Analysis of Tax Code Bill
Small Steps Toward Reform But Special Tax Breaks Remain

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Overview

One of the final pieces of the 2013-14 budget package is a Tax Code bill (House Bill 465, P.N. 2211) that sets tax rates and makes permanent changes in tax law. The bill includes two very important provisions: 1) It maintains the capital stock and franchise tax, which was set to expire at the end of 2013, for two more years, and 2) For the first time, it takes steps to close the Delaware loophole — although not until 2015. These changes will provide some additional revenue to support schools, health care, and other critical state needs.

The bill, however, is filled with new special interest tax breaks for private aircraft owners, banks, gas drillers, satellite TV companies and wireless companies like Verizon and Sprint. These items were added at the last minute, in some cases with no public debate.

The tax bill has been approved by the House and Senate, and is now awaiting Governor Tom Corbett's signature.

Overall, it is expected to increase tax revenue by only $52 million in 2013-14 and $162 million in 2014-15 (with no measure on the future impact).[1] While this is a modest improvement, the bill leaves a great deal of money on the table and weighs the Tax Code down with more special interest tax breaks that will drain revenue for years to come.

Loophole Closing and Tax Reform

A Small Step Toward Closing Loopholes

After years of talk about corporate tax loopholes, this bill takes a small step forward, acknowledging that loopholes are a problem and should be closed, but taking only tentative steps to do so. The tax bill would close the "Delaware Loophole" by requiring corporations to "add back" to their income payments they have made to related companies in Delaware and other states to avoid paying Pennsylvania taxes. Three-quarters of states with corporate income taxes have passed laws to end this and other tax avoidance practices. Pennsylvania's new rules are loosely based on a Virginia law, itself one of the weakest in the nation, and is much weaker than laws in neighboring New Jersey and Maryland. The provisions do not go into effect until 2015 and are expected to generate $40 million to $60 million per year in revenue in 2015.

Capital Stock and Franchise Tax Extended But Still Cut

The capital stock and franchise tax (CSFT) has been extended for two more years under this plan, but the rates are quite low. Current law called for the tax to be completely eliminated in 2014. Under this plan, the rate declines from the current 0.89 mills to 0.67 mills in 2014, declines again to 0.45 mills in 2015, and is eliminated in 2016. In 1998, the tax rate was 11.99 mills and since then has been reduced by 85%.

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[1] According to the fiscal note prepared by the Senate Appropriations Committee on HB 465, PN 1661.

Corporate Loans Tax Repealed

The corporate loans tax, a tax assessed on the value of outstanding corporate debt owed to Pennsylvania residents, is repealed at an eventual cost of $15 million per year.

Corporations Can Write Off More Losses

The plan increases a cap on the net operating losses that a corporation can use to offset current corporate net income tax (CNIT). The current cap is the greater of $3 million or 20% of a company's liability. This bill increases the cap to the greater of $4 million or 25% of a company's liability in 2014 and $5 million or 30% in 2015. This is expected to reduce CNIT collections by $11 million in 2013-14 and $36 million in 2014-15.

A New Tax Break for Gas Drillers

Gas drillers succeeded in persuading Pennsylvania to adopt federal intangible drilling expense rules for personal income tax (PIT) purposes. This will allow owners of drilling partnerships to write off over three years a whole host of costs associated with drilling, as they do on their federal tax returns.[2] Like bonus depreciation, this is a timing difference, but it will allow drillers to defer tax payments to the later years of a well's operation. It is not known how much this will cost in lost revenue now. A large share of the companies drilling wells in Pennsylvania are specialized partnerships, so this could have a larger-than-anticipated cost.

A Sales Tax Break for Plane Owners

Aircraft parts and maintenance will be exempt from sales tax. The idea behind the policy change is to discourage Pennsylvania-based planes from flying out-of-state to get repairs done sales tax-free. This is an improvement over the original proposal that would have exempted the purchase of corporate jets and other private planes from sales tax (whether they were purchased in Pennsylvania or not).

Small Business Exemption from Inheritance Tax May Be Unconstitutional

The bill includes a family small business exclusion from the state inheritance tax, expanding on the family farm exemption passed in last year's budget. This change may be unconstitutional — as neither small businesses nor family-owned businesses are eligible for special tax treatment under the Pennsylvania Constitution. (For the same reason, Pennsylvania cannot have a graduated income tax or personal deductions for PIT purposes, as is done at the federal level).

Reforms to Bank Shares Tax

The bank shares tax is reformed in a way that may be a win-win for Pennsylvania. Currently, banks get a 30% tax cut by expanding their tax base to include out-of-state banks that previously operated here but did not pay the bank shares tax. This change is supposed to be "revenue neutral," at least initially. This is real reform in that it solves a long-standing — yet unaddressed — loophole which allowed in-state banks that merge with out-of-state banks to get a tax reduction based on antiquated language in the tax law. The "fix" for this loophole is to go to a single year of measurement of a bank's share value (it is currently a six-year average). Over time, this will add some volatility to bank shares tax collections.

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[2] Current PIT requires these costs to be amortized over the life of a well.

An Update to the Tax Appeals Process

The tax appeals process gets an update that has been long sought by the business community. The Board of Finance and Review (BF&R) will be restructured to encompass a group of three independent tax professionals who will review tax appeals. Two are appointed by the Governor and one by the Treasurer, each with Senate approval. Tax professionals have argued that the current process does not provide a fair hearing, as the judges were staff of state agencies, including the Treasury and Revenue Department. This change swings the pendulum towards the taxpayer.

Pass-Through Entities Must File Information Returns with State

As more businesses are organized as "pass-through" entities — meaning the taxes due on business income are paid by the individual owners on their personal tax returns — Pennsylvania's tax laws and regulations had fallen behind. To aid tax collection, partnerships will now be required to maintain accurate lists of partners and file information returns with the Department of Revenue. Estates and trusts will be required to withhold tax from non-residents on income earned in Pennsylvania. The Department of Revenue will now be able to assess tax directly on certain pass-through entities. Finally, the tax bill creates new penalties for non-filers to encourage regular filings.

Market-based Sourcing of Services

In 2013, Pennsylvania went to a system that relies solely on sales to determine corporate tax liability for multi-state companies, transitioning from a formula that also had used payroll and property. To create consistency, new rules for taxing sales of services were enacted, which allocate sales based on where the customer is rather than where the work of providing the service is performed. This is known as "market-sourcing." This switch makes good tax policy sense if a state uses so-called single-sales factor.

Unfortunately, the rules do not apply to everyone. Satellite and mobile communications providers were concerned they would pay more under market-based sourcing rules. In what could be a slippery slope, satellite companies received a unique apportionment factor to use, and mobile providers will receive a tax credit for equipment they purchase to help offset their additional costs. Almost every change to tax rules produces some "winners and losers," and this change is no exception. However, giving special tax treatment to some companies impacted by a tax change will likely encourage other types of businesses to seek the same special treatment. This differing tax treatment adds to the complexity of the tax system and makes it more difficult to gauge fairness across the tax system. The switch to market-based sourcing is currently anticipated to raise a modest amount of revenue, but that gain may be short lived if more exceptions are carved out.

Additionally, the market-based sourcing rules still allow copyrights, patents, trademarks and other intangible expenses to be sourced based on where costs are incurred (which seems to allow many companies to continue to source these sales to Delaware and other states that do not tax intangible expenses).

Closing a Realty Transfer Tax Loophole

The plan seeks to close what is called the "89-11 loophole," in which owners of large buildings are able to avoid paying the state's realty transfer tax by selling the buildings in two or more transactions. The 2012-13 budget bill attempted to fix this problem, but the change proved ineffective. If this year's attempt stops the practice, developers will no longer be able to avoid a tax that everyone else pays when they sell property and that costs state and local governments a fairly significant amount of revenue.

Economic Development Zones and Tax Credit Changes

Neighborhood Revitalization Zones

The Neighborhood Improvement Zone, or NIZ, provided taxpayer funds to finance a hockey arena and downtown development in Allentown. Based on the perceived success of this program, the bill expands it into other third-class Pennsylvania cities.[3] The new program, called the City Revitalization and Improvement Zone program, or CRIZ, creates zones in two cities by 2016 and then allows two more to be added to the CRIZ program each year afterward. Under the program, state and local taxes collected within the zone – personal income (including withholding from people working in the zone), sales, corporate, and a whole host of other taxes – are transferred away from state and local coffers to pay for debt service on the privately-owned development. According to budget documents, the NIZ costs $23 million in diverted state taxes this year.[4] If similar in scope to the NIZ, the CRIZ could be reasonably expected to cost a similar amount per city in lost revenue.

Innovate in PA Insurance Premium Tax Credits

Under the new Innovate in PA Program, insurers may bid on $100 million in deferred insurance premiums tax credits. (The Senate version of the bill set the cap at $175 million, but the House reduced it to $100 million.) This program is intended to provide predictable funding for business development within the Ben Franklin Technology Partners, Venture Investment, and Life Sciences Greenhouse programs. As some out-of-state insurance companies' tax payments are reserved for special funds, the General Fund would have to replace any lost funding from the tax credits.

Mobile Telecommunications Tax Credit

A $5 million annual Mobile Telecommunications Broadband Investment Tax Credit (briefly described earlier) is created for mobile communications providers based on the equipment purchases they make. The credits are intended to offset increased taxes paid by this industry due to the change in apportionment rules for services.

Educational Opportunity Scholarship Program

Children receiving scholarships under the Educational Opportunity Scholarship Tax Credit Program will continue to receive scholarships to attend private or parochial schools, even if their home public school is no longer classified as "low performing."

Tax Credits Repealed

The bill repeals the Coal Waste Removal and Ultraclean Fuels Tax Credit. This credit, created for a single company, was never used. In addition, the little-used Call Center Sales Tax Credit is repealed. Due to their lack of use, little to no revenue is gained by repealing these credits.

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[3] To date, there has been little formal evaluation of the program and its results. The Keystone Opportunity Zones were similarly expanded soon after enactment with little measurement of program results.

[4] See page H51 of the *2013-14 Governor's Executive Budget* for more details: http://www.portal.state.pa.us/portal/server.pt/document/1320332/2013-14_governors_executive_budget_cd_pdf. A tax reconciliation can be found here: http://www.portal.state.pa.us/portal/server.pt/community/neighborhood_improvement_zone/20491.

Conclusion

A half a loaf is better than no loaf at all. That is the takeaway from the Tax Code bill advancing along with the 2013-14 budget. Despite flaws in the changes to tax rules and regulations, the adoption of an addback rule to begin closing corporate tax loopholes is a step forward for tax fairness in Pennsylvania. Extending the capital stock and franchise tax for two additional years, while at a lower rate, is also a tangible hard-fought win that will help the state shore up its fiscal health. Unfortunately, the bill also enacts costly new tax breaks for select industries, including banks, private plane owners, gas drillers, and satellite and wireless companies.

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