



Ensuring All Corporations Pay Their Fair Share

Closing Loopholes in Pennsylvania's Corporate Tax System

Pennsylvania has a corporate net income (CNI) tax rate of 9.99%, although more than two-thirds of corporations doing business in the Commonwealth pay no tax, in large part because of loopholes in the law. Those who do pay the tax are often small Pennsylvania-based businesses. Consequently, the state's corporate tax system is unfair to some small businesses and leaves individuals paying a growing share of total state revenues.

"It is as if on the Pennsylvania Turnpike you have hung a sign that says welcome to Pennsylvania, pick our pockets because you have a very old rickety tax structure."

— Dr. Richard Pomp, University of Connecticut School of Law, May 10, 2007¹

Delaware Holding Company Loophole.

Large, multi-state corporations can use a variety of sophisticated "tax planning" techniques to lower their reported net income that is subject to Pennsylvania taxation. One such technique is the so-called Delaware holding company loophole. Here's how it works:

A corporation creates a subsidiary (known as a Passive Investment Company) that holds ownership of its trademarks and patents and is located in a state like Delaware, which doesn't tax royalties, interest, or similar types of intangible income. The tax-haven subsidiary then charges the Pennsylvania-based arm of the corporation for the use of a trademark or patent. That is a tax deductible expense for the Pennsylvania subsidiary, reducing any profits subject to state taxes.

Transfer Pricing

Another technique for shielding business income from Pennsylvania taxes is known as transfer pricing. In itself, transfer pricing is a legitimate way to represent economic activity between related companies. It should mirror what happens in the private market, but often it can be abused to move profit from one jurisdiction to another fairly easily.

Consider a company that owns oil drilling operations, refineries, pipelines, and even filling stations. Each of these different functions is usually set up as a separate company. As the products flow from company to company, they are bought and sold. The prices set internally can change how much income is received by each company – or within a specific jurisdiction. That allows entities to shift income to low- or no-tax states.

¹ Dr. Richard Pomp, University of Connecticut School of Law, Testimony before the Pennsylvania House of Representatives Committee on Finance, May 10, 2007, p. 86.



Combined Reporting Is the Best Way to Close These Loopholes.

It is time for Pennsylvania to join 23 other states in modernizing its out-of-date corporate tax system with the adoption of combined reporting.

Mandatory unitary combined reporting of business income would reduce the ability of multi-state corporations to use tax planning techniques to lower their reported net income that is subject to Pennsylvania taxation. Such techniques are not available to smaller businesses, especially those whose operations are limited to Pennsylvania.

While some states have tried to address tax shelters with targeted legislation, tax experts say that combined reporting is the best option. Targeted approaches can be costly, time-consuming and labor-intensive, and are sometimes vulnerable to legal challenges. Combined reporting closes the door fully to creative tax planning, and has been upheld by the U.S. Supreme Court.

How It Works.

Multi-state corporations often consist of a parent corporation and one or more subsidiary corporations. Combined reporting limits the ability of companies to use a variety of tax avoidance strategies to shift income to affiliated entities in states with lower or no taxes.

Under current law: Each subsidiary files an independent tax return based on the assumption it is a truly independent entity.

Under combined reporting: The parent and subsidiaries would file as a single unified entity, and income taxes would be assessed against state income from all of the businesses.

Why is Combined Reporting Necessary?

- **The current tax system is unfair to individuals and businesses.** Current tax loopholes create an unfair competitive advantage for multi-state companies, which benefit from public services but aren't paying their fair share of taxes.
- **The loss of revenue is considerable.** The Pennsylvania Department of Revenue estimates that closing corporate tax loopholes with combined reporting would generate \$616 million a year.
- **Half of states with corporate income taxes have adopted combined reporting.** Wisconsin recently became the 23rd state out of 45 with corporate taxes to do so.
- **There is little evidence that combined reporting hurts economic growth.** Economist Robert Lynch found that combined reporting has not interfered with the economic progress of states that employ it.²

² Robert G. Lynch, et. al., *Building A Strong Economy: The Evidence on Combined Reporting, Public Investments and Economic Growth* (Boston: Economic Policy Institute and Massachusetts Budget and Policy Center, 2007).