HOW CORPORATIONS ARE TAXED

HISTORY AND TAX CALCULATION

Although commonly referred to as "corporate income tax," corporations are subject to either the corporate excise tax or the corporate income tax.

Corporations doing business in Oregon pay the **excise tax**. Doing business means any transaction or transactions in the course of a corporation's activities conducted within Oregon. A corporation is doing business when it engages in any profit-seeking activity in the State of Oregon. Corporations not doing business in Oregon but with income from an Oregon source pay the **income tax**. Most corporations pay the excise tax.

Current tax law also treats corporations differently according to their organizational structure. For example, C corporations pay corporate excise or income taxes on their income, while the income of S corporations passes through to shareholders who are then taxed under the personal income tax system. Upcoming sections of this report discuss these distinctions in greater detail.

History

Oregon began taxing corporate net income in 1929, the same year that the state began taxing personal income. The state initially enacted these taxes to offer relief from property taxation. The 1929 law states that "…the revenue derived from the tax shall reduce by corresponding amount the direct tax levy which the tax commission would otherwise apportion to the several counties of the state" (*Corporation Excise of 1929*, Oregon Laws 1929, Chapter 427, sec. 23).

Legislation enacted in 1951 broke this explicit tie to the property tax. From that time forward, revenues from the corporate tax have contributed to the General Fund for general appropriations.

Tax Calculation

Below is a basic description of the calculation of taxes for corporations subject to the Oregon corporation excise or income tax. Because the corporate tax program is complex, not every detail is presented here. Instead, this discussion focuses on the major components of the computation of this tax. Exhibit 1.1 provides a flowchart of this computation that will be discussed below. For additional information, please refer to the Oregon Department of Revenue's Corporation Tax Forms and Instructions available on the department's Web site: http://egov.oregon.gov/DOR/BUS/forms-corporation.shtml.

Starting Point: Federal Taxable Income

Oregon's definition of taxable income for corporations begins with federal taxable income. Federal taxable income is essentially gross income minus the costs of doing business such as salaries, repair and maintenance, employee benefit programs, and depreciation. The Oregon corporate return modifies federal taxable income through additions and subtractions.

Additions

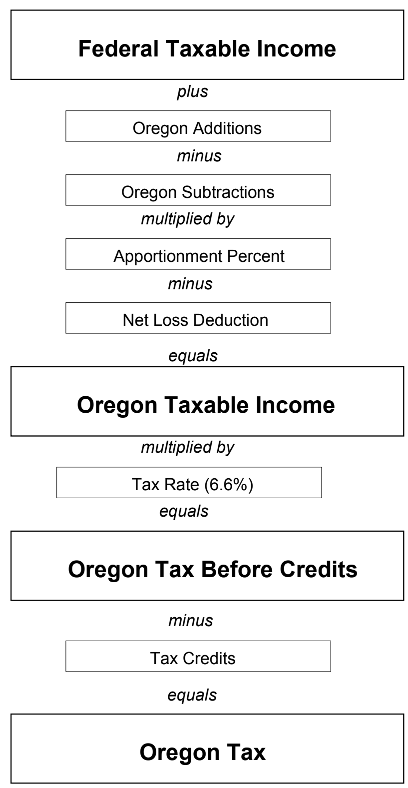
Additions are sources of gross income that are taxable in Oregon but not by the federal government or deductions allowed under federal law but not allowed under state law. Some common Oregon additions include state or municipal interest income, and Oregon excise tax or other state taxes measured by net income or profits.

Subtractions

Subtractions are sources of gross income that are taxable at the federal level but not by Oregon, or deductions allowed by state law but not allowed under federal law. Subtractions include dividend deductions and land donations to school districts.

Additions and subtractions may be any number of adjustments necessary to arrive at the appropriate bottom-line Oregon income.

Exhibit 1.1
Components of the Oregon Corporate Tax



Apportionment of Business Income

For the purposes of state taxation, the income of corporations that conduct business exclusively in Oregon is taxed only by Oregon. Corporations doing business in more than one state must determine the share of their income attributable to Oregon activities. For these corporations, tax year 2003 income is apportioned to Oregon by a three-factor formula.[1] The factors used in this formula are: Oregon payroll relative to total payroll in all states, Oregon property relative to total property in all states, and Oregon sales relative to total sales in all states. An Oregon percentage is calculated for each of these factors and these three percentages are weighted to determine an overall apportionment percentage.

Prior to tax year 1991, Oregon used equally weighted property, payroll, and sales factors when apportioning income for multistate corporations. In 1991, Oregon switched to a double-weighted

[1] The apportionment formula described here is used for most corporations. Certain wood products companies are required to continue using a double-weighted sales formula. Utilities and Telecommunications companies may elect to use a double-weighted sales formula. These two exceptions are described in more detail in the *State of Oregon 2005-07 Tax Expenditure Report*, which is available at http://egov.oregon.gov/DOR/STATS/exp05-07-toc.shtml. As noted in Section 1C, insurance companies that use Oregon Form 20-INS use an equally weighted three-factor formula.

sales factor. For tax years that began before May 2003, the sales factor was “double-weighted” to arrive at the apportionment percent. For 2003, tax years after May 2003 generally used super-weighted sales (i.e. the apportionment percent was 80 percent of the sales factor plus 10 percent each of the property and payroll factors). Tax years starting in July 2005 use only corporations’ Oregon sales relative to sales in all states to determine apportionment. Refer to Exhibit 1.2 for a table summarizing the changes to apportionment.

Exhibit 1.2—Contribution of Factors to Apportionment Percentage

	Property	Payroll	Sales
Three factor (pre-1991)	33%	33%	33%
Double-weighted sales (1991)	25%	25%	50%
Super-weighted sales (2003)	10%	10%	80%
Single sales factor (2005)	0%	0%	100%

The movement toward a single sales factor will reduce Oregon taxes for those companies with significant property and payroll within Oregon but with most of their sales outside the state. Taxes will increase for out-of-state companies with sales in Oregon but with small shares of property and payroll in the state.

Allocation of Nonbusiness Income

Income that does not arise from the regular activities of a taxpayer’s trade or business is not apportioned using the apportionment formula, but is instead allocated to a specific state. This income, known as nonbusiness income, is generally allocated to the state where the income producing activiy occurs. For instance rental income or loss that is not associated with the taxpayers regular business would be assigned to the state where the rental takes place. Nonbusiness income from intangible assets is assigned to the state of the taxpayer’s headquarters.

Net Loss Deduction

Apportioned losses carried forward from prior years may reduce a corporation’s current-year taxable income. Oregon law allows an operating loss to be used to offset future tax liability for up to 15 years. Oregon law does not allow operating losses to offset past tax liability. Capital losses may be used to reduce the amount of capital gain income taxed by Oregon. Capital losses may be carried back up to three years, or carried forward up to five years.

Taxable Income and Tax Before Credits

Oregon taxable income is what remains after applying apportionment and allocation and then subtracting losses. Multiplying Oregon taxable income by the tax rate produces tax before credits. The tax rate has changed a number of times since corporate tax was introduced in 1929, with rates ranging from 5 to 9 percent. The current rate is 6.6 percent, where it has been since its 1987 reduction from 7.5 percent. Exhibit 1.3 on the following page provides a history of Oregon corporation tax rates.

Exhibit 1.3—Corporate Tax Rates, 1929 to Present

Year	Tax Rate	Type of Corporation
1929	5.0%	All Corporations
1932	8.0%	All Corporations
1955	4.0%	All Corporations
1957	6.0%	Regular Corporations
	7.0%	Public Utilities
	9.0%	Financial Corporations
1959	6.0%	Regular Corporations
	6.0%	Public Utilities
	9.0%	Financial Corporations
1963	6.0%	Regular Corporations
	6.0%	Public Utilities
	8.0%	Financial Corporations
1976	6.5%	Regular Corporations
	6.0%	Public Utilities
	6.5%	Financial Corporations
1977	7.0%	All Corporations
1978	7.5%	All Corporations
1987	6.6%	All Corporations

Credits

A corporation can claim any of over 35 applicable credits to reduce its Oregon tax liability. None of the credits is refundable, but most allow unused credit amounts to be carried forward and used in later years. See pages 3-8 to 3-11 of this report for information on credit usage by C corporations. The *State of Oregon 2005-07 Tax Expenditure Report* also provides a thorough discussion of corporate tax credits. The report is available on the Internet at www.oregon.gov/DOR.

Oregon Tax

A corporation's net tax liability is the result of subtracting credits from the tax liability before credits. When established in 1929, the corporation excise tax included a minimum tax of $25. The 1931 Legislature decreased the minimum excise tax to $10, its current level. There is no minimum income tax.

The taxation of S corporations varies from this structure because nearly all income of S corporations is passed on to the corporation's shareholders and taxed as personal income. The taxation of insurance corporations also varies from this structure. Insurance corporations use different definitions and application of apportionment factors and a different computation of taxable income which is based on their annual statement filed with the Oregon Insurance Commisioner. See Section 1B for more information on S corporations and Section 1C for additional information on insurance corporations.

For further information, please refer to Oregon Department of Revenue's *Corporation Excise Tax Form 20,* and *Corporation Income Tax Form 20-I* and their respective instructions. The forms and instructions are available at www.oregon.gov/DOR.

Certain corporations are known as "pass-through" entities because their income (or loss) passes through to the individual shareholders and is then taxed as personal income. These S corporations (so named because of the section in the IRS Code describing them) must be U.S. corporations subject to certain limitations. S corporations must have:

- One class of stock;
- No more than 75 shareholders;
- Only U.S. citizens or residents as shareholders; and
- Only individuals, estates, or certain trusts as shareholders.

In exchange for these limitations, the S corporation receives certain tax advantages. A regular, or C corporation, pays taxes on income first at the corporate level. This income is taxed again when individual shareholders receive it as dividends. An S corporation avoids this double taxation because the income is not taxed at the corporate level. Oregon accepts the S corporation election made for federal purposes and allows the corporation to function as a pass-through entity.

The number of S corporations has been steadily increasing in recent years. For tax year 1990, 18,437 S corporations filed returns in Oregon. For tax year 2003, there were 45,723 S corporations that filed returns.

S corporations generally pass their income through to their corporate owners. As a result, relatively few S corporations have income that is subject to Oregon's corporate tax. This type of income generally occurs when a corporation converts from a C corporation to an S corporation.

S corporations that are paying either the income or the excise tax file Oregon tax Form 20-S. The excise minimum tax is $10, which most S corporation filers pay.

For additional information, please refer to Oregon Department of Revenue’s S Corporation Tax Instructions, Form 20-S.

Prior to 1997, foreign (out-of-state) insurers paid a retaliatory tax and gross premiums tax instead of the corporate excise tax. In response to legal challenges by foreign insurers, the 1995 Legislature enacted laws that made both foreign and domestic insurers subject to the same taxes. Starting with tax year 1997, all foreign and domestic insurance corporations have been subject to the corporate excise tax. Insurers file Form 20-INS.

For tax years beginning on or after January 1, 1997, and before January 1, 2002, Oregon law required foreign insurers to pay a transition tax to the Department of Consumer and Business Services (DCBS) as the gross premiums tax was being phased out. For tax years after 2001, foreign insurers are no longer subject to the transition tax, but they still are subject to the retaliatory tax that is paid to DCBS.[2] The excise tax is paid to the Department of Revenue. Oregon requires insurance companies to file their excise tax returns on a calendar-year basis.

Insurers use a three-factor apportionment formula. The three factors used for 20-INS filers are: the Oregon share of real estate income and interest relative to total real estate income and interest, the Oregon share of wages and commissions relative to total wages and commissions, and the Oregon share of insurance sales (total premiums written) relative to the total insurance sales. All three factors are weighted equally to produce the overall apportionment percentage.

Title insurers file Form 20 instead of Form 20-INS and use the same apportionment factors as most other corporations.

For additional information, please refer to Oregon Department of Revenue's Insurance Excise Tax Instructions, Form 20-INS.

[2] The retaliatory tax is a comparison of the taxes, fees, assessments, penalties, and fines that an Oregon company would pay in the foreign state to the taxes, fees, assessments, penalties, and fines that the foreign insurer actually pays in Oregon. If another state heavily taxes Oregon insurance companies that do business in that state, the retaliatory tax applies that level of tax to the foreign state's companies that do business in Oregon.