California Budget & Policy Center

ISSUE BRIEF

Why Aren't Large Corporations Paying Their Fair Share of Taxes and What Can California Policymakers Do About It?

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California's corporate taxes raise revenue that helps pay for the public services and infrastructure that enable businesses to exist and to profit in local communities and statewide. Corporations depend on high-quality schools to produce a dedicated and educated workforce and to help attract qualified employees. Corporations, like individuals, also benefit from a range of public services such as those provided by fire departments and the state judicial system that protect corporations' legal rights. Yet, profitable corporations are contributing less in taxes that support these public services, as a share of their California income, than a generation ago.

This *Issue Brief* shows how far corporate taxes have fallen as a share of corporate profits in California, explains several reasons for the decline, and points to inequitable policies that provide larger benefits to corporations that are thriving than to small businesses and Californians who are struggling to live and work in the state. By examining and limiting corporate tax policies that benefit multinational corporations and big businesses, California policymakers have an opportunity to advance a more equitable tax structure, raise revenue for critical services, and achieve a vibrant state and economy that serves more people.

Corporations Pay Far Less of Their Income in State Taxes Than a Generation Ago

The share of California corporate income paid in state taxes declined by more than half during the past four decades.[1] In the early 1980s, corporations that reported profits in California paid more than 9.5% of this income in state corporation taxes.[2] In contrast, corporations paid just 4.5% of their California profits in corporation taxes in 2018, the most recent year for which data are available. California's state budget would have received $13.3 billion more revenue in 2018 had corporations paid the same share of their income in taxes that year as they did in 1981 — more than the state spends on the University of California, the California State University, and student aid combined.

DID YOU KNOW?

- California's state budget would have received $13.3 billion more revenue in 2018 had corporations paid the same share of their income in taxes that year as they did in 1981.
- State corporate tax rates can be reduced with a majority vote of the Legislature, but increasing corporate tax rates requires a supermajority (two-thirds) vote of the Assembly and the Senate.

California Cut the State Corporate Tax Rate Twice Since the 1980s

Corporations pay less of their income in taxes today than they did in the 1980s in part due to the reduction of tax rates by state policymakers. Since increasing the corporate tax rate to 9.6% in 1980, the Legislature has cut the rate twice: from 9.6% to 9.3% in 1987 and from 9.3% to 8.84%, its current level, in 1997.[3] State corporate tax rates can be reduced with a majority vote of the Legislature, but increasing corporate tax rates requires a supermajority (two-thirds) vote of the Assembly and the Senate.

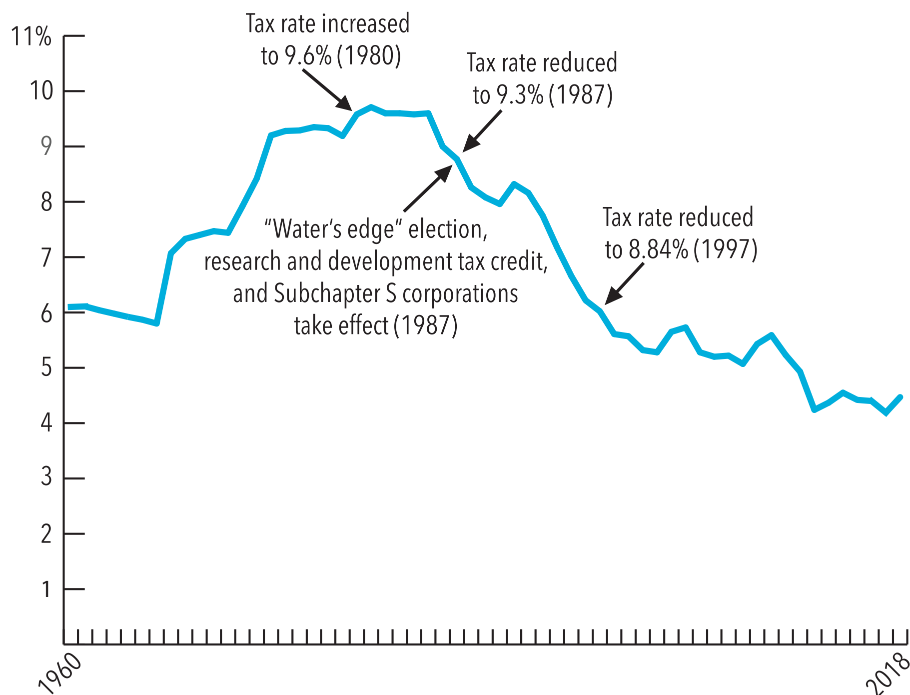
On top of the reduction in California corporate tax rates, the federal Tax Cuts and Jobs Act (TCJA), signed by President Trump in 2017, slashed the federal corporate income tax rate from 35% to 21%, the largest one-time reduction in US history. The TCJA also made several changes to federal tax law that benefit corporations. Altogether, the tax benefit to California corporate business owners from the TCJA was estimated to be more than $13 billion in 2018, according to the Institute for Taxation and Economic Policy.

Tax Breaks: A Key Reason Corporations Contribute Less of Their Profits Than in the 1980s

In addition to cutting tax rates since the 1980s, state policymakers have enacted several corporate tax breaks that reduce the share of income that corporations pay in California corporate taxes, and which restrict the revenue available for public services.

The Share of Corporate Income Paid in State Taxes Declined by More Than Half Between the Early 1980s and 2018

Corporate Taxes as a Percentage of Income for Corporations Reporting Net Income in California



Source: Franchise Tax Board

These tax breaks are sometimes called tax expenditures because they reflect decisions by California policymakers to spend dollars the state would otherwise receive in tax revenue. Unlike spending on programs that is deliberated during the annual state budget cycle, policymakers do not scrutinize most tax expenditures each year. Instead, these tax breaks quietly continue from year to year whether or not they achieve state policy objectives, such as helping meet the economic, health, and education needs of Californians.

The state's three largest corporate tax expenditures — the "water's edge" election, the research and development (R&D) tax credit, and Subchapter S corporations — were established in the late 1980s and account for $5.4 billion of the $6.6 billion the state is projected to spend on tax expenditures for corporations in 2020-21.[4] Beginning in 1987, California allowed multinational corporations to lower their tax liability by calculating their California income based on *either* their total income from worldwide

operations *or* only from their operations within the US. This so-called "water's edge" election will cost the state an estimated $2.6 billion in 2020-21. In 1987, state policymakers also established the state's R&D tax credit, which primarily benefits large corporations. This credit is intended to encourage businesses to conduct R&D in California instead of other states, but the extent to which this is occurring is unknown.[5] The R&D credit will cost the state an estimated $2.4 billion in 2020-21. The amount California spends each year on the R&D credit as well as the water's edge election is unlimited and no expiration date exists for either of the state's two largest corporate tax expenditures.

In 1987, California recognized Subchapter S corporations, another tax expenditure that has reduced the amount of corporate profits paid in state corporate taxes. In contrast to the 8.84% corporate tax rate, Subchapter S corporations face a tax rate of 1.5% or pay a minimum tax of $800, whichever is larger.[6] Income or losses of S corporations are passed through to their shareholders and taxed through the personal income tax.[7] Even after accounting for personal income tax payments made by S corporation shareholders, S corporations will cost the state an estimated $350 million in 2020-21.[8]

California Gives Corporations More Tax Breaks Than Low-Income Households

California spending on tax breaks for corporations far exceeds the amount the state spends on tax benefits for Californians with low incomes. In 2019, California spent $1.1 billion on the state's two largest tax credits targeted to Californians with low incomes — the California Earned Income Tax Credit (CalEITC) and the Young Child Tax Credit (YCTC). The CalEITC and YCTC benefited 6.3 million Californians in 2019 by boosting the incomes of families and individuals with annual earnings of less than $30,000, a large majority of whom are people of color.[9] One example of how tax credits, exemptions, and deductions

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could be more equitably targeted would be to increase the CalEITC, particularly for workers without dependents who receive very small credits and for undocumented Californians who are excluded from the federal Earned Income Tax Credit. The Legislature could pay for this increase by eliminating or reducing tax breaks for corporations that can afford to contribute more to state revenue that supports public services, infrastructure, and education for Californians.

Multinational Corporations and Big Businesses Benefit Most from Tax Breaks

Multinational corporations and big businesses are the primary beneficiaries of California's two largest corporate tax breaks — the water's edge election and the research and development tax credit. The water's edge election, California's largest business tax expenditure, is only available to multinational corporations, which puts smaller domestic businesses that are not able to take advantage of this tax break at a competitive disadvantage.

The vast majority of total spending — 82.5% — on California's research and development credit went to those with gross receipts of more than $1 billion in 2017, even though these businesses made up only 6.3% of those receiving the credit. Big businesses disproportionately benefitting from the state's R&D credit is mirrored by the disparity in corporate profits. Less than 1 out of every 100 corporations (0.4%) made $10 million or more in annual profits in California in 2018, yet this small share of corporations accounted for more than 60% of corporate profits statewide.[10] In contrast, more than 95 out of 100 corporations (96.6%) made less than $1 million in annual profits in California in 2018, which accounted for 21.2% of statewide profits.

While the COVID-19 pandemic and recession have caused many small businesses to fail or to lay off workers, the profits of many large corporations have increased during the past year. For example,

0.4%

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the profits of Amazon and Walmart increased 70% and 45% respectively in the first three quarters of 2020 as compared with the same period in 2019.[11]

The State Should Move to Graduated Corporate Tax Rates

Policymakers could boost state tax revenue by levying additional taxes on the small share of profitable corporations that generate the majority of corporate income in California. These highly profitable corporations can afford to contribute more to support public services that would help more Californians thrive. Policymakers could target these corporations by establishing graduated tax rates — which increase at specific income levels. By increasing tax rates on the most profitable corporations, California could advance equitable tax policy by generating more state tax revenue from corporations with high levels of income without impacting smaller corporations with less profits. Fourteen states impose such graduated corporate income tax rates. For example, New Jersey has four corporate income tax brackets, ranging from 6.5% for income up to $50,000 to 11.5% for corporate profits above $1 million. Had California increased its corporate tax rate by 1.16% on the very small share of corporations with $10 million or more in profits in 2018, the state could have boosted its tax revenue by approximately $1.6 billion, according to unpublished estimates from the Institute for Taxation and Economic Policy (ITEP).[12] Had the state boosted its corporate tax rate by 2.16% on these highly profitable corporations, California could have received about $3 billion in 2018, according to ITEP.[13] The additional revenue generated from increasing tax rates on corporations would not have affected 99.6% of businesses with annual profits below $10 million and only would have come from 0.4% of very profitable corporations that made 60% of corporate profits statewide in 2018.

$1.6 Billion

Had California increased its corporate tax rate by 1.16% on the very small share of corporations with $10 million or more in profits in 2018, the state could have boosted its tax revenue by approximately $1.6 billion, according to unpublished estimates from the Institute for Taxation and Economic Policy (ITEP).

Policymakers Can Choose Equitable Tax Policy Over Tax Breaks for Corporations

Corporations contribute less of their profits to programs supported by state taxes than a generation ago. Policymakers' decisions to cut corporate tax rates and expand tax breaks help explain why corporations are paying less than half the amount in *state* taxes, as a share of their income, than they did four decades ago. Corporations are also likely to pay far less of their income in *federal* taxes due to the federal Tax Cuts and Jobs Act (TCJA), signed by President Trump in 2017. The TCJA's reduction of the federal corporate income tax rate from 35% to 21% creates room for California to increase the state's corporate tax rate. Creating a graduated corporate tax could target the very small share of corporations that make up the majority of statewide corporate profits, some of which have seen those profits skyrocket during the pandemic, and advance equitable tax policy in this critical time for Californians. Moreover, because corporations can deduct state corporate taxes from their federal returns, any tax increase would reduce their federal tax liability.

Increasing the state's corporation tax rate on highly profitable businesses could help boost state tax revenue and support public services, infrastructure, and education for more Californians. Policymakers also have other options for ensuring that corporations pay their fair share in state taxes. This includes reviewing existing corporate tax provisions, such as corporate tax credits, exemptions, and deductions, and reducing or eliminating those that are not achieving the state's policy goals. By reducing spending on corporate tax breaks for corporations and big businesses, the state would have more resources available to support families with low incomes who are working but still struggling to make ends meet and to make investments in the people and services that help ensure that all businesses and Californians can thrive.

Increasing the state's corporation tax rate on a very small share of highly profitable businesses could help boost state tax revenue and support public services, infrastructure, and education for more Californians.

Endnotes

[1] California corporate income refers to state net income (SNI). SNI is the portion of a corporation's net income — generally, revenues minus expenses and other deductions — that is taxable by California.

[2] Corporations that report profits in California have positive state net income.

[3] Three separate taxes comprise California's corporation tax: the corporation franchise tax, the corporation income tax, and the bank tax. The majority of corporations taxed by California pay the corporation franchise tax rate of 8.84% or the minimum franchise tax $800, whichever is greater. Banks and financial institutions pay an additional 2.0% tax in lieu of property tax on equipment and other personal property and local business taxes.

[4] Department of Finance, *Tax Expenditure Report 2020-21*, 9, https://dof.ca.gov/Forecasting/Economics/Tax_Expenditure_Reports/documents/Tax_ExpenditureReport_2020-21.pdf. For a more detailed explanation of these and other tax expenditures, see Kayla Kitson, *Tax Breaks: California's $60 Billion Loss* (California Budget & Policy Center, January 2020), https://calbudgetcenter.org/resources/tax-breaks-californias-60-billion-loss/.

[5] Franchise Tax Board, *California Income Tax Expenditures: Compendium of Individual Provisions, Report for 2017 Tax Year Data*, 45.

[6] Subchapter S bank and financial corporations pay an additional 2.0% tax in lieu of property tax on equipment and other personal property and local business taxes.

[7] Subchapter S corporations may not have more than 100 shareholders.

[8] While California's maximum 12.3% personal income tax rate is higher than the 8.84% corporate tax rate, the net gain in personal income tax revenue from S corporation shareholders is less than the loss in corporate tax revenue that results from S corporations paying a tax rate of 1.5%. This is primarily because S corporation losses that flow through to its shareholders may be used to offset other types of income on their personal income tax returns, which reduces personal income tax revenue from S corporation shareholders.

[9] The 6.3 million Californians that benefit from the CalEITC and YCTC reflects the total number of tax filers, spouses, and dependents in the 3.9 million "tax units" that received these credits in tax year 2019.

[10] Corporations that make profits in California have positive state net income. If the 39.7% of corporations that reported either no income or net losses in California are added to the corporations with positive state net income in 2018, just 0.2% made $10 million or more in profits and this small share of corporations accounted for 89.3% of total statewide net income.

[11] Molly Kinder, Laura Stateler, and Julia Du, *Windfall Profits and Deadly Risks: How the Biggest Retail Companies are Compensating Essential Workers During the COVID-19 Pandemic* (Brookings Institution: November 2020), https://www.brookings.edu/essay/windfall-profits-and-deadly-risks/.

[12] ITEP estimates are based on Franchise Tax Board data and reflect tax rates of 10% for C corporations and 2.66% for S corporations that are not financial institutions as well as the additional 2.0% bank tax for financial corporations.

[13] ITEP estimates reflect tax rates of 11% for C corporations and 3.66% for S corporations that are not financial institutions as well as the additional 2.0% bank tax for financial corporations.

The Budget Center was established in 1995 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The Budget Center engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of Californians with low and middle incomes. General operating support for the Budget Center is provided by foundation grants, subscriptions, and individual contributions.