How does the corporate income tax work?

The United States imposes a tax on the profits of US resident corporations up to a maximum rate of 35 percent. The corporate income tax is the third largest source of federal revenue, after the individual income tax and payroll taxes, and raised $320.7 billion in fiscal 2014.

The United States taxes the profits of US resident corporations at graduated rates ranging from 15 to 35 percent. Most corporate income is taxed at the maximum rate.

Taxable corporate profits are equal to a corporation's receipts less allowable deductions—including the cost of goods sold, wages and other employee compensation expenses, interest, nonfederal taxes, depreciation, and advertising. US resident multinationals pay tax on their worldwide profits, but tax on the profits of their controlled foreign subsidiaries is deferred until those profits are repatriated (that is, paid back as dividends) to the US parent corporation. To avoid double taxation, US multinationals may claim a credit for taxes paid to foreign governments on income earned abroad, but only up to their US tax liability on that income. US-based corporations owned by foreign multinational companies face the same US corporate tax rules on their profits from US business activities as do US-owned corporations.

The corporate income tax is an entity-level tax that applies to C corporations (named after the relevant subchapter of the Internal Revenue Code). Corporate profits can also be subject to a second layer of taxation at the individual shareholder level, both on dividends when distributed and on capital gains from sale of shares. The maximum tax rate on both dividends and capital gains is currently 23.8 percent (including the 3.8 percent tax on net investment income).

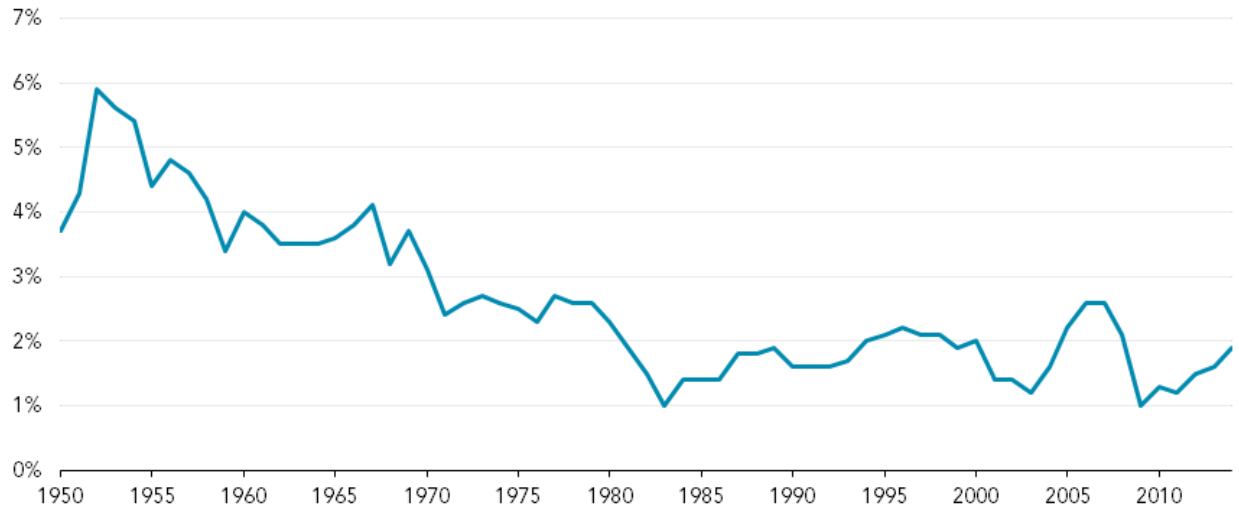
Many US businesses are not subject to the corporate income tax; rather they are taxed as "flow-through" entities. Flow-through businesses do not face an entity-level tax. But their owners must include their allocated share of the businesses' profits in their taxable income under the individual income tax. Flow-through entities include sole proprietorships, partnerships, and eligible corporations that elect to be taxed under subchapter S of the Internal Revenue Code (S corporations).

The corporate income tax is the third largest source of federal revenue, after the individual income tax and payroll taxes. It raised $320.7 billion in fiscal 2014, 10.6 percent of all revenue, and 1.9 percent of gross domestic product. The relative importance of the corporate tax as a source of revenue declined sharply between the 1950s and 1980s, but over the past quarter century it has brought in revenues equal to about 2 percent of gross domestic product (GDP), with some fluctuations mostly associated with the business cycle (figure 1).

FIGURE 1

Corporate Income Tax Revenue as a Share of GDP

FY 1950–2014



Source: Office of Management and Budget, Historical Table 2.3.

DATA SOURCE

Office of Management and Budget. Historical table 2.3. *Historical Tables.* "Receipts by Source as Percentage of GDP: 1934–2020."