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How State Corporate Income Taxes Work

A robust corporate income ensures that profitable corporations that benefit from public services pay their fair share towards the maintenance of those services, just as working people do.. More than forty states currently levy a corporate income tax. This policy brief explains why corporations should be taxed and the basic workings of the corporate tax.

Why Tax Corporations?

Corporations are legally considered "persons," eligible for many of the same rights and protections as ordinary men and women. And just as working families and individuals benefit from the services that state and local governments provide, so too do corporations. 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. While corporations—like individuals—may pay taxes on the purchases they make or on the property they own, they should also pay taxes on the profits they realize, much in the way that people earning a living in the state pay taxes on their income.

Of course, while a corporation may be treated as a single legal person, it exists in reality as a collection of individuals—the shareholders that own it; the executives and staff that work for it; and the consumers that buy its products. As a result, any tax levied on a corporation ultimately falls on one of these groups. Economic research generally indicates that for the most part, it tends to be borne by corporate shareholders. From a fairness perspective, the corporate income tax has three important attributes:

▪ The corporate income tax is one of the most **progressive taxes** a state can levy. Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax falls primarily on the most affluent residents of a state.

▪ The corporate income tax is, in part, **exported to other states**. Because most multi-state corporations have shareholders around the country and around the world, the bulk of a state's corporate income tax will ultimately fall on residents of other states and countries.

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

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In its simplest form, the corporate income tax is a tax on corporate profits. The corporate tax is based on the "ability to pay" principle: a corporation that does not realize a profit in any one year generally does not owe any corporate income tax that year. Here's an overview of how the state corporate income tax is calculated:

▪ **Determining who can be taxed.** A given company must determine whether it has nexus in a given state—that is, the company must determine whether it engages in a sufficient level of activity in the state to be subject to tax. The amount of in-state activity in which a company must engage before achieving nexus with a state for corporate income tax purposes is defined by a little-known federal law known as Public Law 86-272, which says that a state cannot apply its corporate income tax to companies whose only connection to the state is the solicitation of orders from, or the shipment of goods to, the residents of the state. Companies are well aware of nexus requirements and may structure their operations so that they avoid "crossing the nexus threshold" — and, by extension, the corporate income tax—in some of the states in which they do business.

▪ **Measuring profits**. Potentially taxable companies must calculate the net income, or profit, that it earned over the course of the year. To do this, most states "piggyback" on the federal corporate income tax, using the federal definition of taxable income as a starting point.

▪ **Splitting income into "business" and "non-business" components.** The next step is to divide a company's taxable income into a "business income" component and a "non-business income" component. Business income is typically considered to be the profits a company earns from its day-to-day business operations.

▪ **Apportionment, or determining each state's share of corporate "business" income.** A given state is not allowed to simply tax all of the profits of any company that has nexus in the state. If states could do this, the profits of companies that operate in multiple states might be taxed many times over. For more on apportionment formulas see ITEP Brief, **"Corporate Income Tax Apportionment and the Single Sales Factor"**.

▪ **Calculating tax.** Having determined the share of its total taxable income that is attributable to a given state (including the amount of business income that can be apportioned to the state and the amount of non-business income that is allocated to the state), the resulting sum is multiplied by the state's corporate tax rates to yield a tax amount.

▪ **Subtracting credits.** Many states now allow targeted tax credits (for example, credits for research or investment activities) that companies can subtract directly from their pre-credit tax liability.

▪ **Pay the Minimum**. Most states now require that even technically unprofitable corporations must pay some minimal amount of income tax. States' minimum taxes vary from very modest flat dollar amounts to more substantial sums based on a company's net worth. For more on minimum taxes see ITEP Brief, **"State Corporate Minimum Taxes"**.

Conclusion

The corporate income tax is an important component of many state's tax structures. Though the revenue generated from the tax has declined in recent years, a robust corporate income tax can- and should – be part of each state's tax system. Policymakers should work to understand how the corporate tax is calculated to ensure that corporations are paying their fair share. Despite the worrisome recent drop in the yield of these taxes, virtually every state now has available a straightforward set of tax reform policies that could not only end the erosion of their corporate tax base, but could help these taxes regain their former health.