



# Bill to Close Tax Loopholes Doesn't Get the Job Done

## An Analysis of the Addback Rule in House Bill 440

By Pennsylvania Budget and Policy Center Staff

Pennsylvania Budget and Policy Center • 412 N. 3<sup>rd</sup> St, Harrisburg, PA 17101 • [www.pennbpc.org](http://www.pennbpc.org) • 717-255-7156

May 14, 2013

### Overview

A recent proposal to close corporate tax loopholes that drain millions of dollars annually from Pennsylvania schools, colleges, and other vital services would fall far short of its goal and aggravate our state's financial problems. While House Bill 440<sup>1</sup> aims to prevent corporations from unfairly shifting profits earned in Pennsylvania to Delaware and other low- or no-tax states, it would be ineffective at stopping the practice and even creates new tax loopholes corporations could exploit.

Because the bill's loophole-closing measure would be largely ineffective, its cuts in corporate tax rates would end up costing hundreds of millions of dollars per year in lost tax revenue and force further cuts to the assets that make Pennsylvania a good place to do business in the first place.

Corporate tax avoidance is a growing problem that leaves Pennsylvania companies and individuals who play by the rules to pick up more of the tab. But fixing this must be done carefully, and there are better alternatives than House Bill 440.

During the last 10 years, many states took steps to close tax loopholes and collect taxes on income earned in-state. They took two approaches: enacting "combined reporting" laws that keep corporations from shifting profits to their operations in other states to avoid taxes; or adopting "addback" laws requiring that fees, royalties and other transactions between related companies, done primarily to avoid taxes, are added back to the companies' income and taxed. Some states did both. Of the two approaches, combined reporting is the more foolproof, acknowledged by the Multistate Tax Commission the more "comprehensive way of dealing with the Delaware holding company issue."<sup>2</sup>

In 2012, Pennsylvania State Representatives Dave Reed (R-Indiana) and former State Representative Eugene DePasquale (D-York) introduced House Bill 2150<sup>3</sup>, which created a limited addback bill and used revenue from that provision to partially offset a new round of business tax cuts. The bill was reintroduced in 2013 as HB 440 and was passed by the House on May 6.

The legislation reflects a bipartisan recognition that corporate tax avoidance is a serious problem in Pennsylvania and signals a new willingness to address the issue, but it would fail to achieve its stated goal.

- The bill's addback requirement would generate little new revenue to offset the new tax cuts, creating bigger economic and budget problems for Pennsylvania than the ones we already have.

---

<sup>1</sup> House Bill 440, Regular Session 2013-2014, <http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?syear=2013&slnd=0&body=H&type=B&BN=0440>.

<sup>2</sup> Henry J. Reske, "Pennsylvania Rep Renews Push for Addback Legislation," *State Tax Notes* (subscription required), March 6, 2013, <http://services.taxanalysts.com/taxbase/stn3.nsf/dockey/27A30FF58A80EDE585257B2600117DD3?OpenDocument&highlight=0,hb+440>.

<sup>3</sup> House Bill 2150, Regular Session 2011-2012, <http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?sYear=2011&slnd=0&body=h&type=b&bn=2150>.

- The legislation would create new loopholes that would allow corporations to continue to shelter income and fail to end other basic tax avoidance techniques.

Fortunately, there are ways to improve the proposal. Lawmakers could adopt an effective addback rule, such as the one recommended by the non-partisan Multistate Tax Commission (MTC), a group of state tax agency officials. The Legislature should also consider enacting combined reporting, which is more comprehensive and offers fewer opportunities for corporations to continue to game the system.

The corporate tax cuts and other breaks for business also should be dropped from the legislation because the state can ill-afford them. The share of revenue generated from corporate taxes is steadily declining, leaving the state with fewer resources it needs to invest in education, transportation and other things that bolster the economy for the long run and create jobs.

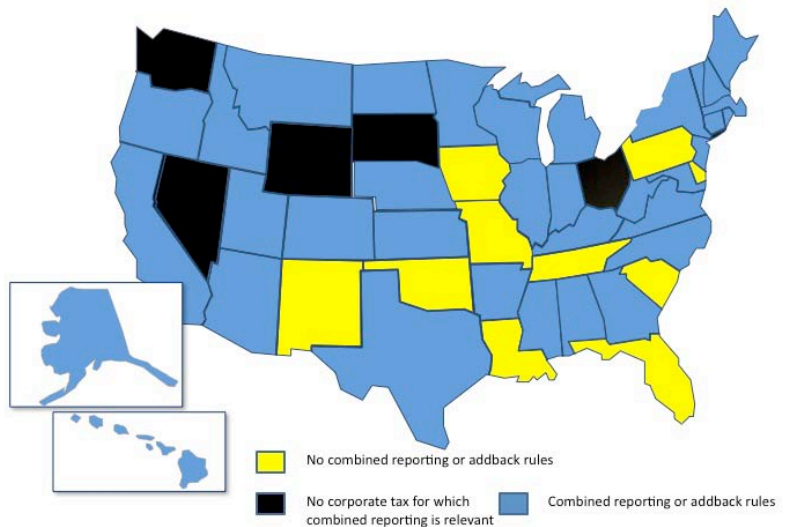
## How Loopholes Work

One common way corporations avoid taxes is by conducting transactions between their subsidiaries. Using an array of “tax planning” techniques, companies can shift profits from one subsidiary to another or into or out of a particular state – with no real economic purpose other than tax avoidance.

The best known strategy is the infamous “Delaware loophole,” of which the Toys “R” Us Geoffrey Giraffe case is the most widely known example.<sup>4</sup> Toys “R” Us set up a holding company<sup>5</sup> in Delaware to hold the trademark for the Geoffrey Giraffe logo. The holding company charges Toys “R” Us retail stores across the country a royalty to use the trademark. The retail stores deduct this payment to the holding company as a business expense, reducing their income in other states and, in turn, their taxes. This is legal, even though there is no need for a company to sell the use of a trademark to itself – and no reason to grant an expense deduction. Because royalty income is not taxed in Delaware, the Geoffrey holding company (owned by Toys “R” Us) gets to keep the money tax free.

Corporations use many other transactions that work in the same way. Some might lend money to a related company and then charge interest on the loan. Interest is a business expense, so it would reduce the borrowing company’s income, resulting in a lower state tax bill.

### 35 of 45 States with Corporate Taxes Have Taken Steps to Close Loopholes (2012)



<sup>4</sup> Jill Schachner Chanen, “Taxes ‘R’ Ours: Suits Challenge Loophole That Lets National Corporations Dodge State Taxes,” *ABA Journal*, April 1, 2004, [http://www.abajournal.com/magazine/article/taxes\\_r\\_ours/](http://www.abajournal.com/magazine/article/taxes_r_ours/)

<sup>5</sup> A company that often has no employees and merely exists to “hold” intangible assets – like copyrights, patents, or trade secrets.

## Why the Proposed Addback Rules Will Not Work

The Reed proposal attempts to close the Delaware loophole by not allowing Pennsylvania corporations to deduct royalties and other payments made to related companies for the use of trademarks and similar types of “intangible assets.” A company would be required to add back the expenses paid to the related company to its taxable income – and pay tax on it.

However, the legislation has a number of exceptions that would nullify its goal of closing the Delaware loophole:

- **The bill’s deduction allowance is too broad.** The bill would allow corporations to continue to deduct royalty and other intangible expenses if the transaction is “directly related to a valid business purpose.” Most companies will have little difficulty claiming a valid business purpose for a Delaware trademark holding company – such as centralized management of their trademarks by employees dedicated to the task – even if their primary reason is tax avoidance. The burden of proof will be on the Pennsylvania Department of Revenue to demonstrate that a certain expense does not have a valid purpose – a difficult hill to climb.
- **Getting an exemption to the rule would be easy.** The legislation presumes that any transaction that occurs at a market price has a valid business purpose, so it would not be required to be added back to income. Royalties or other intangible expenses paid to related companies could be set at the fair market value and still accomplish the same goal – shifting income from Pennsylvania, where it would be taxed, to a state where it would not be taxed. This creates a blanket exemption to the addback rule.
- **The bill creates a loophole allowing some companies to get double tax benefits.** A company would be able to get a credit for taxes paid by an affiliate on the income even when it is allowed to take the deduction of the royalty expense in Pennsylvania – getting tax benefits twice for the same transaction. A company should only get credit for taxes paid by an affiliate on income that has been added back to taxable income.
- **The bill creates a new loophole by exempting intangible expenses from market sourcing rules.** In 2013, Pennsylvania adopted a system where corporate income for taxing purposes is allocated to Pennsylvania based solely on a corporation’s share of sales in the state rather than on its sales, property and payroll in the state. This is commonly called single sales factor. HB 440 proposes changing the rules for determining where sales of services occur to better coincide with the single sales factor. Under the change, sales of services would be allocated to states based on where the customer is located rather than where the work to provide the service is located. This change would create greater consistency between sales of goods and sales of services. However, HB 440 creates an exemption from this rule for intangible sales. This means that the sales of Toys “R” US goods are “sourced” to Pennsylvania, but selling the right to use a trademark is not “sourced” to Pennsylvania, even if used here. Instead it remains in Delaware, where there is no tax on the royalty income. The rules should be applied consistently for sales of services, goods, or use of intangible assets.

## A Better Solution

One way to improve the bill is to replace its addback requirement with the Multistate Tax Commission's model legislation.<sup>6</sup> Pennsylvania doesn't need to reinvent the wheel. This is a subject that other states have been grappling with for many years, and the Commission has taken the most effective ideas from states that have adopted addback language and created legislation that Pennsylvania could adopt.

The Commission's model is superior in a number of ways:

- **It requires both intangible expenses (such as royalties) and interest payments to be added back to income.** This addresses the two easiest ways companies redirect income and shield it from taxes.
- **It eliminates complicated shell games by requiring both direct and indirect payments between related companies to be added back.** Without such a requirement, companies can create complex corporate structures to avoid directly shifting profits from one related company to another.
- **It ensures a company isn't taxed twice, but doesn't allow it to double up on deductions.** The model legislation gives a corporation credit for taxes paid by affiliates on income that has been added back. This helps ensure that the income is not taxed twice – but this deduction is only permitted when the affiliate actually adds back the income.
- **It sets clear standards for allowing legitimate interest and intangible expense deductions by a corporation.** They include:
  - If the related company is ultimately funneling royalty and interest expenses to a truly non-related business *and* the transaction was made for a valid business purpose.
  - If the related company was subject to tax on the income and pays an effective tax rate equal to a certain percentage of the tax that would be due on it if it were taxed by Pennsylvania. However, this does not include taxes paid on the combined or consolidated returns of a corporation.
  - If the related company paid tax on a transaction with a foreign government that has a comprehensive tax treaty with the United States, the rate of tax paid is at least equal to the rate in Pennsylvania, and the transaction was for a valid business purpose.
  - If the taxpayer has a written agreement with the state revenue department to deduct the expense.
- **It requires corporations to provide clear and convincing evidence that they meet the criteria for allowing a deduction.** This evidence must be presented when the returns are filed – not during an audit years later.

---

<sup>6</sup> The Multistate Tax Commission's model addback legislation can be found here: [http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/Add-Back-FINAL\\_version.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Add-Back-FINAL_version.pdf)

## Combined Reporting: A More Comprehensive Approach

Rather than addressing one specific loophole at a time, as addback rules do, combined reporting takes a more thorough approach to combating tax avoidance. This is the direction 23 states have taken.

Combined reporting recognizes that most companies are not fully independent entities making decisions on their own. Rather, they belong to a web of related companies that make numerous transactions with one another.

Under combined reporting, the companies pay taxes based on their combined activities. This means the corporation is taxed based on its total economic activity, rather than its individual parts, eliminating many opportunities for companies to shelter profits. Combined reporting has no impact on smaller corporations with no related companies.

## Conclusion

The Reed bill is a sign that concern is growing about Pennsylvania's corporate tax avoidance problem. It is a positive start – but in its current form, it is not a solution. The bill needs to be strengthened to close other obvious loopholes, and it includes unnecessary corporate tax cuts.

Adopting the Multistate Tax Commission model legislation would provide Pennsylvania with a more sound and effective addback rule than trying to make up a version from scratch. However, if Pennsylvania wants to truly reform its corporate tax system, it should adopt combined reporting. This would eliminate a wider array of tax dodges and close off other tax avoidance schemes that a more limited addback approach would invite.

Effectively closing tax loopholes would level the playing field for all corporations and bring additional revenue for schools, health care and environmental protection – or, when Pennsylvania can afford it, for making responsible corporate tax reductions that benefit all businesses.

An ineffective approach to closing loopholes, combined with tax cuts, would be the worst possible outcome. Corporations that exploit loopholes would continue to do so, maintaining their uncompetitive advantage over companies that operate only in Pennsylvania while enjoying another tax break. State revenues would be further eroded – leading to less investment in education, health care, and infrastructure, which foster job growth and a strong economy.

---

*The Pennsylvania Budget and Policy Center is a non-partisan policy research project that provides independent, credible analysis on state tax, budget and related policy matters, with attention to the impact of current or proposed policies on working families. Learn more at [www.pennbpc.org](http://www.pennbpc.org).*