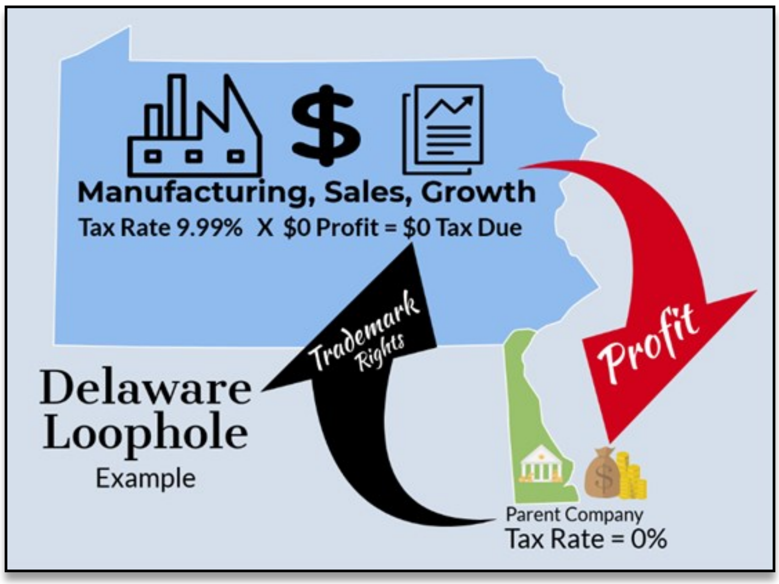
Pennsylvania BUDGET
May 13, 2019
House Appropriations Committee (D)
2019/20

Pennsylvania Corporate Tax Structure

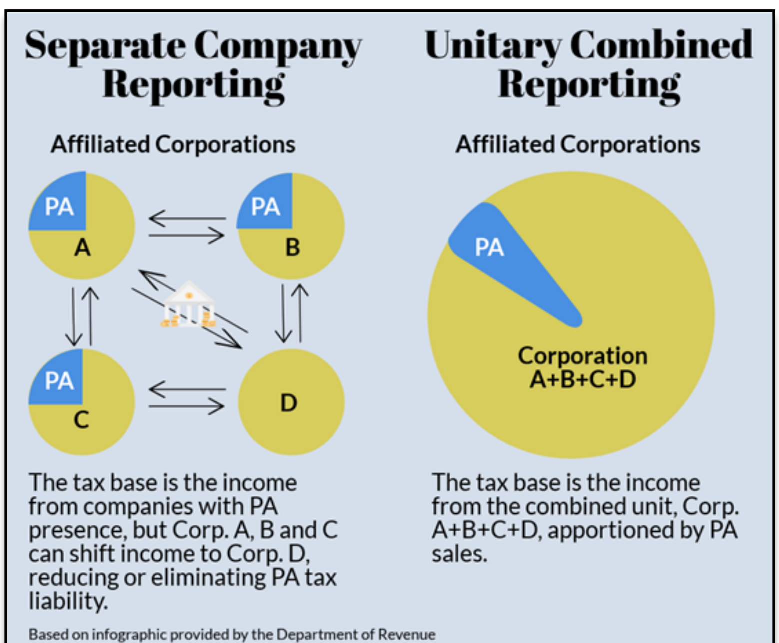
Background

Pennsylvania's corporate tax structure is a system of separate company reporting where each subsidiary or affiliate of a corporation files a separate return. This system reflects a narrow tax base and allows tax planning opportunities such as the use of passive investment companies to shift income outside of the state. This is often referred to as the Delaware loophole since many companies set up shell corporations or holding companies using a Delaware address. Even though the company might not have any assets or employees in Delaware, they are able to shift income to those companies and avoid paying all or part of the tax owed to Pennsylvania.



An alternative to Pennsylvania's current system is mandatory unitary combined reporting, which would require a related group of businesses, such as parent companies and subsidiaries, to combine their income for tax purposes. The combined net income of the group would then be apportioned to the commonwealth.

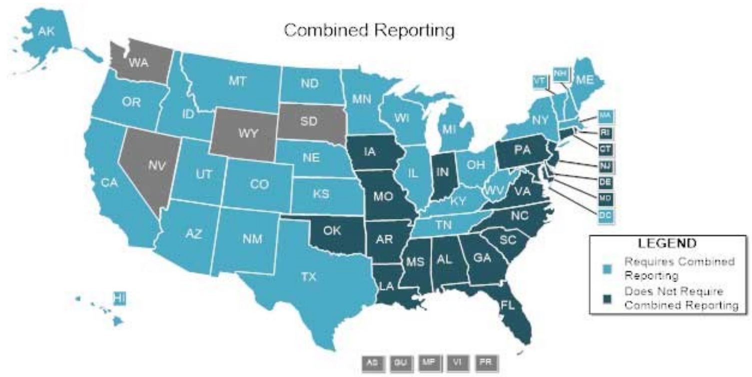
- According to a Business Tax Reform Commission report, mandatory unitary combined reporting would provide a more accurate method of measuring the net income of affiliated corporations as it would substantially broaden PA's tax base and be less subject to manipulation.



Policies aimed at closing specific individual loopholes always fall short, as accountants creatively create new ways to transfer income to tax haven states. **Combined reporting is the most comprehensive way to eliminate all potential tax advantages that can be derived from moving corporate income between states** (Institute on Taxation and Economic Policy, "Combined Reporting of State Corporate Income Taxes: A Primer", August 2011).

In 2013, the General Assembly enacted an "addback" provision (Act 52) to limit the ability of a corporation to deduct certain transactions, which would be blatant tax avoidance. However, this provision is weak because it only applies to single transactions and businesses are able to negate the effect with a different transaction. The provision has not substantially increased compliance.

The concept of combined reporting has been studied and proposed for a very long time in Pennsylvania. In 2004, under Gov. Ed Rendell, the Pennsylvania Business Tax Reform Commission released an extensive [report](#) recommending combined reporting in conjunction with a lower corporate net income tax rate. Gov. Tom Wolf proposed this same plan structure in four of his first five budgets (excluding 2016/17) with varying phased-down rate schedules each time.



Source: National Conference of State Legislatures

Despite proposed rate cuts of 40 to 50 percent, these proposals have not gained traction despite repeated efforts. The major obstacle for these plans is they actually would result in a tax increase on many multi-state businesses, despite the rate cut. Many multi-state corporations are structured to take advantage of loopholes and shift income out of Pennsylvania. Going from zero taxes paid to even a reduced rate triggers opposition from larger, more powerful corporations.

Twenty-seven states plus Washington D.C. require combined reporting. The states that do not require combined reporting are primarily in the southeast U.S. Some states that recently adopted combined reporting did not see revenue increases, and critics point to this as a failure of combined reporting policy. However, the success or failure of combined reporting for the purpose of increasing revenues depends on how well, and how broadly, a "unitary business" is defined.

Revenue Estimates in Governor's Proposal

The Department of Revenue and the Independent Fiscal Office have provided revenue estimates for the governor's 2019/20 budget proposal to require combined reporting in conjunction with a corporate net income tax rate reduction. While there is no significant fiscal impact in the budget year, the cost of the revenue reduction more than outweighs the revenue increase from combined reporting in the out years, resulting in a net revenue loss of several hundred million dollars per year.

The estimates provided by the Department of Revenue and the Independent Fiscal Office differ significantly since they utilized different methodology. The Department of Revenue argues that it is the only entity able to base estimates on actual taxpayer information. Also, the department won an award from the Federation of Tax Administrators in 2005 for outstanding research and analysis for the methodology they used for this specific estimate.

It is difficult to estimate the possible revenue that could result from combined reporting because we don't know how much we don't know. The goal of combined reporting is to require corporations to report all income from affiliated businesses throughout the country. Since that information is currently not reported to Pennsylvania, we do not know the scope of possible revenue. Analyzing the experience of other states is helpful, however other elements of the corporate net income tax law - such as net operating loss caps - are significantly different in other states and would result in significantly different estimates.

The following table summarizes the estimates provided by the Department of Revenue and the Independent Fiscal Office based on rate reductions to 8.99 percent in tax year 2020; 8.29 percent in 2021; 7.49 percent in 2022; 6.99 percent in 2023 and 5.99 percent in 2024 and thereafter.

Combined Reporting Estimates of Governor's 2019/20 Proposal						
	Department of Revenue			Independent Fiscal Office		
	Rate Reduction	Combined Reporting	Total Net Effect	Rate Reduction	Combined Reporting	Total Net Effect
2018/19	$ -	$ -	$ -	$ -	$ -	$ -
2019/20	$ (7)	$ -	$ (7)	$ (78)	$ 76	$ (2)
2020/21	$ (411)	$ 961	$ 550	$ (313)	$ 287	$ (26)
2021/22	$ (1,088)	$ 1,408	$ 320	$ (538)	$ 315	$ (222)
2022/23	$ (1,275)	$ 1,125	$ (149)	$ (762)	$ 344	$ (418)
2023/24	$ (1,695)	$ 1,168	$ (527)	$ (984)	$ 326	$ (658)

Sources: Budget hearing response from the Department of Revenue and March 22, 2019 estimates released by the IFO in response to the governor's 2019/20 budget proposal.

Talking Points

- **Combined reporting increases tax fairness and levels the playing field among corporations.**
  - Smaller corporations that only operate in Pennsylvania shoulder a larger share of the corporate tax burden, whereas larger multi-state corporations can afford tax planners that help them create the most advantageous tax-avoidance structure.
  - Instead of a narrow tax base with a high rate, Pennsylvania could have a broader tax base with a lower rate through combined reporting.
- **Combined reporting helps stop corporate tax avoidance.**
  - The primary way corporations avoid taxes is by using intercompany transactions between affiliated companies. They shift profits out of state or shift deductible expenses into Pennsylvania to eliminate tax liability. Combined reporting negates those transactions to shed full light on true taxable income.
- **Combined reporting modernizes the tax system.**
  - Most corporations are now structured as part of a group of companies with parent, subsidiaries and affiliated companies. The tax code has not been updated in decades to reflect current realities of corporate structure.
- **Pennsylvania needs to lower the corporate net income tax rate, and combined reporting helps pay for the revenue loss.**
  - The current CNI rate is one of the highest in the country, and Pennsylvania also has the largest gap between the CNI rate and the personal income tax rate that partners in pass-through businesses (such as LLCs and S-corporations) pay. This means Pennsylvania businesses have the greatest incentive to structure in a way to avoid paying CNI by shifting profits out of state or trading down for the more favorable PIT rate.
- **Critics might claim that combined reporting is too complicated, however a majority of states already require this method of filing.**
  - Businesses have to take extra steps to modify their federal return by creating a pro-forma return specific to Pennsylvania constraints. Combined reporting would eliminate the extra steps for businesses, and taxable income would be based directly on the federal return.

- Administering combined reporting would require additional staffing at the Department of Revenue, however the benefits outweigh the costs. The Department and Administration are aware of the additional work and are prepared to handle it efficiently.

- **Critics might claim that combined reporting is not business friendly, but it is only unfriendly for tax avoiders.**
  - Cutting the rate by 40 percent, in conjunction with combined reporting, is certainly business friendly. If corporations are opposed to this plan, it probably means they have been paying little or no corporate net income taxes in Pennsylvania.

- **There is no evidence of job losses in the 27 states that have already implemented combined reporting, and the lower tax rate should attract new business to the state.**