on a current basis.

⁸ State corporate income tax statutes typically decouple from the IRC's foreign tax credit and instead use formulary apportionment to allocate income to a state.

⁹ Changes made by H.F. 1938 also include: updating the state's conformity with the IRC through May 1, 2023; imposing a net investment income tax of 1 percent on individuals, estates, and trusts with net investment income over \$1 million; increasing a Social Security income subtraction along with providing a subtraction for qualified public pension income; decreasing the net operating loss deduction from 80 percent to 70 percent of taxable income; modifying the state's passthrough entity tax; and providing or extending some tax credits.

¹⁰ See Minn. Statutes 2022, *supra* note 3. The law was changed effective for tax years beginning after December 31, 2022.

¹¹ Minnesota characterized GILTI as a "dividend" (see H.F. 1938, art. 1, section 47), which is different from how it is characterized for federal tax purposes (see IRC section 951A). This characterization ensures that GILTI qualifies for the 50 percent state dividends received deduction. It also decouples Minnesota's tax on 50 percent of GILTI from IRC section 250, which in 2026 will shift from including 50 percent of GILTI in the federal tax base to 67.5 percent.

¹² In H.F. 1938, for corporations receiving any dividends from 20 percent or more owned corporations, the corporate income tax base inclusion increased from 20 percent of the dividends received to 50 percent. For corporations receiving any dividends from less than 20 percent owned corporations, the corporate income tax base inclusion increased from 30 percent of the dividends received to 60 percent.

¹³ See U.S. News Report, "Top Company Headquarters" (2023), using *Fortune* 1,000 data.

**The Top 25 Most Populous States' Taxation and Apportionment
Of Foreign-Source Income**

State	Top Marginal Tax Rate	Tax on GILTI ^d	Tax on Foreign Dividends ^d	Apportionment Factor Representation for GILTI and Foreign Dividends	Population ^a (in millions)
California	8.84%	None	8.84% on 25% of foreign dividends	Net taxable foreign dividends in apportionment factor denominator	39.54
Texas	See note c	None	None	N/A	29.14
Florida	5.5%	None	None	N/A	21.54
New York ^b	7.25%	7.25% on 5% of GILTI	None	Net taxable GILTI in apportionment factor denominator	20.2
Pennsylvania	8.99%	None	None	N/A	13
Illinois	9.5%	None	None	N/A	12.81
Ohio	See note c	None	None	N/A	11.80
Georgia	5.75%	None	None	N/A	10.71
North Carolina	2.5%	None	None	N/A	10.44
Michigan	6.0%	None	None	N/A	10.08
New Jersey	11.5% (9% starting in 2024)	11.5% on 5% of GILTI	11.5% on 5% of foreign dividends	Net taxable GILTI or foreign dividends in apportionment factor denominator	9.29
Virginia	6.0%	None	None	N/A	8.63
Washington	See note c	None	None	N/A	7.71
Arizona	4.9%	None	None	N/A	7.15
Massachusetts	8.0%	8% on 5% of GILTI	8% on 5% of foreign dividends	No factor representation	7.03
Tennessee	6.5%	6.5% on 5% of GILTI	None	No factor representation	6.91
Indiana	4.9%	None	None	N/A	6.79

**The Top 25 Most Populous States' Taxation and Apportionment
Of Foreign-Source Income (Continued)**

State	Top Marginal Tax Rate	Tax on GILTI ^d	Tax on Foreign Dividends ^d	Apportionment Factor Representation for GILTI and Foreign Dividends	Population ^a (in millions)
Maryland	8.25%	8.25% on 50% of GILTI	None	Net taxable GILTI in apportionment factor denominator; payroll or property factor ratio determines the numerator	6.18
Missouri	4.0%	None	None	N/A	6.15
Wisconsin	7.9%	None	None	N/A	5.89
Colorado	4.4%	4.4% on 50% of GILTI	None	Net taxable GILTI in apportionment factor denominator	5.77
Minnesota	9.8%	9.8% on 50% of GILTI	9.8% on 50% of foreign dividends	No factor representation	5.71
South Carolina	5.0%	None	None	N/A	5.12
Alabama	6.5%	None	None	N/A	5.02
Louisiana	7.5%	None	None	N/A	4.66

^a The 2020 population data from the U.S. Census Bureau identifies the top 25 states by population and reflects 83.7 percent of the total population of the United States.

^b State only. New York City taxes 50 percent of GILTI at 8.85 percent. NYC includes net taxable GILTI in the apportionment factor denominator. NYC does not tax foreign dividends.

^c Texas, Ohio, and Washington do not impose a corporate income tax. Each imposes a gross receipts tax or modified gross receipts tax at rates that are not comparable with other states' corporate income tax rates.

^d Several states that tax 5 percent of GILTI or foreign dividends do so as an expense disallowance.

Source: Council On State Taxation.

For purposes of our study, we evaluated the largest 25 states' inclusion of the two primary categories of foreign-source income: GILTI (on a current-reporting basis) and foreign dividends (on a deferred basis) in the tax base. The results of our analysis are unambiguous: After its recently enacted legislation, Minnesota is clearly set apart from the large-population states. Two-thirds of the top 25 states do not include any foreign-source income in the corporate income tax base. Of the remaining one-third, Minnesota is one of only three states (Colorado and Maryland are the other

two) that includes 50 percent of GILTI in the tax base.¹⁴ Three other states (Massachusetts, New Jersey, and Tennessee) include only 5 percent of GILTI (or an equivalent amount for disallowance of expenses concerning the excluded income) in the corporate tax base. (See table.)

¹⁴ At the local level, New York City taxes 50 percent of GILTI at an 8.85 percent rate. See New York City Admin. Code sections 11-652(8)(a) and (b); New York's S.B. 6615 (2019) enacted a 95 percent GILTI exclusion; however, it only applies at the state level and not for New York City.

Also, Minnesota includes a larger share of foreign dividends in its corporate income tax base than any of the other 25 most populous states. The only other large states that include foreign dividends in the tax base are California, which includes 25 percent of foreign dividends for water's-edge combined filers, and Massachusetts and New Jersey, which each include 5 percent of foreign dividends or an equivalent amount for expense disallowance. Minnesota is now the only large state that taxes 50 percent of foreign dividends. By including 50 percent of foreign dividends in its corporate income tax base, Minnesota taxes one-half of any distributions that do not qualify as previously taxed earnings and profits, as defined under the rules governing GILTI and subpart F income. In so doing, the state essentially taxes one-half of all foreign-source income, on either a current (GILTI and subpart F income) or a deferred (foreign dividends) basis.¹⁵ (See table.)

Minnesota is also an anomaly among the larger states in terms of its corporate income tax rate. Only New Jersey, with a top corporate income tax rate of 11.5 percent (dropping to 9 percent in 2024) has a higher rate than Minnesota's 9.8 percent. Thus, among the small number of large states that tax more than a de minimis amount of GILTI or foreign dividends, Minnesota's 9.8 percent rate is higher than California's 8.84 percent, Maryland's 8.25 percent, and Colorado's 4.4 percent.¹⁶ (See table.)

Our analysis shows that Minnesota now taxes significantly more foreign-source income at a higher corporate income tax rate than any of the other large states. It is the only top 25 state that taxes one-half of all foreign-source income

(50 percent of GILTI, foreign dividends, and subpart F income) on a current or deferred basis.

Interestingly, Minnesota is moving in the opposite direction of the other large state that previously taxed 50 percent of GILTI. In July 2023 New Jersey enacted legislation that sharply reduced the inclusion of GILTI in the tax base — from 50 percent to 5 percent; it now excludes 95 percent of GILTI and 95 percent of foreign dividends from its tax base. Moreover, its corporate income surtax will expire at the end of this year (tax year 2023), dropping the top New Jersey corporate tax rate to 9 percent.¹⁷ Conversely, Minnesota sharply increased its tax base from only including 20 percent of foreign dividends and subpart F income to now including 50 percent of GILTI, subpart F, and foreign dividends. Indeed, Minnesota is the only major state in the last few years to move in the direction of taxing more, not less, foreign-source income.

Minnesota's Law Is Unfair and Inconsistent With Sound Tax Policy

From a tax policy perspective, another dimension of Minnesota's new approach to taxing foreign-source income is perhaps even more troubling. While Minnesota has expanded its income tax base to include 50 percent of all foreign-source income, the state continues its policy of providing no foreign factor representation in apportioning such income.

One of the fundamental principles of state taxation is that if multistate income is added to the tax base, the factors that contributed to producing the income should be in the apportionment formula. Minnesota uses a single-sales-factor apportionment formula. This means that it determines the amount of corporate income apportioned to Minnesota by multiplying taxable income by a fraction whose numerator is Minnesota sales and whose denominator is total sales of the water's-edge combined group. For purposes of apportioning domestic-source income, Minnesota generally includes in the denominator of the sales factor all the sales (both

¹⁵ After the Tax Cuts and Jobs Act, the amount of foreign dividends reflects distributions of residual foreign-source earnings and profits after application of section 951 (subpart F income) and section 951A (GILTI). One of the largest income categories that does not qualify as PTEP, and thus is in taxable foreign dividends (when repatriated) in Minnesota is the amount of a controlled foreign corporation's income equal to 10 percent of qualified business asset investment. In making the GILTI calculation, a "normal" return on investment is calculated (10 percent of QBAI) and is deducted from a CFC's income and thus does not qualify as PTEP. See 26 U.S. Code subpart F, especially IRC sections 951, 951A, and 959. Under the TCJA, foreign dividends generally are not taxable for federal purposes because of the operation of IRC section 245A (dividends received deduction); but Minnesota has its own and more limited dividends received deduction. See generally IRC, "Section 245A Dividends Received Deduction Overview" (Sept. 13, 2021).

¹⁶ Janelle Fritts, "State Corporate Income Tax Rates and Brackets for 2023," Tax Foundation, Jan. 24, 2023.

¹⁷ New Jersey A.B. 5323 and S.B. 3737 (2023) reduced the state's tax on GILTI to 5 percent. On the surtax repeal, see N.J. A.B. 4721.

in state and out of state) of the members of the water's-edge combined reporting group.

However, for apportioning foreign-source income, Minnesota does not include in the denominator any of the foreign sales that contributed to producing 50 percent of GILTI, subpart F, or foreign dividend income.¹⁸ This inequitably results in zero foreign factor representation in the apportionment of the foreign income.¹⁹

Once again, comparatively, Minnesota is an extreme outlier in its approach to apportioning foreign-source income. Of the three large states that tax 50 percent of GILTI, only Minnesota departs from the principles of fair and constitutionally sound apportionment by failing to allow foreign factor representation. Of the two large states that tax 25 percent or more of foreign dividends, only Minnesota allows no form of foreign factor representation.

Indeed, Minnesota is the only one of the top 25 states that taxes more than 5 percent of foreign-source income with no foreign factor representation. (See table.) The other states — while veering away from the best practice (and likely constitutional requirement) of full foreign factor representation — at least include the net amount of taxable foreign-source income in the sales factor denominator. In fact, Minnesota is the only one of all the states, including the smaller states, that taxes more than 5 percent of foreign-source income and clearly precludes foreign factor representation. (See figure.)

¹⁸The foreign sales are not included because the sales factor only includes sales from corporations in the water's-edge combined reporting group, and foreign affiliates are not part of that group. Minn. Statutes section 290.17, subdivision 4. Moreover, the net amount of GILTI, subpart F income, and foreign dividends in the Minnesota tax base is not in the sales factor because they are all characterized as dividends, and dividends are excluded from the state's sales factor base. Minn. Statutes section 290.191, subdivision 5(a)(2). Minnesota's policy of not allowing dividends to be in the sales factor predates the 2023 statutory changes. But previously, this policy affected only the 20 percent of dividends and subpart F income and not the much broader 50 percent of all foreign income in the corporate tax base.

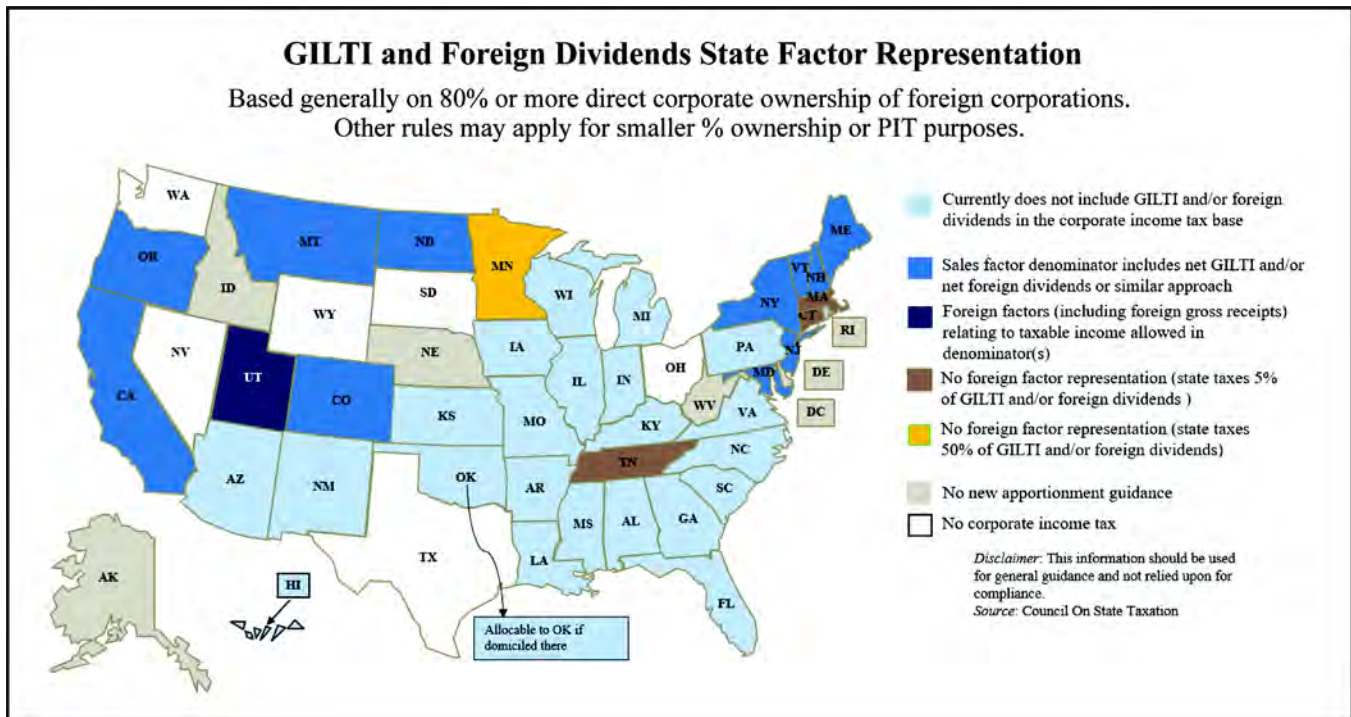
¹⁹While Minnesota has an alternative apportionment provision, Minn. Statutes section 290.20, the state's Department of Revenue has not issued any written guidance to provide relief in this area, and without guidance from the DOR, we are skeptical its use will be allowed to include foreign sales or foreign dividends in the denominator of the state's sales factor. Even if alternative apportionment is allowed in some cases in relation to foreign-source income, unless clear public guidance is put forth by the DOR, it would be on a discretionary, case-by-case basis, and not as a matter of statutory right.

In denying foreign factor representation, Minnesota not only departs from the principles of fair and constitutionally sound apportionment, but also ignores the model rules developed and recommended by the Multistate Tax Commission for apportioning foreign-source income. Minnesota participates as an MTC sovereignty member state.²⁰ The MTC has promulgated a model statute that addresses factor representation for different categories of foreign-source income in conjunction with filing a water's-edge combined return.²¹ The MTC model combined reporting statute addresses several discrete categories of foreign-source income, including subpart F income earned by foreign subsidiaries, income from so-called 80-20 corporations (with 20 percent or more of their factors in the United States), and income from foreign subsidiaries with income in designated "tax haven" countries. In each instance in which it requires foreign income inclusion, the MTC model statute requires inclusion in the taxpayer's apportionment calculation of "the apportionment factors related to that income."²² If the model rule is adopted, the language requires inclusion of the factors (that is, sales) of the foreign subsidiaries that generate the income in the denominators of the apportionment factors.

²⁰According to the MTC, "Sovereignty members are states that support the purposes of the Multistate Tax Compact through regular participation in, and financial support for, the general activities of the Commission. These states join in shaping and supporting the Commission's efforts to preserve state taxing authority and improve state tax policy and administration."

²¹See MTC, "Proposed Model Statute for Combined Reporting," section 5A, as amended by the MTC on July 29, 2011.

²²*Id.*



Minnesota Includes Significantly More Foreign-Source Income in Its Tax Base Than The Federal Government

Before the enactment of the federal Tax Cuts and Jobs Act in 2017, the federal government taxed a small portion of “moveable or passive” foreign-source income (subpart F income) on a current basis and the remainder (foreign dividends) on a deferred basis when repatriated to U.S. multinationals. In general, the TCJA eliminates the taxation of foreign dividends by allowing a 100 percent foreign dividends received deduction.²³ Instead, the federal government expands the amount of foreign-source income of U.S. multinationals taxed on a current basis by adding 50 percent of GILTI to the corporate income tax base (in addition to subpart F income).²⁴

Minnesota partially followed the pre-TCJA federal approach to taxing foreign-source income by taxing 20 percent of subpart F income (on a

current basis) and 20 percent of foreign dividends (on a deferred basis). Its new approach to taxing foreign-source income makes Minnesota not only an anomaly among the U.S. states, but also an outlier in comparison with the federal income tax scheme under the TCJA. The federal government taxes 50 percent of GILTI and 100 percent of subpart F income but excludes foreign dividends. Also, the federal government allows taxpayers to use a credit of 80 percent of the foreign taxes paid on GILTI and 100 percent of the foreign taxes paid on subpart F income to offset that income. For federal purposes, the FTC is critical to avoiding double taxation of foreign-source income. According to a recent study using IRS Statistics of Income division data, in 2018, the first year GILTI was in the federal income tax base, the use of FTCs reduced the federal tax on GILTI by approximately 57 percent.²⁵

By contrast, Minnesota neither allows the FTC to be applied against foreign-source income nor provides any foreign factor representation to ensure that the portion of GILTI, subpart F

²³ IRC section 245A.

²⁴ For a discussion of the transition of the federal taxation of foreign-source income pre- and post-TCJA, see generally Joseph X. Donovan et al., “State Taxation of GILTI: Policy and Constitutional Ramifications,” *Tax Notes State*, Oct. 22, 2018, p. 315.

²⁵ Andrew P. Duxbury, Morgan Whaley, and Irana J. Scott, “Have the TCJA International Provisions Met Revenue Estimates?” *Tax Notes Int’l*, July 31, 2023, p. 541.

income, or foreign dividends in a combined group's tax base is limited to its Minnesota apportioned share.

In essence, Minnesota now adopts a combination of both pre- and post-TCJA federal tax methods for taxing foreign-source income. The state conforms in part to the older federal tax approach by including 50 percent of repatriated foreign dividends in the state corporate income tax base. It also generally conforms to the more recent federal tax approach by including 50 percent of GILTI and 50 percent of subpart F income in the state corporate income tax base.

Thus, in a head-spinning turn of tax policy, Minnesota switched from taxing a much smaller to a much larger share of foreign-source income than the federal government.²⁶ The Minnesota approach is (once again) an outlier from other large states that generally chose to continue their pre-TCJA methods of taxing foreign dividends (California), adopt a model similar to the new federal approach on GILTI (Colorado and Maryland), or refrain from taxing any foreign-source income (most other large states).

The New Minnesota Approach Likely Violates The Commerce Clause

The Minnesota approach to taxing foreign-source income likely violates the U.S. Constitution's commerce clause under precedent related to discrimination, fair apportionment, and foreign commerce.²⁷ The litmus test of a well-designed apportionment method is that if a state subjects new sources of income to the tax base it should also include the factors that contribute to generating that income in the apportionment

²⁶ Minnesota is not only out of sync with other states and the federal government, but also with other subnational state or provincial governments throughout the world. Virtually all other advanced nations address issues related to taxing foreign-source income or imposing global minimum taxes at the national level, not the subnational level. See generally Karl A. Frieden and Barbara M. Angus, "Convergence and Divergence of Global and U.S. Tax Policies," *Tax Notes State*, Aug. 30, 2021, p. 937. Among the advanced nations, only one other country (Korea) taxes foreign-source income at the subnational level, and it does so at a much lower rate. See PwC LLP (prepared for the State Tax Research Institute), "Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income" (Nov. 2019).

²⁷ Our goal here is not to provide the full analysis that would be in a legal brief filed if the Minnesota statute is challenged in court on constitutional grounds, as appears likely, but an overview of the arguments in favor of the taxpayer's position.

formula. As stated in the treatise *State Taxation*, "the factors that are employed to apportion income among the states should reflect the factors that produce the income being apportioned. This virtually axiomatic proposition is also a principle of constitutional law."²⁸ This principle was enunciated by the Supreme Court in *Container Corp.*: "The factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."²⁹

The key to this principle is the use of factors of production — initially property, payroll, and sales, but in recent years, increasingly, just sales — to apportion income. In terms of the sales factor, this generally entails including the gross receipts that contribute to income production in the apportionment ratio. Minnesota's new law fails to address the fair and constitutional apportionment of income. Instead, it has vastly expanded the inclusion of foreign-source income in the corporate income tax base while allowing no foreign factor representation regarding that income.

The Discriminatory Impact of the Minnesota Apportionment Formula

The discrimination built into Minnesota's new statutory approach — taxing 50 percent of foreign income without foreign factor representation — becomes obvious once the statutory apportionment formula is applied to several fact patterns, some with and some without foreign-source income. For any fixed amount of taxable income, under Minnesota's new rules, the greater the share of out-of-state income (in the form of foreign-source income), the greater the corporate income tax liability, regardless of the ratio of the foreign sales to the foreign income.

In Scenario 1, a combined reporting group has \$1 billion of taxable income, with 25 percent sourced (under the single-sales-factor apportionment formula) to Minnesota and 75 percent sourced to other states. Based on Minnesota's corporate income tax rate of 9.8 percent, the Minnesota tax liability is \$24.5 million

²⁸ Jerome Hellerstein, Walter Hellerstein, and Andrew Appleby, *State Taxation*, ch. 9C, para. 9.15(1) (2022).

²⁹ *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

(9.8 percent times \$250 million of Minnesota-sourced income).³⁰

Now assume in Scenario 2 that the combined reporting group doubles its income to \$2 billion of taxable income by increasing its out-of-state domestic-sourced income by an additional \$1 billion. This results in \$2 billion of taxable income (of which \$250 million is sourced to Minnesota and \$1.75 billion is sourced to other states), leading to a Minnesota apportionment ratio of 12.5 percent instead of 25 percent. The new Minnesota tax liability is the same: \$24.5 million. Although the business income doubled, the group's apportionment ratio dropped by half, resulting in the same amount of apportioned taxable income and tax liability.

Conversely, assume in Scenario 3 that the combined reporting group doubles its income to \$2 billion of taxable income by adding \$1 billion of out-of-state foreign-source income. Now the combined reporting group has \$250 million of Minnesota-source income and \$1.75 billion of out-of-state revenue, but the Minnesota apportionment ratio remains at 25 percent because the foreign sales that produced the \$1 billion of additional foreign-source income are not in the Minnesota apportionment formula. As a result, the new Minnesota income tax liability is \$49 million, or double the amount in Scenario 2. The reason for this is that while the business income doubled, the apportionment ratio did not change because of the exclusion of foreign factor representation. This outcome clearly discriminates against foreign commerce in direct proportion to the share of the foreign-source income over total income.³¹

Discrimination Against Interstate Commerce

Under *Complete Auto*,³² a four-prong test is used to evaluate whether a state or local tax regime creates an undue burden on interstate commerce in violation of the commerce clause. A

levy does not discriminate against interstate commerce if “the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.”³³ Minnesota's apportionment statute, especially in light of the increase of its tax base to include half of foreign-source income without foreign factor representation, likely violates the second and third prongs of the *Complete Auto* test (fair apportionment and discrimination).

Regarding the third prong, the Court in *Oregon Waste Systems* wrote that it is well established that a state law is discriminatory if it “tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.”³⁴ The Court explained that “as we use the term here, ‘discrimination’ simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter. If a restriction on commerce is discriminatory, it is virtually per se invalid.”³⁵ In *Oregon Waste*, a fee on out-of-state waste disposed of in Oregon was invalidated as discriminatory because it was three times higher than the fee imposed on in-state waste.

According to the *State Taxation* treatise, the meaning of discrimination as a criterion for adjudicating the constitutionality of state taxes on interstate commerce, according to numerous Supreme Court decisions, is that “a tax that by its terms or operation imposes greater burdens on out-of-state goods, activities, or enterprises than on competing in-state goods, activities, or enterprises will be struck down as discriminatory under the Commerce Clause.”³⁶

In conjunction with the new Minnesota statute, the absence of any foreign factor representation in relation to foreign-source income clearly discriminates against out-of-state activities. Indeed, as illustrated in the above

³⁰ All these scenarios assume that the in-state and out-of-state revenues are produced by a similar sales-to-income ratio.

³¹ For example, if in a Scenario 4, an additional \$2 billion of foreign-source income were added to the income in Scenario 1, the Minnesota liability would increase to \$73.5 million, compared again with \$24.5 million if the additional \$2 billion had been earned domestically in other states.

³² *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

³³ *Id.* at 279.

³⁴ *Oregon Waste Systems Inc. v. Department of Environmental Quality*, 511 U.S. 93, 100 (1994) (citing *Chemical Waste Management Inc. v. Hunt, Governor of Alabama*, 504 U.S. 334, 342 (1994) (quoting *Armco Inc. v. Hardesty*, 467 U.S. 638, 642 (1984))).

³⁵ *Id.* at 99.

³⁶ Hellerstein, Hellerstein, and Appleby, *supra* note 28, Part III, ch. 4C, para. 4.14.

scenarios, the greater the share of out-of-state income (in the form of foreign-source income), the greater the level of discrimination against out-of-state activities.

The Absence of Fair Apportionment

Under the fair apportionment prong of *Complete Auto*,³⁷ a corporate income tax fails constitutional scrutiny if it is not fairly apportioned. As the Supreme Court wrote in *Japan Line*:

It is a commonplace of constitutional jurisprudence that multiple taxation may well be offensive to the Commerce Clause. In order to prevent multiple taxation of interstate commerce, the Court has required that taxes be apportioned among taxing jurisdictions, so that no instrumentality of commerce is subjected to more than one tax on its full value.³⁸

To determine whether a state tax is fairly apportioned, it must be internally and externally consistent. Internal consistency requires a tax to be structured so that if every state imposed an identical tax, no multiple taxation would result.³⁹ It is clear from the scenarios above that the Minnesota statute's apportionment formula for foreign-source income, with its exclusion of foreign factor representation, violates the internal consistency test. If every state adopted Minnesota's apportionment formula, corporate taxpayers earning foreign-source income would be taxed at a higher effective tax rate in every state than taxpayers earning income from in-state and other domestic sources.

Discrimination Against Foreign Commerce

The Supreme Court sets an even higher threshold for satisfying constitutional requirements if the out-of-state commerce at issue is "foreign" commerce. In *Kraft*,⁴⁰ the Court held that Iowa, a separate reporting state, violated the

foreign commerce clause by taxing "foreign" dividends from a foreign subsidiary but not "domestic" dividends from a unitary (non-nexus) domestic subsidiary.

Minnesota's discrimination against foreign commerce is clear-cut through its allowance of factor representation for in-state and "domestic" out-of-state commerce but not for "foreign" out-of-state commerce. The state includes in the corporate income tax base all the domestic-source income of affiliated corporations that are unitary with companies doing business in Minnesota and the factors (sales) that contribute to the production of the income of these companies. Conversely, the state includes one-half of the foreign-source income of unitary foreign subsidiaries of companies doing business in Minnesota (by taxing 50 percent of GILTI, subpart F, and foreign dividends) but none of the foreign factors, for example, the sales that contribute to the production of the income. The inclusion of the foreign-source income from foreign unitary affiliates without providing for representation of the factors that produced such income in the apportionment formula clearly treats foreign-source income from foreign unitary affiliates less favorably than it treats domestic source income from domestic unitary affiliates (whose factors are in the combined report). Indeed, the greater the proportion of foreign-source income to all income, the more the corporate income tax base increases without any corresponding change in the apportionment ratio (through dilution of the sales factor), and the greater the tax liability.

To be sure, *Kraft* was based on discrimination related to a tax base issue in a separate reporting state, not to a factor apportionment issue in a combined reporting state. Nonetheless, the extra protection afforded to foreign commerce by the Court's opinion in *Kraft* and the earlier 1979 case, *Japan Line*,⁴¹ applies to situations such as Minnesota's discriminatory treatment of foreign commerce. The *State Taxation* treatise concurs, noting that *Kraft* is not limited to tax base issues

³⁷ *Complete Auto*, 430 U.S. 274.

³⁸ *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 446-447 (1979).

³⁹ See *Oklahoma Tax Commission v. Jefferson Lines*, 514 U.S. 175, 184-197 (1995), and *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542 (2015), both discussing fair apportionment and the Supreme Court's application of its internal consistency requirement.

⁴⁰ *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992).

⁴¹ *Japan Line*, 441 U.S. at 446-447.

and that discrimination against foreign commerce can also occur in a combined reporting state based on the absence of factor representation:

Nevertheless, the inclusion of foreign-source income without providing for representation of the factors that produced such income in the apportionment formula clearly treats foreign-source income less favorably than it treats domestic source income (whose factors are in the combined report). Merely because such discrimination may be more difficult to discern than the discrimination the Court invalidated in *Kraft* is no justification for tolerating it.⁴²

Other States Also Limit Foreign Factor Representation

Minnesota is not the only state that provides less factor representation in the context of foreign-source income than domestic-source income. In fact, as illustrated in the figure, the troubling norm among the states that tax foreign-source income is to limit the use of apportionment factors associated with foreign-source income in ways that discriminate against that income. However, Minnesota has taken this flawed state tax policy to an extreme by including more foreign-source income in its corporate income tax base with less foreign factor representation (here, none) than any other of the 25 most populous states. (See table.)

No clear legislative history explains why Minnesota chose to select such an unfair and potentially unconstitutional approach to apportioning foreign-source income. One explanation could be that the state was simply following its historic method, which provided no factor representation in connection with the inclusion of 20 percent of dividends or subpart F income in the tax base. However, that treatment

applied before the inclusion of 50 percent of GILTI in the Minnesota income tax base. It also applied when only 20 percent of some types of foreign-source income (foreign dividends and subpart F income) were in the Minnesota corporate income tax base, compared with the 50 percent of all types of foreign-source income now in the tax base.⁴³

Minnesota also has a nearly 30-year-old Minnesota Supreme Court precedent related to the taxation and apportionment of interest and royalties paid to a Minnesota corporate taxpayer by its foreign affiliates. In *Caterpillar*,⁴⁴ the state's highest court found no commerce clause violation created by including this foreign-source income in the corporate income tax base without foreign factor representation.

That case, however, is distinguishable on both its facts and the legal analysis applied to those facts. The income subject to tax in *Caterpillar* (that is, 20 percent of interest and royalty payments to the U.S. parent) was characterized by the Minnesota Supreme Court as expenses and not income of the foreign subsidiaries.⁴⁵ By implication, no foreign factor representation is required if there is no additional foreign income in the corporate income tax base. What Minnesota is taxing under its current statute (50 percent of GILTI, subpart F income, and foreign dividends) is clearly income of the foreign subsidiaries, requiring commensurate foreign factor representation. Moreover, and leaving aside the characterization of the income, the court in *Caterpillar* validated the absence of foreign factor representation in the context of a much smaller statutory inclusion of foreign subsidiary

⁴³ While not raised in connection with the recent Minnesota legislation, advocates of taxing foreign-source income without allowing foreign factor representation have argued that all or most taxable foreign-source income is actually "displaced" domestic source income because of the high level of profit shifting, so inclusion of foreign factors in the apportionment formula is not required. However, as one of the co-authors has written, these analyses are based on both exaggerated estimates of profit shifting and clearly erroneous math. See Karl A. Frieden and Erica S. Kenney, "Eureka Not! California CIT Reform Is Ill-Conceived, Punitive, and Mistimed," *Tax Notes State*, May 24, 2021, p. 808. The new Minnesota approach to taxing foreign-source income has nothing to do with addressing low-taxed or high-taxed foreign income. It is a statutory scheme that taxes half of all global income without any allowance for either foreign taxes paid or foreign factor representation, and thus deviates from both U.S. and global approaches to global minimum taxes. See generally Frieden and Angus, *supra* note 26.

⁴⁴ *Caterpillar Inc. v. Commissioner of Revenue*, 568 N.W. 2d 695 (Minn. 1997).

⁴⁵ *Id.* at 6.

⁴² Hellerstein, Hellerstein, and Appleby, *supra* note 28, at Part III, ch. 4D, para. 4.23 [1][b][iv]. On June 26, the Supreme Court granted a writ of certiorari petition in *Moore v. United States*, No. 22-800. *Moore* has potentially far-reaching implications because the Court will address the meaning of the "realization" requirement and whether IRC section 965 income (and possibly GILTI and subpart F income) qualify as constitutionally permissible income taxes within the meaning of the 16th Amendment. See generally Mindy Herzfeld, "Limiting the Fallout From *Moore*," *Tax Notes Int'l*, July 10, 2023, p. 113.

“income” (only 20 percent of interest and royalty payments) compared with the current statutory inclusion of 50 percent of all foreign-source income.⁴⁶

Conclusion

Under its new statutory approach, Minnesota is including more foreign-source income in its corporate tax base at a higher corporate income tax rate than any of the larger states — and it is continuing to do so with zero foreign factor representation. Importantly, Minnesota has flipped from taxing only 20 percent of repatriated foreign dividends (and subpart F income), a position that was in the mainstream of the minority of states that taxed foreign income, to now taxing 50 percent of all foreign-source income, an approach exceeding that of any of the other 25 most populous states.

Given the constitutional infirmities of Minnesota’s new approach to taxing half of foreign-source income without foreign factor representation, revenues raised under this new statutory regime are insecure. The statute is vulnerable to challenge under several different threads of Supreme Court jurisprudence. Protracted litigation will certainly follow from

audit assessments or refund claims, and it will likely take years before the issue is resolved. Unless Minnesota wants to risk losing this revenue in litigation, the Legislature should reconsider its outlier approach to including 50 percent of foreign-source income in its corporate income tax base and, at a minimum, provide foreign factor representation consistent with fair and constitutionally permissible apportionment. ■

⁴⁶*Id.* In analyzing the potential for discrimination against foreign commerce in *Caterpillar*, the Minnesota Supreme Court said that the appropriate comparison might be between the (non-nexus) non-unitary domestic subsidiaries and the (non-nexus) unitary foreign subsidiaries of the Minnesota corporate taxpayer, both of which were denied any factor representation under state law. Clearly, the more appropriate and statistically significant comparison is between the (non-nexus) unitary domestic subsidiaries whose factors were in the apportionment formula and the (non-nexus) unitary foreign subsidiaries whose factors were excluded from the apportionment formula. While dividends received by a Minnesota taxpayer from a non-nexus, non-unitary domestic subsidiary are in the Minnesota tax base without any factor representation, for most corporate taxpayers this is an insignificant source of income. Alternatively, the court in *Caterpillar* reasoned that even if the appropriate comparison was the (non-nexus) unitary domestic and foreign subsidiaries, all the income of the domestic subsidiaries was in the corporate income tax base compared with only a small portion of the income (interest and royalty payments) of the foreign subsidiaries. But as noted, *Caterpillar’s* fact pattern is clearly distinguishable from the current Minnesota corporate tax base inclusion of all the income of (non-nexus) unitary domestic subsidiaries and half of the income of the (non-nexus) unitary foreign subsidiaries. Finally, there are several other state court decisions from the 1990s noted in the *Caterpillar* decision, which held that foreign factor representation was not required in connection with state taxation of foreign dividends. *Id.* at 11. See Donovan, *supra* note 24, at 326-330; and Frieden and Donovan, “Where in the World Is Factor Representation for Foreign-Source Income,” *Tax Notes State*, Apr. 15, 2019, p. 213, for a detailed analysis of why the Kansas and Maine supreme court cases relating to factor representation were wrongly decided, and conflict with U.S. Supreme Court commerce clause precedent.