Corporate Income Tax

Statewide Economic Growth and Taxation Issues in South Carolina

SC Department of Commerce

INTRODUCTION

South Carolina imposes corporate income tax at a rate of 5%. This tax created $268.6 million in tax revenue in FY 2009-2010 and accounted for 2.1% of General Fund revenues. The state also levies a corporate license fee, generating $73.4 million, or 1.4% of General Fund revenues, in FY 2009-2010.

Businesses organized as C Corporations pay a state corporate income tax on income allocated to operations in South Carolina, including interest, dividends, royalties, rents, property sale gains and losses, and personal services income. To determine the percentage of income from the state, an income apportionment formula is applied. South Carolina is currently transitioning from a multi-factor income apportionment method to a single-factor method. When fully in effect in 2011, firms will apply the 5% corporate income tax rate to the percentage of total firm sales made within South Carolina.

Corporate income tax revenues are credited to state general funds. The starting point of corporation income tax calculation is determined by the firm's federal taxable income. South Carolina allows a 15-year net carry-forward for losses.

All corporations also pay a state corporate license fee (or franchise fee) equivalent to $15 plus 0.001 of the corporation's capital stock and paid-in surplus. The minimum license fee is $25. The fee paid by multi-state firms is determined by apportionment in the same manner as the corporate income tax. The corporation license fee is also applied to the state's general funds. Unless otherwise exempted, every corporation is required to file an annual report to pay the annual license fee.

South Carolina is one of 32 states, including the District of Columbia, that levies a flat rate of tax on corporate income in 2010. Five states have no corporate income taxes (Nevada, South Dakota, Texas, Washington and Wyoming). The remaining states impose progressive tax rates.

Seven of the nine southeastern states have a flat corporate income tax rate. South Carolina's rate is the lowest for 2010. Additionally, South Carolina had over 20 types of credits against corporate income tax in FY 2007-2008 (see Appendix Table A1).

OVERVIEW OF ECONOMIC MODELS & ISSUES

The primary aim of taxation is to raise enough revenue to cover government services efficiently, such that the imposition of the tax does not distort the economic decisions of firms and individuals. Utility is improved by replacing distortionary taxes with non-distortionary ones, and lump-sum taxes are theoretically and empirically found to minimize these economic distortions.

The corporate income tax has been studied extensively in economic literature. Although large taxes can hinder investment, large tax breaks can encourage over-investment, leaving vacant and unused capital. Key features and issues of economic models are described as follows.

Taxes, Incentives and Business Investment

The relationship between firm investment and tax structure is of particular interest due to the increasing use of state and local financial incentives to firms who invest in a geographic area.

While neither state corporate income taxes nor state financial incentives are commonly considered the primary factors for business location decisions (versus factors such as population, skilled workforce, access to transportation or markets, energy prices, etc.), governments increasingly utilize credits against corporate taxes or other mechanisms to recruit business investment.

Hines (AER 1999) empirically shows that foreign direct investment (FDI) is positively influenced by lower state corporate tax rates, yet achieving this result depends upon how repatriation laws of foreign countries are structured. For example, companies from countries with tax systems that allow credits for foreign taxes paid are less sensitive to US state corporate income tax variations.

Agostini (2007) confirms these findings by treating tax rates endogenously (states can strategically set their rates relative to other states) and including the option for investors to invest outside of the US. He finds that for a 1% increase in the corporate income tax rate, the state's share of FDI drops by 1%.

Although no major studies to date have directly compared the relative impact of corporate income tax versus state financial incentives on business investment, results would certainly be dependent upon how the incentives were structured.

Multi-State Firms and Income Apportionment

Corporations that have a presence in a state (nexus) are subject to that state's corporate income tax. The degree to which a firm is subject to that state's tax varies by state, however. In 1957, the Uniform Division of Income for Tax Purposes Act (UDITPA) prescribed three factors to be used in determining the percentage of a corporation's income to be taxed by each state:

1. % of corporation's property located in state
2. % of corporation's sales made in state
3. % of corporation's payroll paid to state residents

Over time, a number of states have begun more heavily weighting the sales factor, some even using only one factor—sales, commonly referred to as the Single Sales Factor (SSF). South Carolina is currently in the midst of a transition to SSF.

SSF generally favors large goods-producing companies (often manufacturers) with large amounts of in-state property and employees but with a high percentage of out-of-state sales. Firms (often smaller ones) who sell goods primarily within the state bear the highest tax liability.

SSF also provides a disincentive for companies with large in-state sales but no physical presence to locate within the state, as the firm will move from zero tax to a large tax on all in-state sales. Conversely, the SSF gives companies with a large in-state employee and property base the incentive to move out of state to remove their nexus and eliminate their tax burden.

Because multi-state corporations face different tax laws in different states, they have the ability to minimize their state corporate tax liability through the use of one of several mechanisms:

1. Transfer pricing allows firms to shift profits from one state to another through the purchase of goods sold from one subsidiary to another.
2. Holding companies or passive investment companies can be established as a subsidiary in a state with no tax to shift profits from one state to another.

Taxation and Investment Timing

The corporate income tax is commonly identified as a form of "double" taxation on income. The C-corporation is taxed as an entity itself on income. Distributions to shareholders are then taxed again as ordinary income from dividends. While considerable leeway is provided to companies to pay large salaries to shareholder employees as a means of avoiding taxation at the corporate level, this mechanism would not apply to all shareholders.

Finally, the corporate income tax can affect the timing of investment

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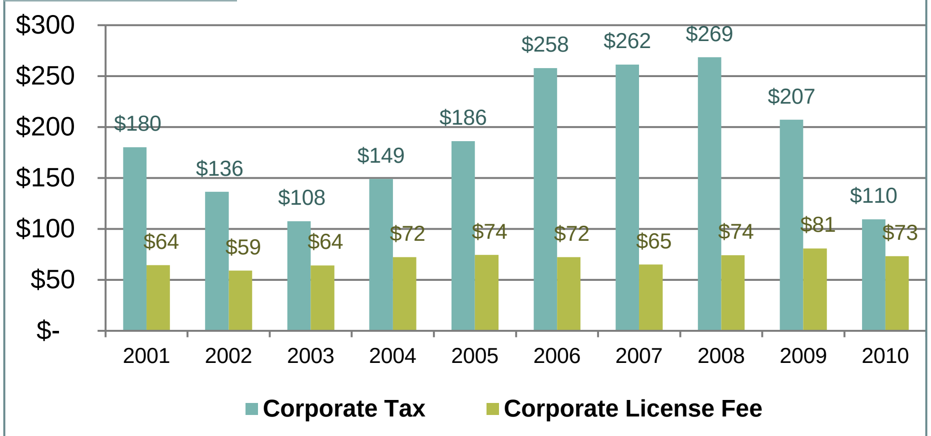
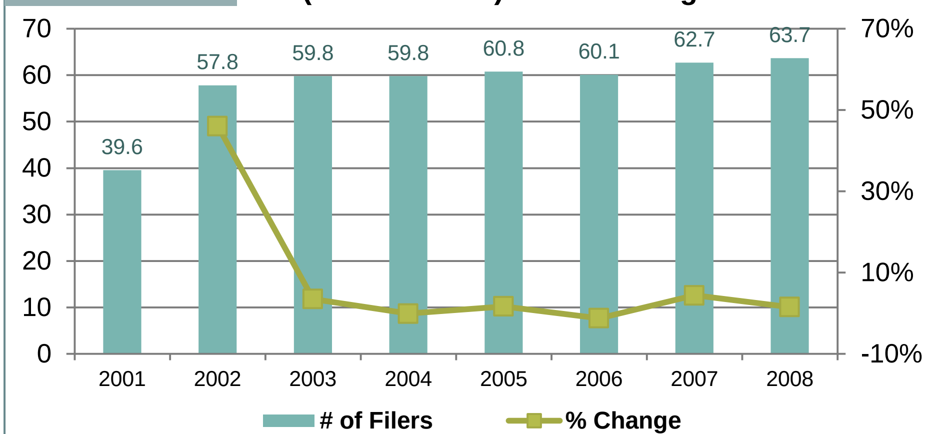
by a firm. Firms who chose to save for future period investment across a calendar year will face the corporate tax on those retained earnings.

FIGURE 1 **Corporate Income Tax and License Fee (in millions)**



Sources: Comptroller General's CAFR, FY01-03; Comptoller General's Year End Press Releases, FY 04+

FIGURE 2 **Corporate Income Tax Filers (in thousands) and % Change**



Source: SC Department of Revenue.

CORPORATE TAX HISTORY IN SOUTH CAROLINA

A Timeline of Major Changes

The corporate income tax was instituted in South Carolina in 1927. In 1989, the rate was reduced from 6% to the current rate of 5%.

In 2006, Senate Bill S1245 amended section 12-6-545 of the code of law to reduce the income tax rate of pass through entities (e.g.-sole proprietorships, partnerships, S-corporations or LLCs filing as one of the aforementioned entities) in increments of 0.5% per year to a rate of 5% by 2009. This change was intended to "level the playing field" between large C-corporations, who were taxed at 5%, and small businesses whose income is taxed as Schedule C income on individual income tax returns.

In 2007, Senate Bill S91 established a Single Sales Factor for use in determining income apportionment for multi-state firms operating in South Carolina. It prescribed a phased-in transition period with the SSF in full effect for tax year 2011. Prior to the change, South Carolina had used a double weighting of sales in a three-factor income apportionment method:

- 25% SC property vs. all property,
- 25% SC payroll vs. all payrolls, and
- 50% SC sales vs. all sales.

STATE CORPORATE TAX REVENUES

Historical Trends

In the past decade, corporate income tax revenue in South Carolina has varied from year to year, decreasing in 2002, 2003, 2009, and 2010. Corporate license fees have remained relatively more stable throughout the period (see Figure 1). Revenue from the corporate license fee ranged from $59 million in 2002 to $81 million in 2009.

Corporate Tax Filers

The number of filers has increased every year except 2006 between 2001 and 2008. In 2002, when corporate income tax revenue declined sharply, the number of filers increased by 46% over the previous year. Since 2002, the changes in the number of filers have been incrementally small each year. The number of filers and corporate tax revenues appear to move independently of each other. In 2008, although the corporate income tax revenue fell, the total number of corporate income tax filers increased.

Corporate filers represented 96 different industry sectors (at the NAICS 3-digit level). In 2008, 47 out of these 96 industries added new corporate filers. 39 experienced a reduction in the number of filers. Others remained the same. Among the industries with expanding numbers of filers, professional services, religious and similar organizations, ambulatory health care service and specialty trade contractors increased by more than 100 filers. On the other hand, the number of filers in miscellaneous store retailers, merchant wholesalers and construction of buildings decreased more than in other industries.

In 2008, the number of corporate income tax filers ranged from a low of 57 in Allendale County to a high of 8,415 in Greenville County. Greenville, Charleston, Horry, Richland and Beaufort are the five counties with most corporate income tax filers. Allendale, McCormick, Saluda, Lee and Bamberg are the five counties with least number of tax filers. Such distribution has not changed since 2001.

Corporate Income Tax Credits

South Carolina had over 20 different types of credits against corporate income tax in FY 2007-2008. During that year, $708.9 million in credits were claimed by only 454 filers. South Carolina allows credits to be carried forward up to 15 years. In 2008, $645.7 million in credits were carried forward by 279 filers.

Apart from carry-forwards from previous years, the New Jobs tax credit and the Economic Impact Zone (EIZ) credit are the largest credits (see Figure 3). In 2008, credits carried over from previous years accounted for 89% of total credits, New Jobs credits account for 5%, and EIZ credits accounted for 3%.

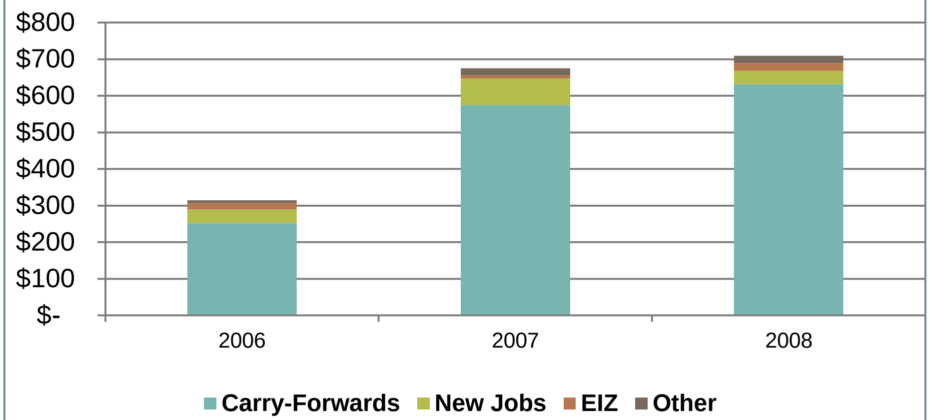
Credits for various types of corporate investment effectively favor new capital over existing capital, stimulating investment by the new (often larger) companies locating in the state, but lowering the value of existing capital of the state's smaller and/or established in-state companies.

Carryover Credits

Corporate income tax credits carried forward to the future have been increasing since 2003, as shown in Figure 4. The amount of

FIGURE 3

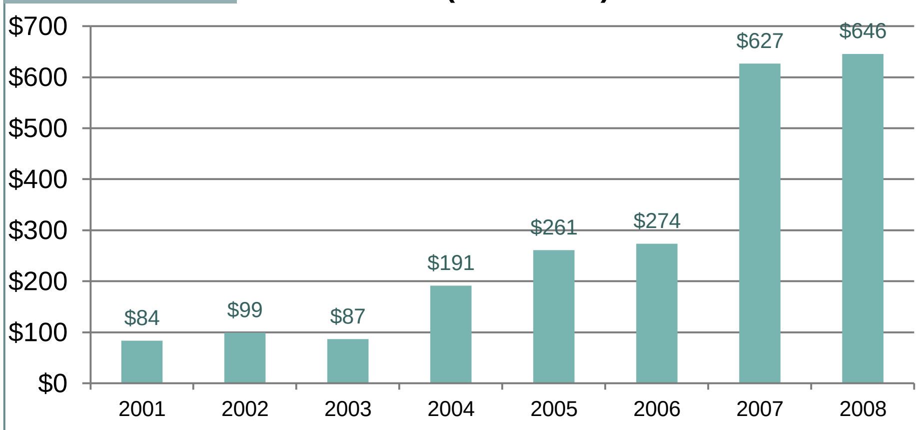
Corporate Tax Credits (in millions)



Source: South Carolina Department of Revenue Annual Reports 2006-2008.

FIGURE 4

Corporate Tax Credit Carry-forwords (in millions)



Source: South Carolina Department of Revenue Annual Report 2001-2008.

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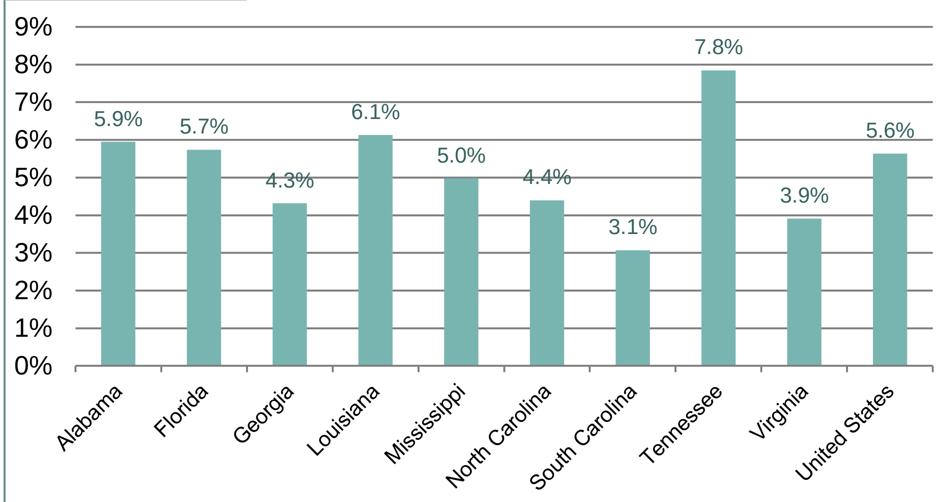
FIGURE 5 Corporate Income Tax as a Percentage of Total Tax Revenue, 2009



Source: Annual Survey of State Government Tax Collection by US Census Bureau, 2009.

carryover credits from previous years increased dramatically in 2007, rising $353 million or 129% over 2006. The level remained high in 2008. This increasing use of tax credits and carry-forwards over time not only reduces state corporate revenues, but also increases year-over-year variability.

SOUTH CAROLINA VERSUS OTHER STATES

Corporate Tax Rate

In terms of corporate income tax rate, South Carolina's rate is the lowest among the seven southeastern states that impose flat rates. Louisiana and Mississippi both have progressive tax brackets as shown in Table 1. Of all states nationwide that impose a flat tax rate, South Carolina's is tied with Utah for the fourth lowest.

Table 1: Southeastern State Corporate Tax Rates, 2010

State	Corporate Tax Rate
NC	6.9%
AL	6.5%
TN	6.5%
GA	6%
VA	6%
FL	5.5%
SC	5%
LA	4% ($25,000) to 8% ($200,000)
MS	3% ($5,000) to 5% ($10,000)

Source: Tax Foundation (http://www.taxadmin.org/fta/rate/corp_inc.pdf); Louisiana has 5 brackets; Mississippi has 3 brackets.

Five states impose no corporate income tax (Nevada, South Dakota, Texas, Washington and Wyoming). Some states impose other taxes on businesses however. For instance, a number of states, including South Carolina, impose a franchise fee. Texas, who lowered its corporate rate to zero, levies a margin tax of 1% on entities with more than $1,000,000 in total revenues, or 0.5% on retail or wholesale trade entities on the lesser of 70% of total revenues or 100% of gross receipts (after deduction for cost of goods sold). Michigan, who has a flat 4.95% rate, also levies a modified gross receipts tax at rate of 0.8% on receipts of $350,000 or more. In addition, it imposes a 21.99% surcharge, capped at $6 million per year.

Corporate Tax Revenue

The nine southeastern states share similar trends of changes in corporate income tax revenue. In the past decade, they all experienced a decrease in 2002 or 2003, followed by a second in 2008 and a third in 2009.

In terms of the percentage of corporate income tax revenue as total tax revenue, for the year 2009, Tennessee ranks highest (7.85%). Tennessee, Louisiana (6.13%), Alabama (5.95%) and Florida (5.74%) are above the US average (5.64%). South Carolina ranks the lowest among the eight southwestern states (3.1%). See Figure 5.

Tax Reporting Mechanisms

In 2008, 21 states applied combined reporting methods to corporate income tax. Combined reporting requires that companies combine profits from all related subsidiaries, including captive real-estate investment trusts (REITs) and passive investment companies (PICs), before determining what portion of their profits are taxable in that state.[1]

For the four states that did not levy corporate income tax in 2008, this issue was irrelevant. (Texas has since instituted a 0% corporate tax rate.)

Besides D.C., South Carolina is one of the remaining 25 states that still uses a separate reporting method. Separate reporting methods can facilitate a company's ability to shelter corporate income from taxes, typically through PICs and REITs.

No other southeastern states apply combined reporting mechanisms, however. Commissions in Kentucky, Pennsylvania, and North Carolina have also recommended the adoption of combined reporting.

The "Throwback Rule"

The "throwback rule" is used to rectify the loss of corporate income tax revenue caused by the conflict between state apportionment formulas and Public Law 86-272.

When a corporation produces and/or sells goods in more than one state, each state requires the business to pay tax on just a portion of its nationwide profit. That taxable share is calculated by an apportionment formula in each state's corporate income tax law. The most commonly used formula assigns some of the profit to the state(s) in which the corporation produces goods, some to state(s) in which employees are based, and some to the state(s) in which the corporation makes sales.

However, Public Law 86-272, establishes a threshold level of presence or "nexus" a corporation must have in a state before it can be subjected to a corporate income tax on profit earned in that state. Public Law 86-272 frequently blocks states in which a corporation merely makes sales from imposing an income tax on the states' respective shares of the corporation's profit (as calculated by the formula).

The throwback rule effectively allows a state in which a corporation produces goods or services to tax the profit on any sales made by the corporation into states in which the corporation has insufficient presence to be subjected to a tax on its profit from those sales. Including D.C., 31 states in the nation issue the "throwback rule" to avoid such loss of corporate income tax. Alabama and Mississippi are the only two southeastern states that apply the "throwback rule".

KEY ISSUES & RECOMMENDATIONS

Evaluate Benefits of Corporate Income Tax

Public discussion has recently focused on the elimination of the state corporate income tax for several reasons. The tax inserts a number of distortionary factors into the economy, affecting firm location, investment, and hiring decisions. State corporate tax revenues accounted for only 2.1% of total general fund revenues in South Carolina in FY 2009-2010 and have been widely variable over the past decade. While an estimated 89% of filers have no corporate tax liability, a small percentage qualify for very large tax credits that are increasingly being built up and carried over from year to year, reducing future corporate revenues.

At the same time, South Carolina's corporate tax burden is currently one of the lowest in the nation. Its business climate is consistently ranked as one of the highest in the nation, and industry recruitment leads other southeastern states for 2008 and 2009.[2] While benefits will certainly accrue to the economy due to the elimination of the corporate income tax, the magnitude of these benefits would need to be estimated using detailed data to establish how substantial the effect would be.

Finally, although the time and cost for firms to prepare tax filings and for the state to administer the corporate tax system and its network of tax credits is unknown, investigation of this amount may

1 These states are: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, and West Virginia.

2 Source: SC Department of Commerce

be worthwhile, particularly given the small revenues attributed to it.

Taxed Versus Pass-Through Entities

In 2006, the income tax rate of pass through entities was reduced in increments of 0.5% per year to a rate of 5% by 2009. This change was intended to provide tax parity between large C-corporations, who were taxed as an entity at 5% before profit distribution, and small businesses whose profits are taxed as Schedule C income on individual income tax returns. As a result of this change, individual filers of income reported on Schedule C of form SC-1040 pay income tax at a lower rate (5%) than filers who report income from W-2 wages or dividends (7% for taxable income over $13,350). Furthermore, pass-through entities, by definition, are not taxed, whereas C-corporations are. Thus, shareholders in C-corporations must pay the 5% corporate tax on profits of the entity, followed by individual income tax on dividend distributions (7% for taxable income over $13,350). Even if the shareholder is an employee and can take most of the earnings in the form of W-2 wages, those are still taxed at the higher 7% rate.

Facilitate Combined Reporting of State Corporate Income Taxes

If the corporate income tax is to remain a factor in state revenues going forward, combined reporting can facilitate higher compliance and revenues. Multi-state corporations face different tax laws in different states. As a result, more states are requiring combined reporting of state corporate income, in which all income of a company, regardless of in which state it was earned, is reported on a single combined form.

Combined reporting prevents the use of transfer pricing to shift profits from one state to another by altering the prices of goods sold from one subsidiary to another. Additionally, it prevents use of holding companies, PICs, or REITs that may be established as a subsidiary in a state with no tax to shift profits from one state to another. Currently, 21 states require combined reporting.

Because the single sales factor (SSF) generally favors one type of company over another (in this case, goods-producing companies with large amounts of in-state property and employees but with a high percentage of out-of-state sales), a more balanced mechanism for apportionment may provide more equity among firms and efficiency for the state economy. Also, the disincentives presented by the SSF for firm location decisions (e.g.- discourages companies with large in-state sales but no physical presence to locate in the state) would encourage a multi-factor formula.

Targeted Credits

While South Carolina's current network of multiple, targeted corporate tax credits encourages new investment by typically larger companies recruited to the state, it also sets up a competitive advantage for these firms over firms not receiving the credits (e.g.-smaller and/or established in-state companies). Alternatively, lowering taxes broadly stimulates investment and increases the value of all capital (not just new capital).

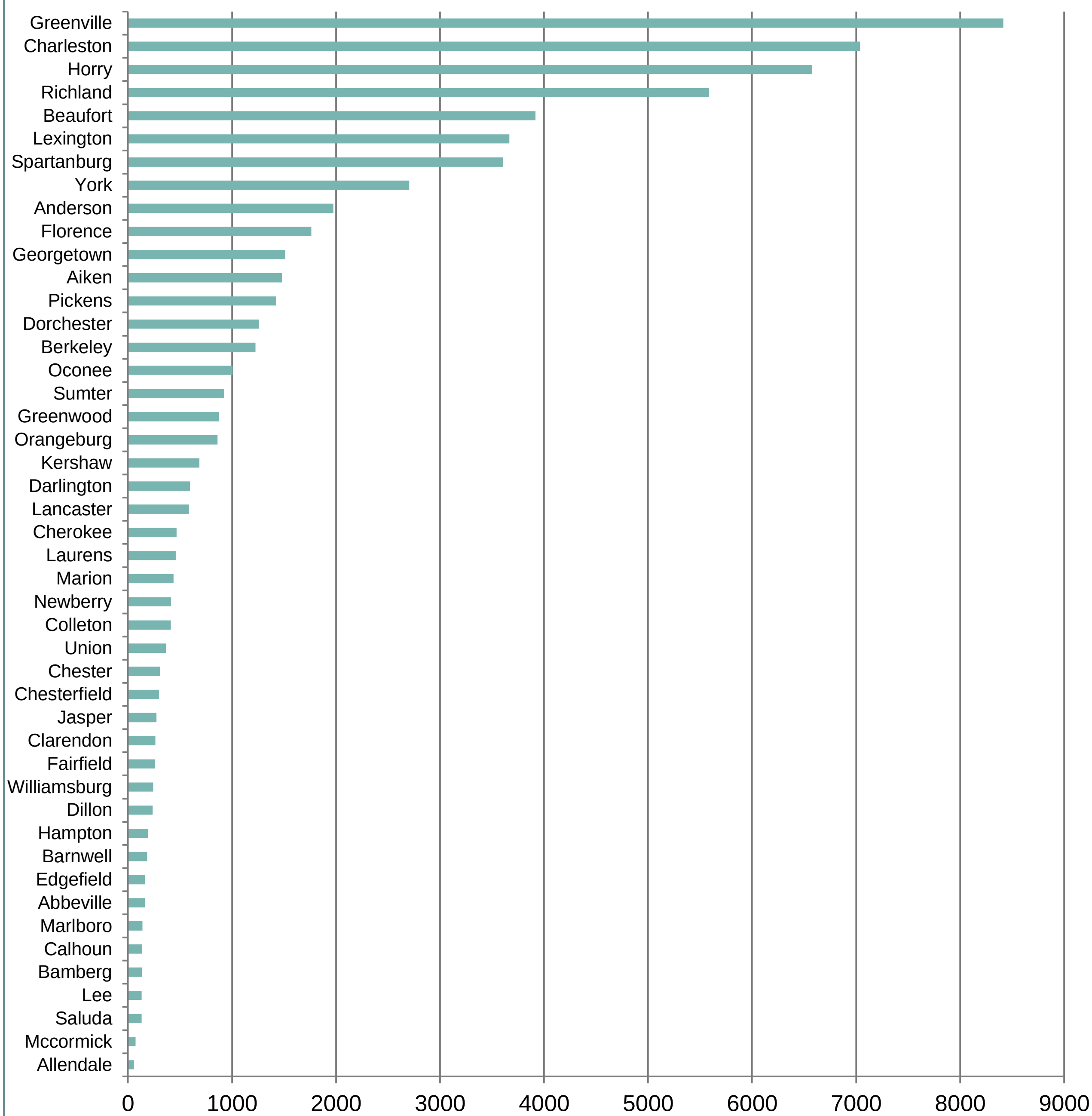
CONCLUSIONS

Overall, while the corporate income tax possesses distortionary features which affect the behavior of firms, South Carolina's corporate income tax rate is relatively low among all states, and is generally considered to maintain a competitive environment for business investment. The low level of annual corporate revenues, the variability of these revenues year-over-year, the small percentage of filers who have any liability, combined with the extensive number of targeted tax credits that are being rapidly built and carried forward, will continue to put downward pressure on the revenues attributed to the corporate tax system in South Carolina. In order to maintain a viable corporate tax going forward, an effort to close loopholes and reduce favored status through combined reporting and multi-factor apportionment should assist in promoting stability for the corporate income tax system.

APPENDIX

FIGURE A1

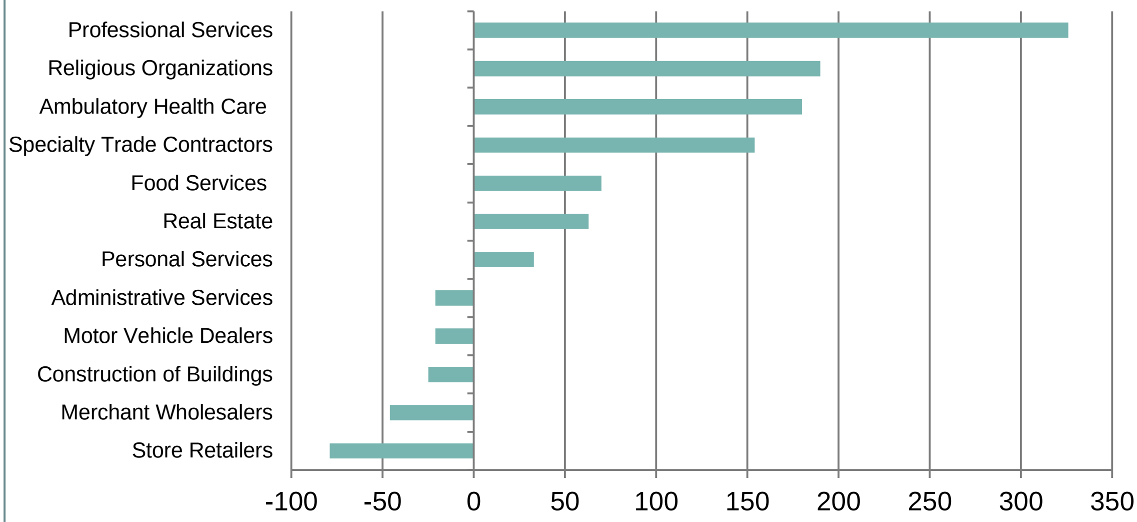
Number of Corporate Income Tax Filers by County, 2008



Source: South Carolina Departmetn of Revenue.

FIGURE A2

Change in Number of Filers by Industry, 2007 to 2008



Source: South Carolina Department of Revenue.

TABLE A1	State Corporate Tax Credits, FY 2007-2008	
Type of Credit Claimed	Returns	Amount
TC-Column A- Carry Over From Previous Year	175	$631,714,509
TC-1-Drip/Trickle Irrigation Systems	3	1,295,285
TC-2-Socio/Economic Disadvantaged Small Business	3	56,742
TC-3-Water Resources	1	82,500
TC-4SB-New Jobs Credit	102	36,581,029
TC-5-Scenic River	0	0
TC-6-Infrastucture	8	1,519,781
TC-7-Palmetto Seed Capital	0	0
TC-8-Corporate Headquarter	1	434,736
TC-9-Employer Child Care	0	0
TC-10-Base Closure	1	482
TC-11-Economic Impact Zone	84	20,772,039
TC-12-Family Independence Payments	12	71,739
TC 12A-Add. AFDC	6	17,262
TC-17-Recycling Property Tax	1	7,026,056
TC-18-Research Expenses	47	7,425,132
TC-19-Qualified Conservation Contribution	1	469
TC-21-Certified Historic Structure	1	77,477
TC-28-SC Quality Forum ***	3	1,158,981
TC-30-Port Cargo ***	2	53,144
TC-36-Industry Partnership Fund	1	500,000
TC-37-Toxicity Testing Credit ***	2	142,200
Total	**454**	**$708,929,563**