

TESTIMONY ON COMBINED REPORTING
PRESENTED TO THE HOUSE MAJORITY POLICY COMMITTEE

BY

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Good afternoon, I am Michael Wood, Research Director for the Pennsylvania Budget and Policy Center. The Pennsylvania Budget and Policy Center is a non-profit, non-partisan research project. PBPC provides budget and fiscal analysis and public education in support of policies that improve the economic and social well-being of low and middle income Pennsylvanians.

The purpose of my testimony is to briefly describe how corporate tax loopholes are hurting tax collections, how Combined Reporting is the best solution to begin fixing the problem, and what this means for Pennsylvania.

Pennsylvania's corporate income tax system is antiquated and inequitable

The current tax system, based on separate company filing, is out-of-date. This hurts Pennsylvania in a number of ways:

- The status quo acts as if each corporation operates independently. The economic reality is that many corporations operate as part of a centrally controlled group of parent corporations and subsidiaries.
- The status quo favors large, multi-state corporations to regional firms or those solely based in Pennsylvania. It unfairly forces Pennsylvania-only and regional corporations to pay a high tax rate, while corporate groups, operating a complex array of corporations and subsidiaries across the county – and often across the globe, pay substantially less. This occurs due to the heavy weight on the sales factor. A regional company with much of its sales base in Pennsylvania must pay tax based on that large portion of the sales base. A corporation that only does business in Pennsylvania cannot apportion its income – so they pay 9.99% on their entire taxable income. A company with national sales, however, pays tax on only that small portion of its sales that occur in Pennsylvania – no matter how large or small their presence is here.
- The status quo allows corporations operating in several states to use a variety of accounting gimmicks to lower profits in Pennsylvania. These companies can shift profits in and out of states and to and from specific companies within a group using Delaware holding companies, shell corporations, and artificial transfer prices. These transactions lower the corporation's tax bill, leaving others to pick up the tab. States are ill equipped to find these abuses, which are hidden deep within financial statement data.
- The status quo of tax loopholes and decades of business tax cuts have shifted more responsibility for funding state government to Pennsylvania families. Business taxes, including

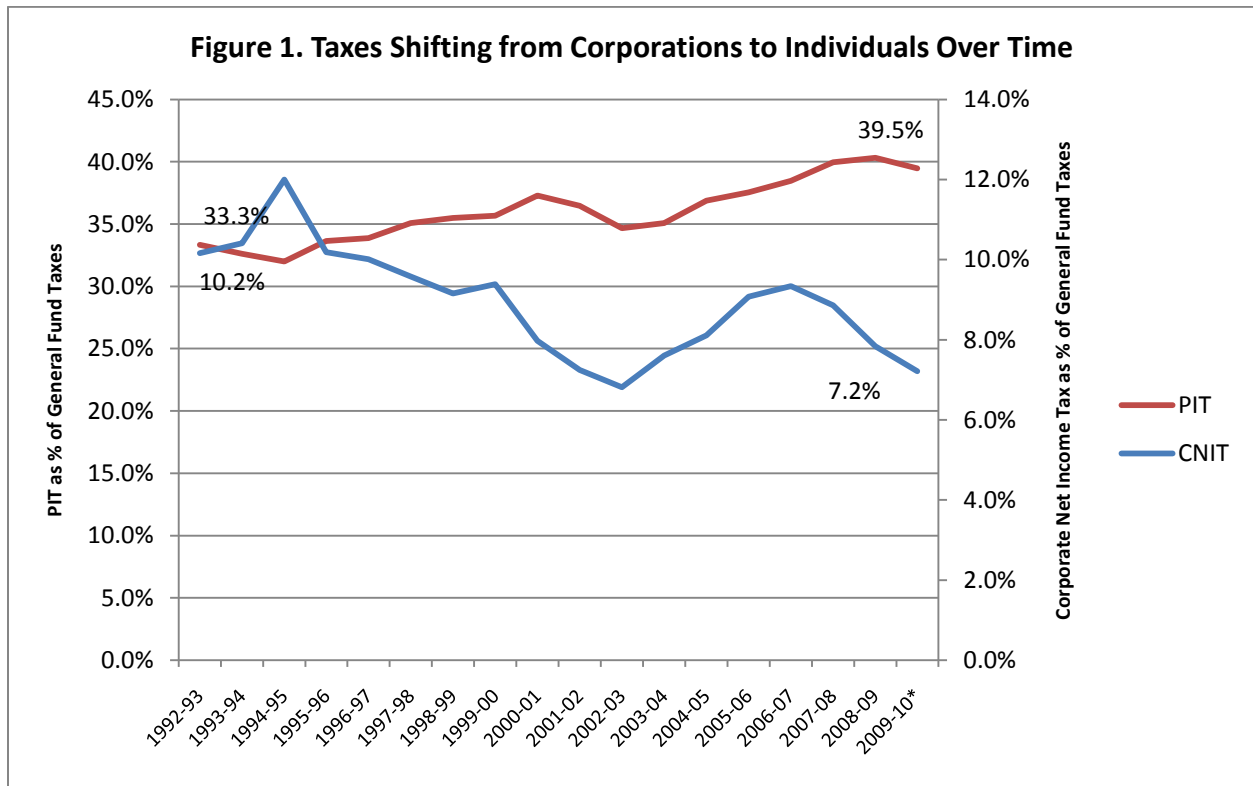
the phase-out of the Capital Stock and Franchise Tax, have reduced the state tax bills of businesses by billions of dollars over the past fifteen years. Meanwhile, the share of taxes paid by Pennsylvania residents is rising.

The state’s ongoing revenue crisis should be seen as an opportunity for Pennsylvania to modernize its tax system, make it fairer, and help make it more stable. Closing corporate tax loopholes by adopting Combined Reporting should be part of this effort. It would raise needed revenue now to protect public investments in education, infrastructure, and health care – and permit a tax rate reduction for ALL corporate income taxpayers once the economy and tax revenues recover.

Corporate income taxes provide shrinking support for the General Fund

In 1992-93, the Corporate Net Income Tax made up slightly more than 10% of all tax collections in the General Fund. By 2009-10 (using the Rendell Administration’s revenue estimates), this percentage has dropped to 7%, a reduction of almost a third.

During this same period, the portion of General Fund tax collections financed by the state’s Personal Income Tax increased from 33% to 40%.



This means that Pennsylvania families pay for a growing share of the General Fund.

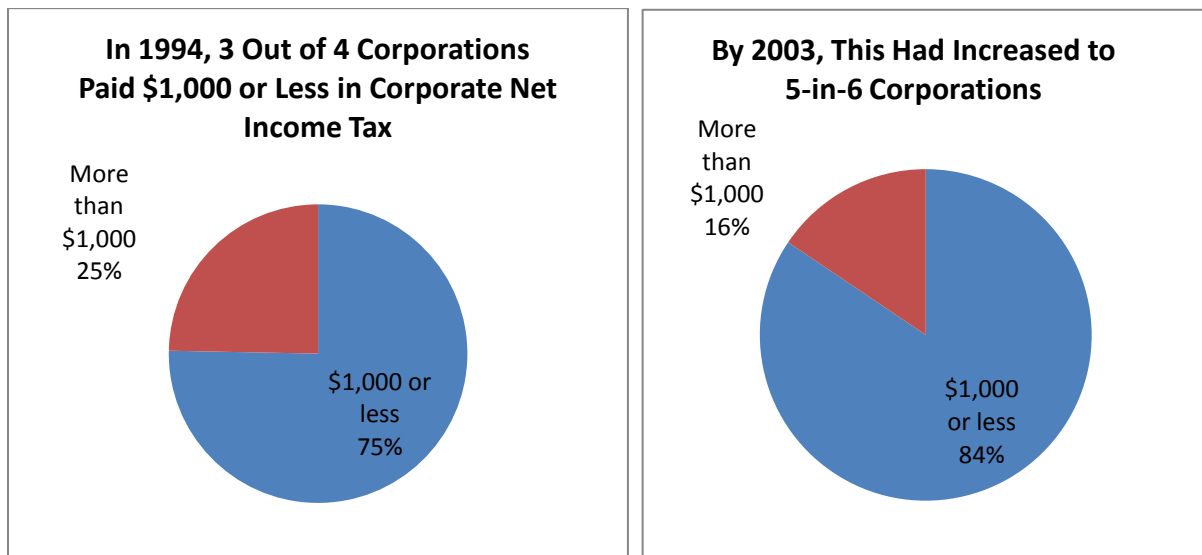
Business tax cuts and an increase in the PIT rate account for some of this change – but only a portion of it. The ability of large corporations to determine how much they want to pay in income taxes is likely a significant factor in the remainder.

The losses from corporate taxes due to loopholes are significant

A 2003 study by the Pennsylvania Public Interest Group estimated that the use of a single common tax planning vehicle - the Passive Investment Company loophole - cost Pennsylvania \$276 million that year. A more recent study by the state of Maryland estimated that its corporate income tax revenue would have increased 13% to 20% had Combined Reporting been in effect in 2006. If similar numbers are applicable to Pennsylvania, it would mean an additional \$245 million to \$375 million in 2009-10.

Most families pay more in Personal Income Tax than corporations pay in Corporate Net Income Tax – and this inequity is growing

In 1994, three-quarters of corporations in Pennsylvania paid \$1,000 or less in income taxes. By 2003, this figure had increased to 84%. To put this in perspective, a family earning about \$32,600 pays \$1,000 in Personal Income Tax, at a rate of 3.07%. This means that more than five out six corporate filers in Pennsylvania pay less in income tax than a family earning \$32,600. When people of vary modest means are taxed more heavily than five of every six corporations, even the most dispassionate among us would see the need for reform.



Source: Pennsylvania Department of Revenue *Corporate Tax Statistics*, 1994 and 2003 editions.

Corporations benefit from the public spending financed with tax revenues – from having an educated workforce, a well-developed transportation system, and clean water. They have a responsibility to pay their share of the freight.

Combined Reporting is a sensible solution to many of Pennsylvania’s corporate tax issues

Under Combined Reporting, groups of affiliated corporations are required to pool their economic activity and determine their taxes as if they were a single, or unitary, entity. This process eliminates transactions between companies – which are often the vehicle for shifting income out of state. Grouping of related companies provides a fairer method of measuring economic activity in Pennsylvania, as well.

The other alternative for addressing loopholes is by changing the tax code to eliminate each practice. Without Combined Reporting, companies can react to loophole closure by moving to other income and expense shifting practices. By the time specific practices, like the Geoffrey Passive Investment Company loophole or the misuse of Real Estate Investment Trusts (REITs) by Walmart, become public, corporate tax lawyers and accountants have moved on to other, less noticeable methods. State actions often come too late to prevent further tax losses.

Pennsylvania has some limited experience with trying to close loopholes, most notably Act 46 of 2003, which attempted to reign in the misuse of captive REITs, but it is not clear if the law has acted as even a speed bump for corporate tax planners.

Combined Reporting is not a new subject in Pennsylvania

In 2004, the Governor's Business Tax Reform Commission examined a wide array of corporate tax issues in an effort to even the playing field for all companies and make Pennsylvania more competitive. At the center of the commission's recommendations was adopting Combined Reporting. Combined Reporting would bring in sufficient revenue from companies currently shifting profits elsewhere to adopt the following changes requested by the business community:

- Adopting an apportionment method based more heavily on sales
- Allow for greater use of Net Operating Losses (NOLs)
- Cutting the Corporate Net Income Tax rate from 9.99% to 6.99%.

In total, these changes were deemed to be revenue neutral – meaning the state gained zero tax dollars by the changes but gathered them more fairly.

Governor Rendell included the Business Tax Reform Commission package in his 2005-06 budget proposal and Representative Levdansky introduced legislation, but the General Assembly hasn't taken action.

Instead, the last few budget agreements have included specific business tax changes that benefit only a small portion of Pennsylvania's corporate community. Even in the face of a \$3 billion revenue shortfall, companies including U.S. Steel, Hershey, and PPG were successful in trading a temporary Capital Stock and Franchise Tax increase for a permanent shift in income apportionment towards the sales factor. This shift created winners and losers within the business community. For a few companies, it cuts their taxes significantly. Many others will see their taxes increased. Purely Pennsylvania corporations saw no benefit at all from the change.

Increases in the state's Net Operating Loss (NOL) provisions are hailed as helping fledgling companies. A recent study by the Department of Revenue found that the vast majority of benefit from loosening NOL restrictions, in fact, goes to corporations with corporations having a net worth in excess of \$100 million.

The Pennsylvania business community has argued that the state's 9.99% Corporate Net Income Tax rate hurts competitiveness. There is little evidence that tax rates are significant influence on business location decisions. Only 71% of corporations in the state pay any taxes at all. But the business

community has blocked the effort to close loopholes in the law. They are, in effect, protecting certain companies at the expense of the majority of Pennsylvania businesses.

When provided the opportunity to reduce the 9.99% tax rate that supposedly hurts Pennsylvania's competitiveness so much, the business lobby has flatly refused if it is coupled with Combined Reporting.

Critics' arguments are not backed by the evidence

Combined Reporting critics are often parties with vested interests in the current, inequitable system. A common claim is that businesses will flee to other states if Combined Reporting is enacted. It is also suggested that Combined Reporting is too complicated and will lead to lawsuits. Finally, in a familiar refrain, critics will also say that in this weak economy we should be cutting business taxes rather than reforming them. None of these claims pan out when examining the evidence.

Multi-state corporations, including those based in Pennsylvania, are familiar with Combined Reporting and report on a unitary basis in other states. The majority of states with corporate income taxes require Combined Reporting, including large states such as California, Illinois, New York, Massachusetts, and Texas. Other corporations may also operate on a solitary basis; Combined Reporting requires nothing new of them.

An increase in lawsuits is likely when Combined Reporting is introduced, as companies will test the boundaries of what the state calls a unitary group, but that should not be a deterrent. Pennsylvania would benefit from the experiences and case law of the 23 states that have come before it in enacting Combined Reporting.

Finally, it cuts both ways with corporate tax changes – as state taxes are such a small portion of corporations' cost structure. While increasing taxes will have a marginal negative effect on businesses, cutting their taxes will have only a minor stimulative effect. Corporate profitability is more affected by the skill of the workforce, access to transportation systems, and energy prices than it is by state corporate tax policy.

In conclusion, Combined Reporting could be a powerful tool for modernizing our corporate income tax system. It slams the door on the most outrageous tax avoidance schemes and better reflects the economic reality of corporate groups. Despite the delay of the phase-out of the Capital Stock and Franchise Tax negotiated in the 2009-10 Budget, it will soon be gone – as will \$800 million in tax revenue each year. Pennsylvania can no longer afford to run an antiquated, inefficient corporate income tax system and the budget cuts necessary to maintain the current, unfair system.