Business Income Taxes in Indiana: Who Pays?

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Corporate income tax revenues as a share of total tax revenues at the national level have declined over the past decade, as evidenced by a recent report by the federal General Accounting Office, which found that a majority of corporations reported no federal corporate income tax liability during the 1996–2000 period.[1] The large portion of corporations with no federal income tax liability has raised questions about business income taxes at the state level. A comprehensive analysis of business income taxes includes analyzing not only corporate income tax systems but also business income taxed through the individual income tax system.[2]

The examination of business income taxed through the individual income tax systems is particularly pertinent since new forms of business organization, such as limited liability companies (LLCs), and differential tax rates between corporate and individual tax systems have led an increasing number of businesses to be taxed under the individual rather than corporate tax system. In many states, business income taxes—just one of the taxes that businesses pay—are receiving greater scrutiny.

Under Indiana's current system, which was restructured in 2002, businesses paying taxes through the individual tax system face a 3.4 percent income tax rate while those paying through the corporate tax system face an 8.5 percent tax rate.

The following discussion examines business income from 2001 returns in both the corporate and individual income tax systems. (Bear in mind that the impact of Indiana's 2002 corporate income tax restructuring will first be reflected in the 2003 tax data, but this will not be available for analysis until the fall of 2005.)

The decrease in the corporate share of total tax collections at the state level has been linked to four causes:

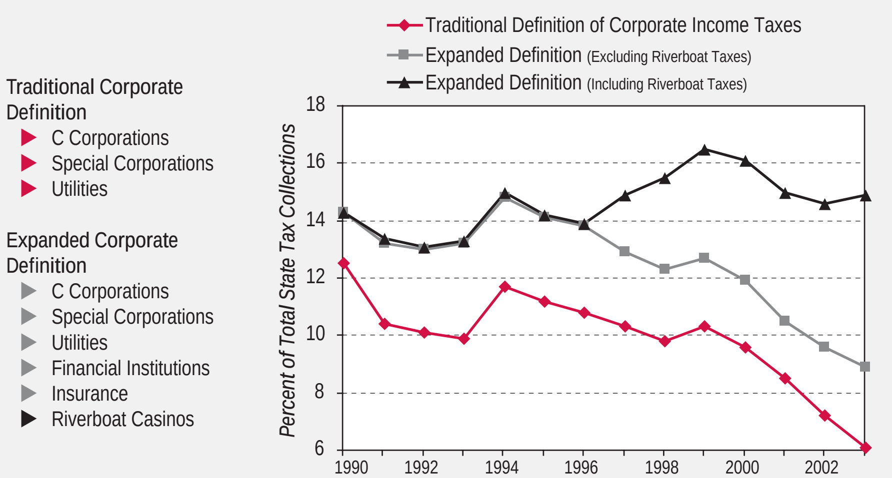
1. Cyclical declines in profits
2. Erosion of the federal corporate tax base
3. State policy decisions to decrease corporate tax burdens, including an increased use of deductions and exemptions
4. Aggressive corporate tax planning and increased use of tax shelters[3]

Corporate Income Taxes in Indiana

Traditionally, discussions of Indiana corporate income taxes refer to the gross income tax, corporate adjusted gross income tax, and the supplemental net income tax (SNIT). This narrow definition of corporate taxes (collected from C corporations, special corporations,[4] and utilities) shows that the share of corporate tax collections has decreased substantially over the past several years (see **Figure 1**).

However, when using a broader definition of corporate income that also includes financial institutions and insurance, the decline in the corporate share of total tax collections is less dramatic. Moreover, if one adds in the riverboat taxes that took effect in 1996, the corporate share of state tax collections is relatively stable.

Figure 1
Corporate Income Taxes as a Percent of Total Indiana Tax Collections, 1990 to 2003



Distribution of Corporate Tax Liability

In 2001, approximately 39,450 Indiana corporate income tax returns were filed: about 580 returns from financial institutions, 21,600 returns from C corporations, and 17,250 returns from special corporations.[5]

Just over 44 percent of these corporations had no income tax liability in 2001 (see **Table 1**). Almost 88 percent paid $10,000 or less in income tax; meanwhile, approximately 2.5 percent (1,000 corporations) paid almost 80 percent of the total corporate income tax liability (see **Figure 2**).

Multistate Corporations

While multistate corporations[6] represented about 35 percent of tax returns filed, these corporations paid about 83 percent of the total corporate income tax. As shown in **Figure 3**,

Table 1
Distribution of Corporate Income Tax Liability, 2001

Income Tax Liability	All Corporate Entities				Multistate Corporations				Indiana Only Corporations			
	Returns		Tax Liability		Returns		Tax Liability		Returns		Tax Liability	
	Number	Percent	Amount ($)	Percent	Number	Percent	Amount ($)	Percent	Number	Percent	Amount ($)	Percent
None (No Tax Liability)	17,471	44.3	0	0	3,471	24.9	0	0	14,000	54.8	0	0
$1 to $5,000	15,212	38.6	17,342,396	2.3	5,814	41.8	7,025,394	1.1	9,398	36.8	10,317,003	8.3
$5,000 to $10,000	2,003	5.1	14,254,076	1.9	1,074	7.7	7,729,793	1.2	929	3.6	6,524,283	5.2
$10,000 to $25,000	1,954	5	30,726,070	4.1	1,327	9.5	21,174,062	3.4	627	2.5	9,552,008	7.7
$25,000 to $50,000	1,053	2.7	37,276,970	5	787	5.7	28,039,221	4.5	266	1	9,237,749	7.4
$50,000 to $100,000	755	1.9	54,081,322	7.2	613	4.4	43,807,359	7	142	0.6	10,273,963	8.2
$100,000 to $250,000	567	1.4	88,566,390	11.8	447	3.2	69,992,906	11.2	120	0.5	18,573,484	14.9
$250,000 to $500,000	220	0.6	76,413,540	10.2	191	1.4	66,812,869	10.7	29	0.1	9,600,670	7.7
$500,000 to $1 Million	123	0.3	82,954,798	11.1	115	0.8	77,550,289	12.4	8	0	5,404,508	4.3
Over $1 Million	91	0.2	347,086,130	46.4	79	0.6	301,872,649	48.4	12	0	45,213,481	36.3
Total	39,449	100	748,701,692	100	13,918	100	624,004,542	100	25,531	100	124,697,149	100

Calculating Tax Liability

Corporate Income Tax System

The calculation of corporate income tax liability in most states (including Indiana) begins with federal corporate taxable income and then allows for some additions and subtractions. A decrease in the federal corporate tax base, either as a result of federal policy changes, tax planning by corporations, or increased use of tax shelters will decrease state corporate tax bases and state corporate tax revenue.

Individual Income Tax System

When looking at business income in the individual income tax system, various sources of business income are documented on the federal return (Form 1040) and its various schedules as components of federal adjusted gross income (FAGI). In twenty-six states, including Indiana, the starting point for computing the state individual income tax is FAGI.[7] Components of FAGI reported on Form 1040 include net income and net losses (gross receipts less total expenses) from sole proprietorships, farms, partnerships, S corporations, real estate mortgage investment conduits (REMICs), rental real estate, royalties, capital gains, and dividends.

Taxable income includes not only business income from the sources described above but also wage and salary income, interest income, and Social Security. Indiana taxable income is equal to FAGI plus addbacks of federal deductions not allowed by Indiana, minus Indiana deductions and exemptions. The taxpayer's gross tax liability is computed on taxable income and then tax credits are applied.

more than twice as many corporations with only Indiana locations (54.8 percent) had no tax liability relative to multistate corporations (24.9 percent).

In both cases, a small number of corporations paid the bulk of corporate income taxes. For multistate corporations, 385 corporations paid just over 70 percent of the total corporate income tax liability. For corporations with only Indiana locations, 311 corporations paid approximately 70 percent of total corporate income tax liability.

Business Income on Individual Returns[8]

Over one million Hoosier individual income tax returns included at least one type of business income, representing about 33 percent of all individual income tax returns filed in the state for 2001. (Note: many returns report more than one form of business income.) Returns with dividend income were most numerous at 574,008, followed by returns with capital gains or losses, totaling over 504,000 (see Figure 4).

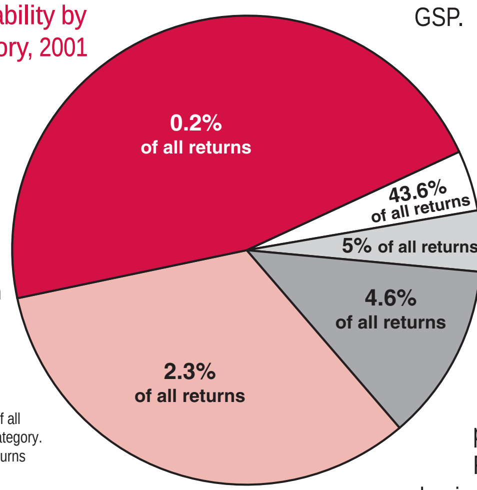
Net income from sole proprietorships, partnerships, S corporations, rent, and royalties totaled about $10 billion in 2001, or about 5.3 percent of gross state product (GSP).[9] Over half (about $5.5 billion) was generated by partnerships and S corporations, with sole proprietorships generating approximately $3.7 billion. Net income from capital gains and dividends totaled $5.6 billion, or 2.9 percent of GSP.

The average net income from these businesses is quite different (see Figure 5). Partnerships and S corporations generated an average of about $63,000 in net income per return, while dividends generated just $2,800 per return.

For each type of business activity, the frequency of returns reporting a

Figure 2
Total Corporate Liability by Distribution Category, 2001

Income Tax Liability
- $1 to $10,000
- $10,000 to $25,000
- $25,000 to $100,000
- $100,000 to $1 Million
- Over $1 Million



*Graph labels show the percent of all returns falling into each liability category. The remaining 44.3 percent of returns had no tax liability.

net loss, as well as the absolute magnitude of total net losses reported, were substantially lower than for returns reporting net income. Net capital losses totaled around $283 million, while net losses from sole proprietorships, partnerships, S corporations, rent, and royalties totaled about $1.4 billion. Over half of that amount (about $739.4 million) was generated by partnerships and S corporations.

As would be expected, the proportion of returns containing net income and net losses from farming is fairly small. Farm income was the only category in which the number of returns containing net losses exceeded the number containing net income (33,028 to 22,482). Net income and net losses reported from farming were almost equal at $318.7 million and $304.9 million, respectively.

Share of Individual Income Tax Revenue Attributable to Business

Indiana's taxable income was approximately $105.8 billion for 2001. **Figure 6** shows the share of taxable income attributable to each business category. Taxable income from partnerships and S corporations were the largest portion of Indiana taxable income at 5.2 percent for 2001. In comparison, taxable income from capital gains comprised the largest share at 5.9 percent in 1999—not surprising considering the economy was still expanding.

Individual adjusted gross income tax revenue was approximately $3.58 billion in 2001, so the share of tax revenue paid by business was approximately $540 million (or 15 percent). This represents less than one percent of GSP and about 6 percent of state operating revenue for the 2001 fiscal year.

Income Distribution of Tax Filers Reporting Business Income

The distribution of Indiana taxable income for returns that include at least one form of business income for 2001 is positively skewed, with the preponderance of returns falling at or below $50,000 in taxable income. The amount of taxable income on the average tax return was $58,000 in 2001. Of the one million returns with business income filed in that year, 61.1 percent had taxable income of $50,000 or less, 88.7 percent had taxable income of $100,000 or less, and 98 percent had taxable income of $250,000 or less.

Figure 3
Distribution of Income Tax Liability for Multistate and Hoosier Corporations, 2001

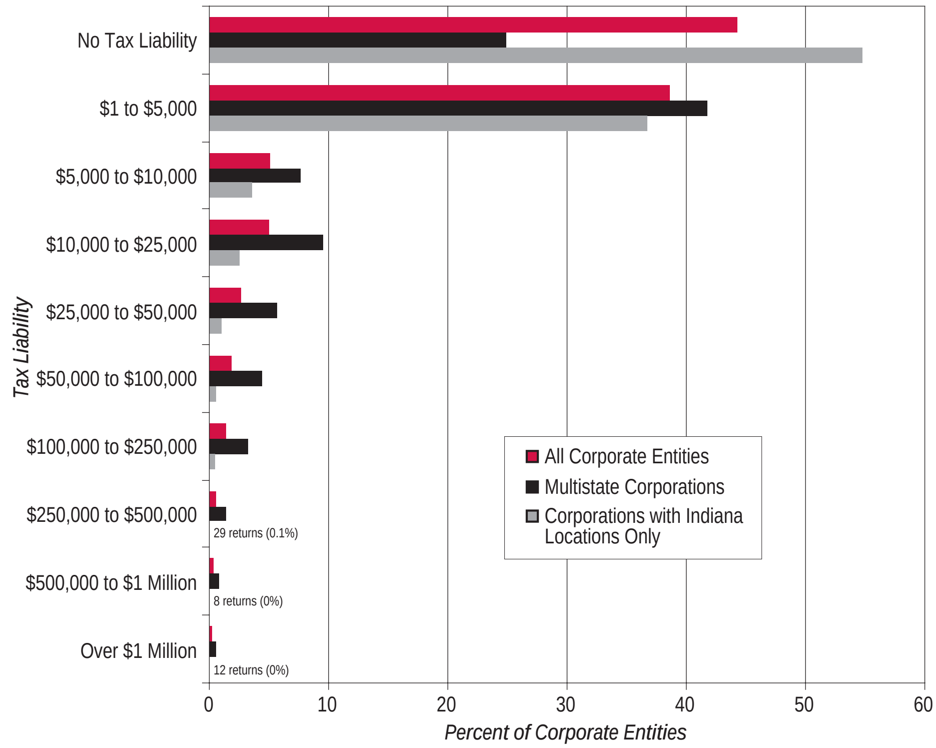
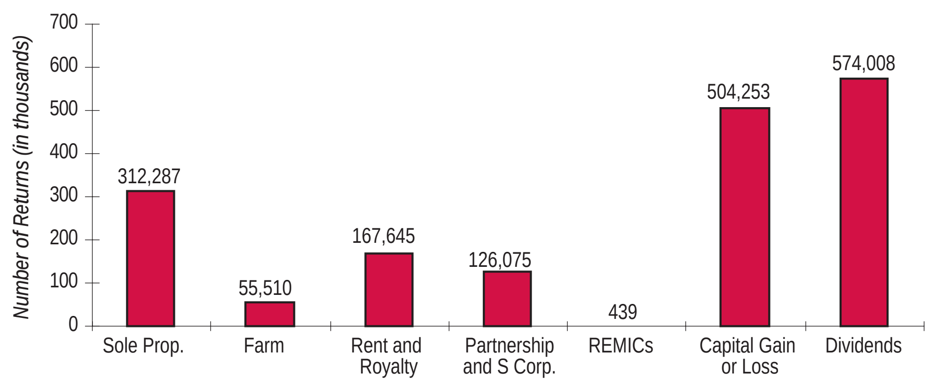
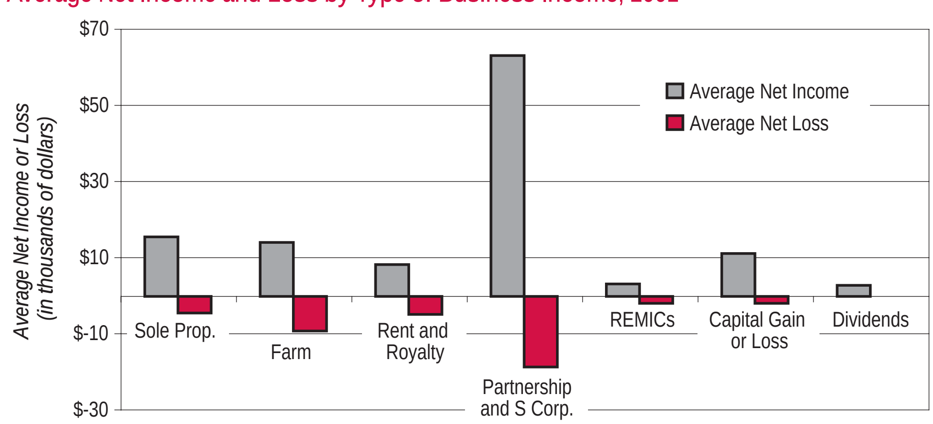


Figure 4
Individual Income Tax Returns with Either Business Income or Loss, 2001*



* Returns reporting more than one type of income are shown in the totals for each type of income they reported.

Figure 5
Average Net Income and Loss by Type of Business Income, 2001



Summary

Three questions are commonly asked regarding state business income taxes:

1. How much business income is taxed through the individual income tax system?
2. What portion of corporations have no state corporate income tax liability?
3. What is the distribution of corporate income tax liability among corporations?

This analysis has sought to address each of these questions and a few closely related issues using data from 2001. Approximately 15 percent of the income taxed through the individual income tax system is business income. Just over 44 percent of corporate income tax returns have no corporate income tax liability, while 2.5 percent of corporations pay approximately 80 percent of the corporate income tax collections. Finally, multistate corporations pay the bulk (approximately 83 percent) of corporate income tax collections. ◂

Endnotes

1. General Accounting Office, *Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000*. GAO 04-358 (February 2004).
2. Forms of business organization taxed under individual rather than corporate income tax systems include sole proprietorships, partnerships, and S corporations (corporations where income and expenses are divided among, and passed through to, their shareholders. The shareholder reports the income and expenses on their own income tax returns).
3. For a more detailed analysis, see: LeAnn Luna and William F. Fox, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal* (September 2002): 491–508.
4. C corporations pay taxes on their earnings, then each shareholder pays taxes separately on his or her share of the dividends. Special corporations could file as S corporations through the individual income tax system but choose to file through Indiana's corporate tax system because of certain tax advantages. Special corporations were eliminated during the 2002 tax restructuring.
5. Corporate income tax returns in Indiana are IT-20 for C corporations, FIT-20 for financial institutions and IT-20SC for special corporations. In addition, over 124,000 information returns were filed for partnerships and S corporations using IT-65 and IT-20S returns and are not included in the analysis. Analysis of tax liability among Indiana corporate income tax returns is based on the number of corporate returns available in Legislative Services Agency (LSA) databases as of May 2004.
6. Corporations that apportion income are considered multistate corporations.
7. See the Federation of Tax Administrators' website: www.taxadmin.org.
8. All calculations used in this analysis are based on data available in LSA databases through December 2003.
9. Gross state product is the value added in production by the labor and property located in a state. It is often considered the state counterpart to the nation's gross domestic product.

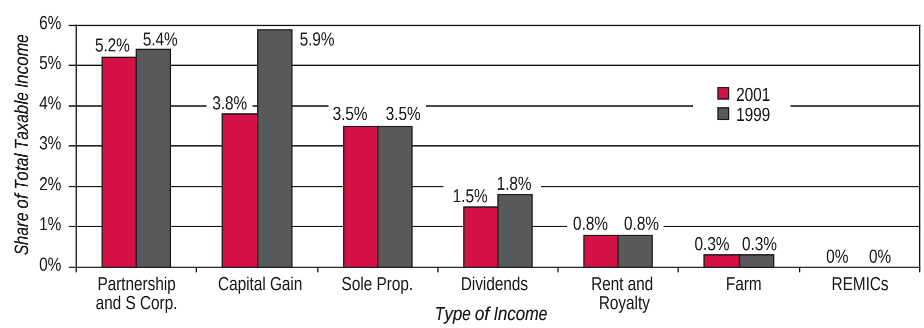
Indiana's Tax Restructuring of 2002

Corporate income tax data for 2003, which will begin to reflect the changes from tax restructuring, will not be available for analysis until the fall of 2005. With the 2002 tax restructuring, the gross income tax and the supplemental net income tax (SNIT) were repealed, and beginning in 2003, a corporate adjusted gross income tax (AGI) was put in effect with a tax rate of 8.5 percent. The individual AGI tax rate is 3.4 percent, so businesses that pay taxes through the individual income tax system (sole proprietorships, partnerships, and S corporations) pay a lower tax rate than corporations. The following table shows the 2001 and current tax rates for various types of businesses in Indiana:

Type	2001	Current
Corporations	Gross income tax rate: 0.3% or 1.2% depending on industry	AGI tax rate: 8.5%
	AGI tax rate: 3.4%	
	SNIT rate: 4.5%	
Financial Institutions	AGI tax rate: 8.5%	AGI tax rate: 8.5%
Insurance	Premium tax: 1.9% of net premiums*	Premium tax: 1.7% of net premiums*
	Fire insurance tax: 0.5% of net premiums	Fire insurance tax: 0.5% of net premiums
Utility Receipts	Gross income tax rate: 1.2%	Gross receipts rate: 1.4%
Riverboat Taxes	Admission tax: $3 per admission	Admission tax: $3 per admission
	Wagering tax: 20% of adjusted gross receipts	Wagering tax: 22.5% of adjusted gross receipts -OR- A graduated rate schedule ranging from 15% to 35% if the boat implements flexible scheduling
Businesses in the Individual Income Tax System	AGI tax rate: 3.4%	AGI tax rate: 3.4%

* In 2000, an incremental decrease in the insurance premium tax began from its former level of 2 percent to 1.3 percent in 2005.
Source: *Indiana Handbook of Taxes, Revenues, and Appropriations*, 2001 and 2003.

Figure 6
Business' Share of Taxable Income in the Individual Income Tax System, 1999 and 2001



For a more detailed analysis of these issues, see the Legislative Services Agency briefs, *The Corporate Income Tax in Indiana* and *Business Income Subject to Indiana's Individual Income Tax,* available at www.in.gov/legislative/.