

CHAPTER SIX

CORPORATE INCOME TAXES

Corporate taxes are an important tool for state tax fairness. In the 45 states that levy one, the corporate income tax helps to offset the regressivity of property and sales taxes. But corporate income taxes are declining as a revenue source nationwide. This decline is troublesome for two reasons: first, it appears to be at least partially the result of tax avoidance strategies by corporations rather than the conscious design of federal and state lawmakers. Second, the decline of the corporate tax means that individuals must pay a bigger share of the tax pie. This chapter surveys the basic workings of the corporate tax and looks at potential reforms.

Why Tax Corporations?

In the end, all taxes on business are paid by individuals. It may be a company's shareholders that bear the tax, or its employees, or consumers buying its products—but ultimately, these business taxes fall on individuals. So why should corporations be taxed at all?

The most commonly cited reason for taxing corporations is that they derive benefits from the public services a state provides. Corporations rely on a state's education system to provide a trained workforce, use a state's transportation system to move their products from one place to another, and depend on the state's court system and police to protect their property and business transactions.

Another reason is that corporations have special privileges—limited liability and unlimited life, for example—that individuals do not have.

The corporate income tax also acts as an important backstop to the personal income tax. Without the corporate tax, much of the income of wealthier Americans would go entirely untaxed, because individuals could easily shelter their personal income by putting it in a corporate form.

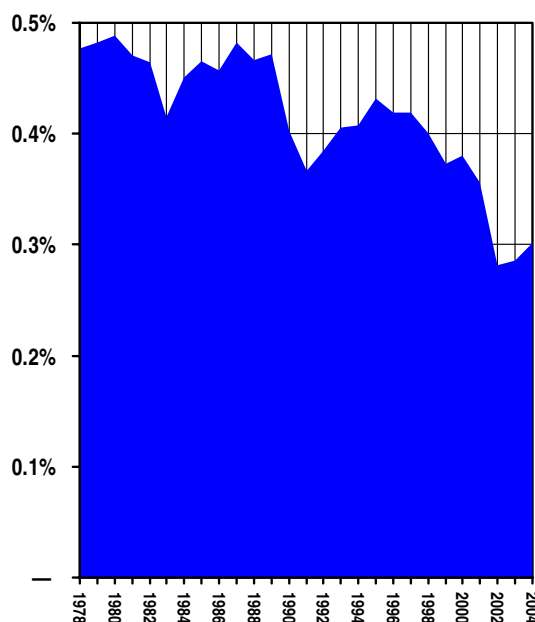
In addition, states find corporate taxes attractive because they often are the only option available for taxing residents of other states. Many of the shareholders of a corporation doing business in a state likely live in other states. States seeking to tax these non-residents on the benefits their company receives from public services have no other means of doing so than the corporate tax.

How it Works

Like personal income taxes, state corporate income taxes are usually based on the “ability to pay” principle. The tax applies to corporate profits—that is, income minus business expenses. Most states “piggyback” on the federal corporate income tax, using federal taxable income as a starting point in determining each corporation's state taxable income. But states must take several additional steps in determining how much (if any) of a corporation's profit they can tax.

- First, the state must determine whether a corporation has **nexus** in a state—that is, whether the company engages in a sufficient level of activity in the state to be taxable by the state.

State & Local Corporate Income Taxes
As a % of GDP — Fiscal 1978-2004



- For those companies that have nexus with a state, the state must next divide each company's taxable income into a "business income" component and a "non-business income" component. This distinction matters because business income is typically divided up between the states depending on the location of the firm's business operations, while non-business income is typically assigned exclusively to the state in which the assets generating the income are managed—usually the state in which a company is headquartered.
- Finally, the state uses a process called **apportionment** to divide a company's business income into an "in-state" portion (which is taxable) and an "out-of-state" portion (which is not).

These additional steps are required by federal law to ensure that each state can tax only its "fair share" of the corporate profits earned by companies doing business in the United States. If these rules didn't exist, any given state would be able to tax the profits of corporations that had no activities whatsoever in the state—and every dollar of corporate income could, in theory, be taxed multiple times by multiple states. The amount of in-state activity that a business must engage in before achieving nexus with a state for corporate income tax purposes is defined by a federal law known as Public Law 86-272. This law says that states cannot apply their corporate income tax to businesses whose only connection to the state is soliciting orders in and/or shipping goods into the state.

Once states have determined the total amount of taxable business income for businesses that pass the nexus test, they divide each company's nationwide taxable business income into an "in-state" portion and an "out-of-state" portion. Each state uses its own **apportionment formula** to achieve this. In the 1950s, legal reformers worked to set up a fair, uniform way of allocating income between states that would result in multi-state businesses' profits being taxed exactly once. The result was the Uniform Division of Income for Tax Purposes Act (UDITPA). The UDITPA model legislation prescribed relying equally on three different factors in determining the share of a corporation's profits that can be taxed by a state. These factors are:

- 1) The percentage of a corporation's nationwide **property** that is located in a state.
- 2) The percentage of a corporation's nationwide **sales** made to residents of a state.
- 3) The percentage of a corporation's nationwide **payroll** paid to residents of a state.

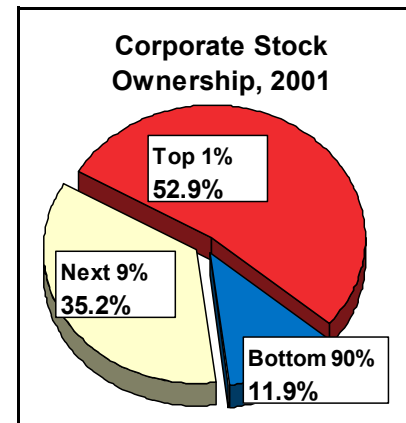
The main rationale for using these three factors to determine taxable income was that companies benefit from a state's public services in a variety of ways, including owning property in a state, making sales within a state, and having an in-state employee base. The three-factor formula ensures that corporate tax liability reflects the benefits received by each type of corporation.

The UDITPA three-factor approach prescribes assigning each of these three factors an equal weight in determining a corporation's taxable income. In other words, the percentage of a corporation's taxable income that can be considered "in-state" is calculated as a simple average of these three percentages. So, for example, suppose that the Acme Corporation has located 90 percent of its property, 30 percent of its total sales, and 90 percent of its payroll in one state. Under the three-factor formula, that state could tax 70 percent (the average of 90, 30, and 90) of Acme's apportionable business income.

For each company, the total amount of taxable income in a state is determined by adding together the amount of business income that can be apportioned to the state, plus the amount of non-business income that is attributable to the state. (As noted above, non-business income is generally allocated entirely to the state in which the assets generating that income are managed.) Taxable income is multiplied by a set of tax rates to yield a pre-credit tax amount. Most states provide special tax credits for research or investment activities which are then subtracted to yield net tax liability.

Fairness

Corporate income taxes are paid by businesses. But as with any business tax, the corporate tax is ultimately paid by individuals. Corporate income taxes are usually passed through to shareholders. Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax is one of the most progressive taxes a state can levy. As the chart at right shows, the wealthiest one percent of Americans held 52.9 percent of all corporate stock in 2001, while the poorest ninety percent of Americans owned just 11.9 percent of the total. Also, because most multi-state corporations have shareholders around the nation, the burden of any state's corporate tax is largely distributed to the other states in which shareholders live. The ability to export part of the corporate income tax is important because out-of-state shareholders benefit indirectly from the public services provided to in-state corporations.



Corporate Minimum Taxes

All states with corporate income taxes use corporate profits to define the tax base. This ensures that the corporate tax reflects a business' ability to pay the tax: if a corporation loses money in any year, they don't pay the tax. But the growing use of tax avoidance strategies means that many profitable corporations are now able to report artificially low (or negative) profits for tax purposes even when they've done quite well financially. These tax avoidance strategies have created the specter of profitable "zero-tax corporations." Federal tax reform legislation in 1986 created an "alternative minimum tax" (AMT) to ensure that all profitable corporations would pay some tax no matter how many loopholes they might otherwise claim.

States seeking to follow the federal government's lead have taken one of three strategies: imposing an AMT based on the federal tax, imposing a flat-dollar minimum tax, or using a non-profit-based measure of business activity as a backstop to the corporate profits tax.

More than a dozen states now use an AMT based on the federal tax. Like the regular corporate income tax, the AMT usually is defined as a percentage of corporate profits—but the AMT typically applies a lower tax rate to a much broader definition of corporate taxable income. This approach has become much less useful because the federal AMT has been seriously watered-down over time by Congress—but a state AMT based on the older federal AMT rules could still help prevent the excessive use of tax loopholes.

A growing number of states rely on a simpler, lower form of minimum tax: a flat-dollar amount that all corporations must pay. This amount ranges widely, from \$50 in Ohio to a maximum of \$1,500 in New York. As more and more corporations rely on tax avoidance strategies, the fixed-dollar minimum tax has become more important in these states: in New York, for example, more than sixty percent of all corporations now pay only the minimum tax. In New Jersey, 30 of the state's 50 largest corporations paid only the \$200 minimum tax in 2002.

About half of the states now levy a "corporate franchise tax." In general, these taxes are based on a company's net worth. Some states also use corporate taxes based on gross receipts. These taxes are described in Chapter Eight.

Each of these options can help eliminate the "zero-tax corporation" problem—and (in some cases) can also help states to get around the problem of corporate nexus described above. Some nexus rules only apply to taxes that are based on profit. So a company that does business in a state, but doesn't have enough physical presence in the state to satisfy the nexus rule, cannot be reached by a profits-based tax, but can be reached by a fixed-dollar minimum tax.

How “Decoupling” State Corporate Taxes From Federal Rules Can Help Shore Up Your State’s Tax Base

Many of the tax breaks that reduce state tax collections are inherited from federal tax law. Since state corporate income taxes are based on federal rules, federal corporate tax breaks will usually be automatically passed on to the state level. States do, however, occasionally “decouple” from specific federal tax giveaways: a substantial majority of states decoupled from the Bush Administration’s “bonus depreciation” giveaways in 2001-2003. Decoupling allows states to avoid revenue losses from certain federal tax breaks while keeping their corporate tax rules simple by continuing to link to federal tax definitions in most other areas.

Now states face a new federal tax break enacted in 2004 for manufacturers—the so-called “qualified production activities income” deduction. This new deduction was enacted to compensate manufacturers for the loss of an unjustified and illegal (under World Trade Organization law) export subsidy. Decoupling from this new tax break makes sense because this manufacturers’ tax break is in no way tied to the creation of manufacturing jobs in any particular state. Massachusetts has already decoupled from this new federal tax break, and the other states with corporate income taxes can do so as well.

Deductible in Computing Federal Income Tax

Like the personal income tax, corporate income taxes are deductible for federal corporate income taxpayers. Since the federal corporate income tax rate is 35 percent, this means that up to 35 percent of the state corporate income tax paid by businesses in your state will be ultimately paid for not by these businesses but by the federal government, in the form of reduced federal tax collections. This interaction also means that state corporate income tax increases are subsidized by the federal government—and that part of any state corporate income tax cut will never be received by in-state businesses, but will go instead to federal tax coffers.

Revenue and Stability

Corporate income taxes can raise significant revenues—but they are also quite volatile. Corporate tax collections have declined in recent years, in part due to the slow economy. The corporate income tax is affected by the state of the economy because the tax is based on corporate profits, which usually fall significantly during economic downturns. State corporate income taxes are also facing downward pressure because they are linked to the federal tax code: the proliferation of tax loopholes at the federal level is being passed through, in many cases, to state governments. Another reason for declining corporate income tax revenues is that many companies have become better at taking advantage of loopholes that Congress never intended to create.

Corporate Income Tax Issues

The decline of the state corporate income tax has been so dramatic in recent years that a few anti-tax advocates have suggested repealing the tax entirely, arguing that the limited yield of the corporate tax makes it not worth the trouble of collecting. But this pessimistic outlook ignores a set of easily administrable, sound reforms that could help revitalize the state corporate tax. This section looks at problems facing the state corporate income tax, and suggests possible reforms.

Tax Credits and the Incentive Illusion

Many states give businesses numerous **tax credits** that significantly reduce (or even eliminate) their tax liability. These include credits supposedly intended to create jobs or encourage investment. Unfortunately, these credits usually just reward businesses for doing things they would have done anyway—or shift investment into areas that do not make the most economic sense.

The **investment tax credit** (ITC) is one example. Under the ITC, when a firm makes a qualifying investment, a percentage of the investment is allowed as a dollar for dollar reduction in the firm’s tax liability. The theory is that companies will invest more if they are rewarded with tax breaks.

In practice, however, if an investment makes business sense, the company will generally make it whether there's a tax credit or not. Thus, the ITC largely rewards companies for what they would have done anyway and therefore does not serve as an economic growth stimulus at all.

Ironically, to the limited extent that businesses do make investments because of the tax credit, it's bad for the national economy. The country is better served by investments based on sound business grounds than those based on the tax code.

The ITC is also very expensive, and the majority of its benefits typically go to only a few very large firms. In fact, three-fourths of the federal investment tax credits from 1981 to 1986 went to firms with over \$250 million in assets—the top one-tenth of one percent of companies. Similarly, in New York in 1985, five companies, each with over one billion dollars in net profits, got 44 percent of the state's total investment tax credits—more than \$100 million worth. As a result, at least one of these billion-dollar companies paid only the \$250 minimum New York corporate tax.

The question for policymakers is whether they want to support a program that:

- gives a large amount of scarce government funds to huge corporations;
- doesn't cause companies to significantly change their overall investment levels; and
- to the extent companies do change their investment patterns, is usually bad for the nation's economy.

The federal government abandoned its own investment tax credit in 1986 after Congress and President Reagan concluded that it was ineffective in stimulating investment.

Manipulating Apportionment Rules in the Name of Economic Development?

In determining what portion of a multistate company's profit is taxable in a given state, most states use the three-factor, payroll-property-sales apportionment formula method described on page 37. In recent years, however, many states have deviated from this basic three-factor approach by increasing the importance of the "sales factor." For example, Arizona allows companies to count the sales factor twice. (In the example on page 37, this means that instead of taxing 70 percent of a company's business income (the average of 90, 30 and 90), Arizona can only tax 60 percent of that income (the average of 90, 30, 30 and 90). This "double weighting" approach reduces the tax paid by corporations that sell most of their products in other states—for example, manufacturing corporations. A dozen states still use the unweighted UDITPA formula.

Several states have gone even further, increasing the weight of the sales factor to one hundred percent—eliminating the payroll and property factors entirely. This is known as the "single sales factor," or SSF. Under SSF, the sole determinant of a corporation's state tax is how much of its sales are made to in-state customers. Advocates of increasing the sales factor claim that it encourages exporting businesses to locate in a state, since it favors companies with greater payroll and assets in a state than sales. But claims that an increased sales factor attracts corporate investment are dubious. Indeed, in some cases, it might actually *discourage* investment in a state.

If a company, for instance, only ships products into a state, it may not have nexus with the state. But in a state with an increased sales factor, if such a company makes even a small investment in a state, it will immediately have much of its income apportioned to the state because the sales factor counts so heavily. And a company with only a small amount of property or payroll in a sales factor state can reduce its in-state corporate taxes to zero by moving this property and payroll out of the state. Thus, increasing the sales factor can actually have exactly the opposite effect of what its proponents intend: discouraging in-state investment.

In addition, increasing the sales factor discriminates between companies in a way that is hard to defend. Increasing the sales factor will reduce taxes for some companies, but will increase taxes for others. For each corporation that benefits from SSF because most of its sales take place in other states, there are also corporations that will be punished by SSF rules because their sales are

mostly *in-state*. Smaller corporations that tend to make most or all of their sales within the state in which they are located generally get little if any tax savings under the SSF approach. In short, adoption of the single sales factor ultimately benefits some corporations while punishing others in an arbitrary way.

These arbitrary distinctions reduce the confidence of the public—and of corporations—in the fairness of state tax administration. When profitable companies benefit from a state’s services—as the manufacturing companies that typically benefit from the single sales factor clearly do—they should pay their fair share of the corporate tax burden. When these corporations are allowed to reduce or eliminate their tax liability, that lost revenue must be made up by other competing companies—and by individual taxpayers.

Separate Accounting & Transfer Pricing

A further inconsistency in state corporate taxes stems from the fact that some states permit companies to determine their in-state taxable income using **separate accounting** for each of their related subsidiaries. Separate accounting is a bookkeeping procedure that determines each company’s taxable income by having companies keep separate accounts for their in-state and out-of-state business segments. Every transaction between the legally distinct subsidiaries of a company is supposed to have a **transfer price** (that is, the “sales price” at which these companies are essentially selling products to themselves) attached to it, which is supposed to be carefully scrutinized by auditors.

Not surprisingly, separate accounting is subject to abuse by large, multistate companies. In fact, it’s an open highway for corporate tax avoidance. A large multistate company can use separate accounting to shift taxable profits to low-tax jurisdictions. Here’s how it works:

Consider a multistate company that has two subsidiaries, one in State A that permits separate accounting and one in State B, which has no corporate income tax. To reduce its taxable profits, the subsidiary in State A might say that it “pays” high transfer prices for the items it “buys” from the State B subsidiary. This shifts income out of State A (where it would be taxed) and into State B (where it’s not).

For example, a furniture company might machine the metal parts for its furniture (handles, knobs, etc.) in State B, but assemble the furniture in State A. The company will, on paper, charge very high prices to its State A subsidiary for the metal parts. This makes the State B subsidiary look like it has very high profits (which are not taxed) and the State A subsidiary look like it has very low (taxable) profits.

Of course, except for tax considerations it doesn’t matter to the parent company if its State B subsidiary has 80 percent of the total profits and its State A subsidiary has only 20 percent. Either way, the parent company gets 100 percent of the profits.

Another example of transfer pricing that has gotten more attention in recent years is the passive investment company (PIC) approach. In this variation on the transfer pricing scheme, a multi-state company will set up a subsidiary in a state that does not tax certain types of intangible income like royalties and interest—and make sure that this subsidiary receives all of the company’s royalty income. The most infamous example of this practice is the Toys R Us corporation, which created a subsidiary in Delaware called Geoffrey, Inc. The subsidiary owns the Toys R Us trademark, and Toys R Us stores around the nation pay royalty fees to the Delaware subsidiary for their use of the trademark. This reduces the taxable profit of Toys R Us in two ways: stores based in other states get to deduct their royalty payments as a cost of doing business, which reduces their taxable profit, and the Delaware subsidiary pays no tax on their royalty income because Delaware does not tax such income.

Trying to assure accurate transfer pricing under separate accounting creates huge enforcement problems. It is a time-consuming, complicated and often impossible job for state auditors to

determine whether separate accounting methods accurately reflect a company's net business income in the state. The federal government, which tries to apply the same approach to multinational corporations, has had the same kinds of difficulties.

States seeking to prevent these income-shifting strategies have two options. They can close down these loopholes one at a time—as some states have done in response to the PIC problem by enacting legislation that prevents the use of PICs—or they can adopt a comprehensive solution known as **combined reporting**. Combined reporting requires a multi-state corporation to determine its apportionable income by adding together the profits of all its subsidiaries into one total. Since the income of subsidiaries in the various states is added together in one sum, there is no tax advantage to income shifting between these subsidiaries under a combined reporting regime. While anti-PIC legislation can close down one particular path to tax avoidance, combined reporting is a better, more comprehensive approach to loophole-closing because it simply removes the incentive to shift income from high-tax to low-tax jurisdictions.

Combined reporting is intuitively more fair than separate accounting because it ensures that a company's tax should not change just because its organizational structure changes. It also creates a level playing field between smaller and larger companies. Small companies doing business in only one state can't use separate accounting to reduce their tax because they have no business units in other states to shift their income to. Large, multi-state corporations will find it easier to avoid tax using separate accounting because they have business units in multiple states.

“Nowhere Income” and the Throwback/Throwout Rule

Every state with a corporate income tax uses the location of the corporation's sales as a factor in apportioning business income between states. The “sales factor” for a given corporation in a given state is calculated by assigning each individual sale a company makes to exactly one state, and then calculating what percentage of total nationwide sales are in each state. In general, the rule states use to decide which states a given sale should be assigned to is the “destination rule,” which says that a sale should be assigned to the state to which the product sold is being sent.

Sometimes, however, sales allocated to other states using the destination rule end up not being taxed at all because the destination state lacks the authority to tax the seller. When this happens, it's because the seller doesn't have *nexus* in the destination state.

Unless states take action, this “**nowhere income**” will not be taxed anywhere at the state level. The best remedy for the problem of nowhere income is enacting a **throwback rule**, which simply says that any sales to other states that are not taxable will be thrown back into the state of origin for tax purposes. The throwback rule was among the tax rules adopted by the UDITPA in the 1950s, but many states still have not enacted it. The lack of throwback rules poses a major threat to state corporate income tax revenues in twenty states.

Splitting Hairs? Exploiting the Business/Nonbusiness Income Distinction

The first step in calculating state corporate taxes is dividing a company's income into a “business income” component and a “nonbusiness income” component. Business income is apportioned (divided) between the states in which a company does business, while non-business income generally is taxed entirely by the one state in which the asset generating that income is managed. But each state must set its own legal dividing line between business- and non-business income—and the way in which states do this has important implications for corporate tax fairness.

The appropriate dividing line between these two types of income has been the topic of frequent litigation in the states. In many states, business income is defined as any income that arises from the regular transactions that a company typically engages in—which means that any income that can be characterized as “irregular” may be considered non-business (and therefore non-apportionable) income. Businesses sometimes try to take advantage of this poorly defined distinc-

tion between business and non-business income by misleadingly classifying some business income as irregular non-business income, then allocating this non-business income entirely to a low-tax state in which they are nominally headquartered. A 1992 U.S. Supreme Court case, *Allied Signal v. New Jersey*, made it clear that many states currently falling prey to these tax-minimization strategies are not taxing all the corporate income they could legally tax.

States with corporate income taxes have responded to these corporate tax-minimization efforts using two strategies:

- Six states define business income as everything they can legally apportion under the U.S. Constitution—which means that non-business income is whatever is left over. This approach is recommended by corporate tax experts as the best way of fairly taxing multi-state corporations' income.¹⁰
- Thirteen states define all income as business income. This approach allows states to tax some of the “irregular” income that companies seek to classify as non-business income, but prevents states from taxing some non-business income that they are entitled to tax. For example, if a company is based in state A, and generates \$100 million of non-business income in state A, the state should be entitled to tax the entire amount as non-business income (since non-business income is not apportioned between states). But when states make no distinction between business and non-business income, all of a company's income is apportioned—which means that state A can only tax a percentage of this income.

Every state with a corporate income tax (except for the six states that currently define business income in accordance with the U.S. Constitution's limits), could enact statutory changes that would allow them to prevent the nonbusiness income loophole from depleting their tax base.

Corporate Disclosure: An Important Tool for Tax Fairness

Tax fairness is important. The perception that state and local taxes treat individuals and corporations fairly is a cornerstone of public support for the tax system. Corporate tax fairness at the federal level can be evaluated, with some difficulty. Publicly available Securities and Exchange Commission (SEC) filings allow analysts to determine how much the nation's largest corporations have paid in federal taxes and compare this to their profits. In a series of reports, ITEP has shown that many profitable corporations pay little or no federal income tax. A September 2004 ITEP report surveyed 275 of the most profitable corporations, and found that almost a third of these companies paid zero (or less) in federal taxes in at least one year between 2001 and 2003.

Unfortunately, the fairness of state corporate taxes cannot be evaluated in the same way, because neither the SEC nor most state governments require corporations to release detailed information on their state corporate tax payments. A few states have now implemented some form of corporate tax disclosure. For example, Massachusetts now requires very limited anonymous disclosure of basic information about profits, taxes paid and tax credits received. But nearly all states still have no such requirements. Greater state corporate tax disclosure is the best means available to ensure that each corporation is treated fairly—and that corporations as a group pay their fair share of taxes.

Corporate disclosure can also help states to prevent the accounting hijinks described above. For example, some companies will report certain income as “non-business income” in one state and “business income” in another to minimize their tax liability. More open reporting of this information could allow states to check for consistency in income reporting between states.

¹⁰Michael Mazerov, *Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States* (Center on Budget and Policy Priorities, 2003).