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MULTISTATE INCOME/FRANCHISE TAX

Minnesota enacts several changes to its income and franchise tax laws

Tax Alert

Overview

On May 24, 2023, Minnesota House File 1938 (H.F. 1938), Minnesota's omnibus tax bill, was enacted into law. This legislation includes changes to Minnesota corporate franchise, pass-through entity tax, individual income, sales and use, and property tax laws.

This Tax Alert summarizes some of the significant provisions of H.F. 1938 impacting the Minnesota corporate franchise tax, pass-through entity tax, and individual income tax laws. A summary of the significant sales and use tax provisions will be addressed in a separate tax alert.

Updated conformity to the IRC

As applicable to all Minnesota corporate franchise tax, pass-through entity tax, and individual income tax laws, H.F. 1938 updates the date of conformity to the Internal Revenue Code to May 1, 2023, from December 15, 2022. This provision is effective the day following enactment (May 25, 2023). Furthermore, H.F. 1938 provides that changes to the IRC incorporated by federal legislation are retroactively effective to when the changes were effective for federal purposes.

Corporate franchise tax changes

H.F. 1938 makes several significant changes to Minnesota's corporate franchise tax law. These changes are effective for tax years beginning after December 31, 2022, unless specifically noted otherwise. The changes include, among others, the following:

- Reduces the amount of net operating loss ("NOL") deductions that can be used in a given tax year to 70% of taxable income.
- Broadens the classification of income from controlled foreign corporation to include net income under IRC § 951 of any corporation. Net income under IRC § 951 is considered dividend income.

- Updates the classification of GILTI under IRC § 951A to classify it as dividend income.
- Reduces the deduction for dividends received from 20% or more owned corporations from 80% to 50% of dividends received. GILTI is now subject to Minnesota's dividend received deduction; therefore, 50% of GILTI is subject to tax.
- Reduces the deduction for dividends received from less than 20% owned corporations from 70% to 40% of dividends received.
- Updates the addback modification for federal special deductions to remove IRC § 965 from the list of items included as a special deduction.
- Updates the subtraction modification for deferred foreign income to state that deferred foreign income is income under IRC § 965.

Pass-through entity tax changes

H.F. 1938 makes several changes to Minnesota's elective pass-through entity tax ("PTET") laws. These changes are effective for tax years beginning after December 31, 2022, unless specifically noted. H.F. 1938 incorporates, among others, the following changes:

Changes to qualifying entity, qualifying owner, and election

- Broadens the definition of "qualifying entity" for the PTET to include a partnership, limited liability company taxed as a partnership or S corporation, or S corporation that has at least one qualifying owner.
- Broadens the definition of "qualifying owner" for the PTET to include a disregarded entity that has a qualifying owner as its single owner.
- Excludes partners, members, shareholders, or owners who do not meet the definition of a qualifying owner from participating in the PTET.
- Modifies the PTET election such that the election can only be made by qualifying owners who collectively own more than 50% of the ownership interests in the qualifying entity held by qualifying owners.

Clarification on calculation of income for PTET for Minnesota residents

- H.F. 1938 provides that income of a resident qualifying owner of a qualifying entity, which is a partnership or limited liability company taxed as a partnership, is not subject to allocation under Minn. Stat. § 290.17, subd. 1(a) (i.e., the resident qualifying owner's income is based on all the income reported from the qualifying entity).
- Similarly, H.F. 1938 provides that income of a resident qualifying owner of a qualifying entity that is taxed as an S corporation, including a qualified S subsidiary, is allocated and assigned to Minnesota as provided for nonresidents under Minn. Stat. §§ 290.17, 290.191, and 290.20.

Coordination with newly created net investment income tax

- H.F. 1938 requires that to compute a qualifying owner's PTET liability, each qualifying owner's Minnesota net investment income tax liability must also be computed in accordance with the newly enacted Minn. Stat. § 290.033. The net investment income tax is described in the section below on individual income tax changes. This provision is effective for tax years beginning after December 31, 2023.

PTET administrative items

- Provides that the PTET will expire at the same time as IRC § 164(b)(6)(B) expires. Further, the legislation adds that the expiration of the PTET does not affect the commissioner's authority to audit or power of examination and assessment of the PTET.
- Requires taxpayers to file an amended PTET report to report the final federal audit adjustments and pay any additional PTET liability due as if federal audit adjustments had been properly reported. An amended PTET report is required for all direct partners who were included in a PTET return in the year a partnership return was audited for federal purposes. This provision is effective retroactive to taxable years beginning after December 31, 2020.
- Clarifies that Minnesota will allow a credit for pass-through entity tax paid to another state against a qualifying entity's liability under PTET. The credit is considered as a tax paid to another state and may only be claimed by a qualifying owner. This provision is set to expire when the PTET expires.

Individual income tax changes

H.F. 1938 makes a quite a few changes to Minnesota's Individual Income Tax laws. These changes are effective for tax years beginning after December 31, 2022, unless specifically noted. The changes include, among others, the following:

- Creates a state-level net investment income tax which imposes a 1% tax on the net investment income ("NII") of individuals, estates, and trusts over $1 million. NII means NII as provided in IRC § 1411(c). This tax is imposed separately from the individual income tax computed under Minn. Stat. § 290.06.
    - Nonresidents calculate taxable NII using a ratio of NII allocable to Minnesota over total NII. The NII allocated to Minnesota is calculated under the general apportionment and allocation provisions.
    - The net investment income tax is effective for tax years beginning after December 31, 2023.
- Applies an income-based reduction to both standard and itemized deductions, indexed for inflation.
    - Taxpayers with adjusted gross income ("AGI") over $220,650 must reduce their itemized deductions by the lesser of (1) 3% of AGI over $220,650 but not over $304,970, plus 10% of AGI over $304,970 or (2) 80% of the taxpayer's itemized deductions.
    - Itemized deductions for taxpayers with AGI over $1 million are reduced by 80%.
- Amends the addition modification for FDII to include any amount deducted under IRC sec. 250.
- H.F. 1938 also extends the expiration of the credit for investment in small businesses under Minn. Stat. § 116J.8737 to December 31, 2024, amends the film production credit under Minn. Stat. § 116U.27, and provides additional credits and deductions available to low and middle-income taxpayers.

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