



# Ensuring All Corporations Pay Their Fair Share

## Closing Loopholes in Pennsylvania's Antiquated Corporate Tax System

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Corporations pay income taxes just like people do, but in Pennsylvania, tax loopholes allow many businesses to avoid paying taxes on their income. In fact, more than 70% of Pennsylvania corporations pay no income tax at all.

Large, multi-state corporations have an army of accountants who develop sophisticated “tax planning” techniques to avoid paying taxes on income they earn. Pennsylvania companies can’t use many of these tricks and gimmicks. This leaves homegrown companies and individuals to pay the freight for multi-state and foreign corporations.

*“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, 2007<sup>1</sup>*

### Many States Have Closed Corporate Tax Loopholes

In the past few years, states have been cracking down on businesses that game the system to avoid paying state taxes. Today a majority of states with corporate income taxes—23 in all—use something called combined reporting to ensure multi-state companies are paying their fair share.

Closing Pennsylvania’s corporate tax loopholes could bring in \$500 million dollar or more in new revenue each year, which could be used to pay for schools, hospitals, state parks and nursing homes.

The General Assembly is considering proposals that would close tax loopholes and use some of the money to reduce the corporate income tax rate and make other changes favorable to business. Still, a few big companies have been blocking this reform.

Many of these large Pennsylvania companies have subsidiaries in states that have closed the loopholes. In the wake of the recession, more states are looking at combined reporting to raise revenue and make the system fairer for local businesses. Pretty soon, Pennsylvania could find itself the only state losing revenue to a leaky corporate tax system.

### Favorite Loopholes Cost Pennsylvania Big Bucks.

One favored technique is the Delaware loophole. Here’s how it works: A corporation creates a subsidiary (known as a Passive Investment Company) in a tax-haven state like Delaware or Nevada. This subsidiary has no employees and is often nothing more than a post office box.

The corporation then transfers ownership of trademarks and patents to that Delaware-based subsidiary and makes the Pennsylvania company pay the Delaware company for use of the patent. This then becomes an expense for the Pennsylvania company, reducing its taxable income and its tax payments to the state.

It isn’t illegal, but it isn’t right. And it is used a lot. There is one address in Delaware, a modest one-story building, that is home to 14,000 of these subsidiaries.

Transfer pricing is another way companies shield business income. Transfer pricing in itself is a legitimate way for companies to keep track of the activities of their different parts, but it can be abused to move profit from one state to another.

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

For example, oil companies know how to take advantage of this loophole. A company like ExxonMobil has a different company to drill, refine, transfer and sell gas. One company buys the product from the other company. So a refinery can “sell” the gas at a higher price in a higher-tax state like Pennsylvania, making the profit smaller or even disappear altogether, even though the Pennsylvania company sells lots of gas and has lots of income here.

Without state action, big companies will continue to get away with these tax “planning” schemes.

### The Wal-Mart Example

Documents uncovered in a tax case show that accounting giant Ernst & Young and Wal-Mart have been working together for years to excessively cut Wal-Mart’s state tax bills, including in Pennsylvania, by using exotic accounting tricks.

Ernst & Young accountants concluded: *“The successful completion of this project will result in substantial state income tax savings to Wal-Mart... We don’t think there is much the state taxing authorities can do to mitigate the savings to Wal-Mart, however some states might attempt something if they had advance notification. We think the best course of action is to keep the project relatively quiet.”*<sup>2</sup>

### Combined Reporting Is the Best Way to Close These Loopholes.

It is time for Pennsylvania to modernize its out-of-date corporate tax system by adopting combined reporting.

While some states have tried to close specific tax shelters, tax experts say that combined reporting is the best option. Closing one loophole encourages companies to find a different loophole. Targeted approaches are also more vulnerable to legal challenges. Combined reporting slams the door on most tax-shifting schemes and has been upheld by the courts.

*Under combined reporting:* A parent company and all of its subsidiaries file as a single unified or “combined” company. Pennsylvania corporate net income tax would be assessed against income EARNED IN PENNSYLVANIA from all of the related businesses.

### Key Facts:

- **The current tax system is unfair to individuals and businesses.** 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. Combined reporting levels the playing field.
- **Combined reporting better reflects economic reality of corporate groups.** Companies operating in multiple states are often part of a group of companies controlled by a parent. Merging these related companies for tax purposes better represents their true economic activity as decisions are made by the parent company.
- **The status quo means considerable loss of revenue.** The state Department of Revenue estimates that closing corporate tax loopholes with combined reporting would generate \$616 million a year. These funds could lower the tax rate and provide needed funding for health care, education, and public safety services.
- **Half of states with corporate income taxes have adopted combined reporting.** Wisconsin recently became the 23<sup>rd</sup> state out of 45 with corporate taxes to do so. The companies most affected by the change, multi-state corporations, already file combined returns in other states where they do business. Small companies operating only in Pennsylvania would be unaffected.
- **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.<sup>3</sup>

<sup>2</sup> Ernst & Young, “Wal-Mart State Tax Project,” internal correspondence dated April 30, 1996.

<sup>3</sup> 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).