Pennsylvania Needs a Comprehensive Addback Law:
Bill Should End Practices Banned in Majority of States

PENNSYLVANIA
Budget and Policy Center

412 N. 3rd St, Harrisburg, PA 17101 • www.pennbpc.org • 717-255-7156

June 27, 2013

Overview

The Pennsylvania House of Representative passed legislation (HB 440), sponsored by Representative Dave Reed, that begins to close some of the most egregious corporate tax loopholes. The Corbett Administration has accepted this policy change and is building on the House bill, advancing a proposal similar to a Virginia law enacted in 2003.

The Pennsylvania Senate should take this opportunity to adopt a strong addback bill that stops practices that are simply not tolerated in the majority of states. The Virginia statute, with some improvements, is a good model that will move Pennsylvania squarely into the mainstream.

To restore balance to Pennsylvania's business tax reform efforts, revenue from the addback should not pay for new tax cuts. Instead it should be considered a partial repayment for tax cuts already enacted between 2003 and 2012.

Tax Reform Should Be Revenue Neutral

As first conceived by the Business Tax Reform Commission in 2004, tax reform would pair tax base expansion, through combined reporting, with tax rate and other changes favored by the business community. Revenue neutral tax reform has been presented as an important goal of House Bill 440.

Since 2003, many of the tax changes proposed by the business community have been enacted, at a cost of hundreds of millions of dollars, including raising the Net Operating Loss (NOL) carryforward, moving from triple weighted to single sales factor apportionment, increasing tax credit programs, and expanding sales tax manufacturing process exemptions, in addition to the continued phase-out of the broad-based capital stock and franchise tax (CSFT). To date, no action has been taken to broaden the tax base. Pennsylvania's tax reform has not been revenue neutral.

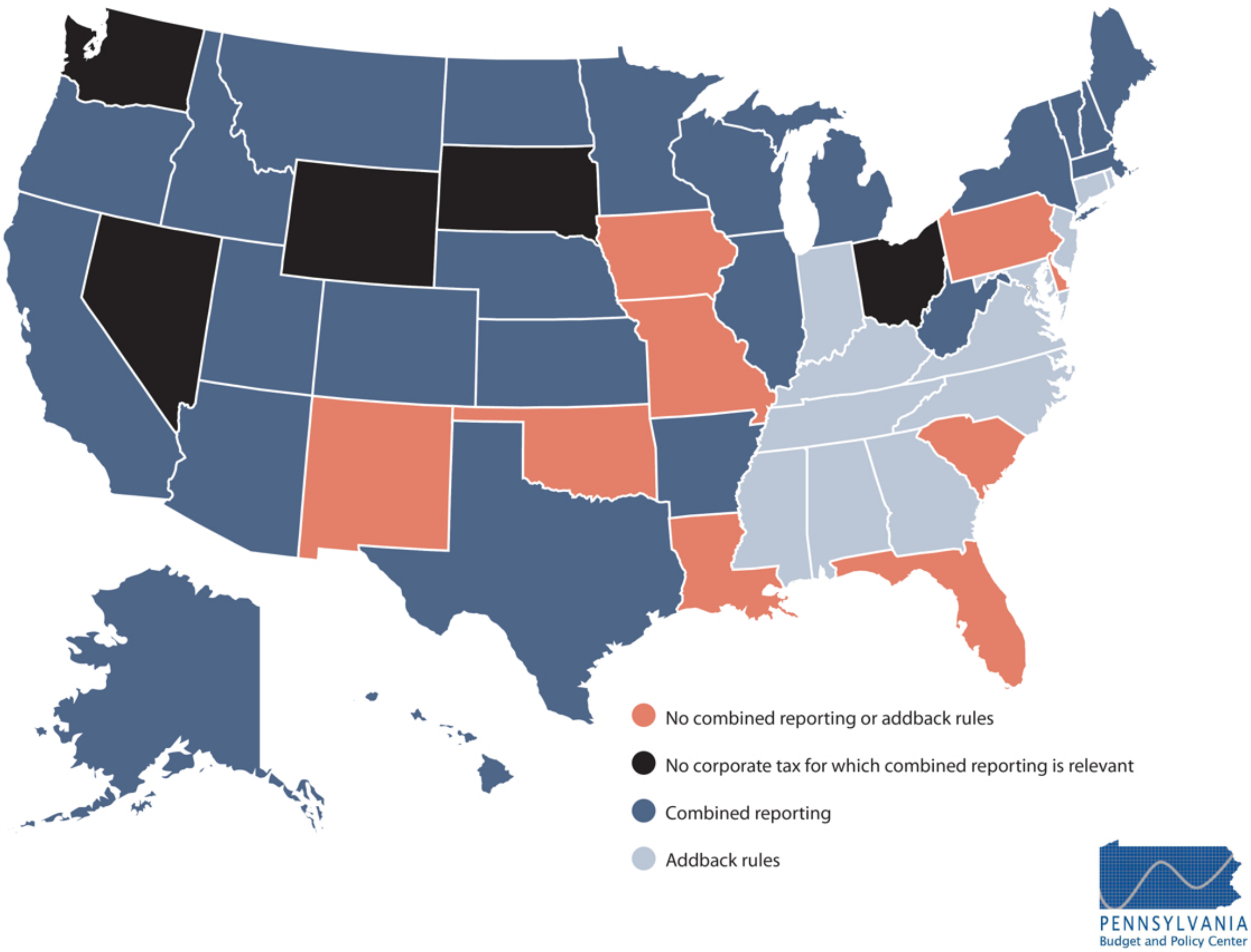
Most States Have Taken Action to Close Tax Loopholes

In recent years, states have taken steps to crack down on practices that, while technically legal, are used primarily to avoid paying state corporate income taxes. **Since 2000, six states have adopted combined reporting, while an additional 18 states have adopted addback provisions.**[1]

---

[1] Pennsylvania Independent Fiscal Office (IFO), *Corporate Tax Base Erosion: Analysis of Options*, March 4, 2013, http://www.ifo.state.pa.us/resources/PDF/Corporate%20Tax%20Base%20Erosion%20-%20Analysis%20of%20Policy%20Options%20-%20March%202013.pdf.

States with Combined Reporting or Addback Rules (2013)



States that Have Closed Loopholes Have Not Suffered Economically

A 2013 report from the Independent Fiscal Office finds that Pennsylvania's corporate tax base has experienced greater erosion than the nation as a whole, which can be explained in part by its lack of action on steps to protect the tax base through either combined reporting or an addback law. The study also found the corporate tax base in states with these provisions expanded more quickly than in states like Pennsylvania without them.

"A very simple trend analysis suggests that Pennsylvania tax base and revenues have expanded at a slower rate than the state economy," the report states. "In contrast, the U.S. tax base and the majority of other states have expanded at a rate that slightly exceeds economic growth. Moreover, separate entity filing states *(like Pennsylvania)* have generally expanded at a slower rate than combined reporting and addback states."[2]

---

[2] Page 19 of the IFO corporate tax base erosion report. Italicized items added for clarity.

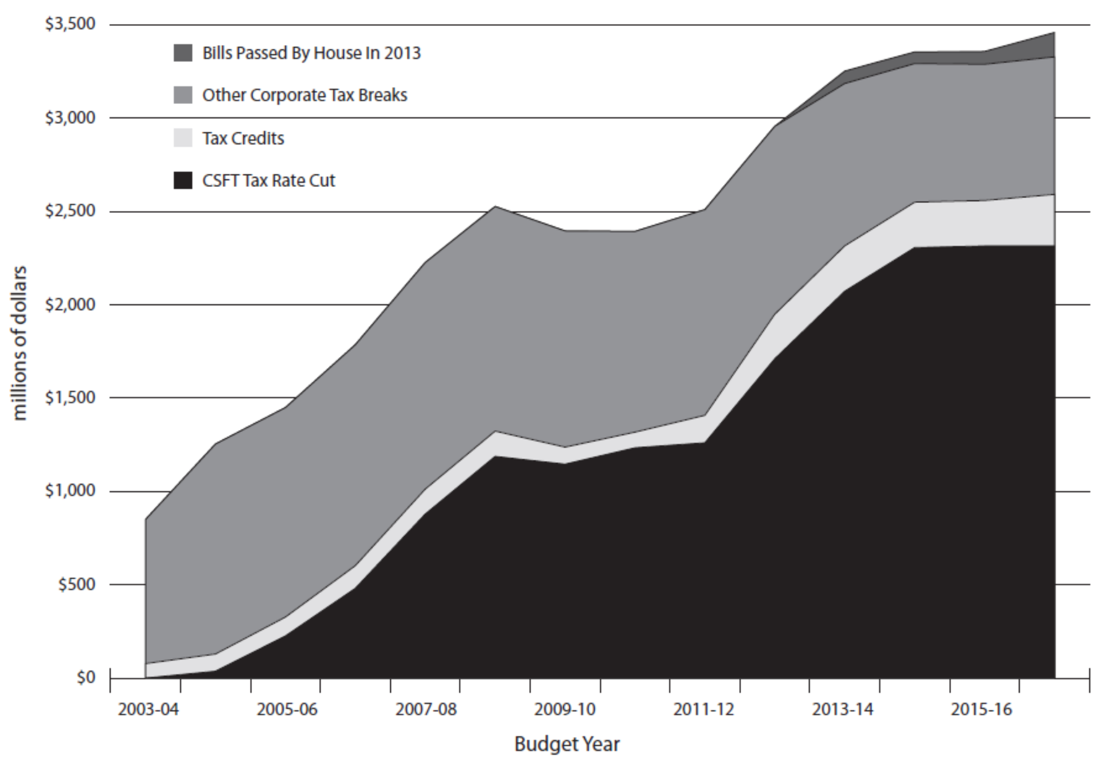
Costly Tax Cuts Have Been Enacted While No Action Has Been Taken to Close Loopholes

Figure 2 below shows the value of corporate tax changes from 2003-04, projected ahead to 2016-17. The analysis begins the fiscal year before the Business Tax Reform Commission report was issued, reflecting the value of any changes adopted after that time. It covers four areas of tax changes:

(1) The annual cost of reducing the capital stock and franchise tax from the 2002 rate of 7.24 mills.
(2) The annual cost of tax credits.
(3) The annual cost of other business tax expenditures,[3] including items recommended by the Business Tax Reform Commission that were adopted in 2004 and after.
(4) The annual cost through 2016-17 of new tax cuts adopted by the House and currently under consideration by the Senate. These include the Governor's Tax Reform plan, elimination of the business loans tax, natural gas tax credits, and inheritance tax changes.

The annual cost of these business tax reductions grew from $850 million in 2003-04 to $2.9 billion in 2012-13. By 2016-17, the annual costs will grow to almost $3.5 billion.

GROWTH OF BUSINESS TAX CUTS IN PENNSYLVANIA



---

[3] The cost of business tax credits and expenditures in effect in 2003-04 were taken from the Governor's Executive Budget and updated with subsequent budget documents.

Features of a Strong Addback Law

There are several good state laws that can serve as a model for Pennsylvania, including laws enacted in Tennessee, Kentucky and Indiana since 2006. At a minimum, the Pennsylvania law should:

(1) Require all companies to add back intangible expenses when submitting tax returns, list deductions taken for intangible expenses, and provide clear and convincing evidence that those deductions have economic substance and were not primarily undertaken for tax avoidance purposes. This transparent process ensures every company will be treated the same and will avoid "fishing expeditions" by the Department of Revenue.
(2) Include interest as well as intangible expenses. Loaning money from one related company to another is a second popular way of legally hiding income. Fifteen of 18 states with addback laws extend them to interest expenses.
(3) Do not presume that any transaction done at market rates has a valid business purpose.
(4) Include a strong economic substance test. Many corporations have Delaware subsidiaries that have some function, but whose primary purpose is tax avoidance. A strong test will protect those companies for whom a Delaware company adds economic substance, while identifying those whose subsidiaries have another function (such has administering all trademarks) that is a secondary to the tax avoidance objective.

Conclusion

While Pennsylvania has not taken any steps to reduce the corporate net income tax rate, lawmakers, both Republicans and Democrats, have been extremely generous in providing other business tax rate reductions and other tax changes sought by the business community. These tax changes save these companies several billion dollars annually and have substantially reduced the effective tax rate paid by companies operating in the Commonwealth. It is not at all clear to what extent these tax cuts have contributed to jobs or growth of the economy.

These tax changes have not been paid for and have made it more difficult for Pennsylvanians to provide core public functions, including education, health care, transportation and assistance to the vulnerable.

A strong addback bill should be adopted to recover some of the funds that Pennsylvania has let slip away through costly tax cuts during the past 10 years. Other taxpayers, including 25% of Pennsylvania companies that have no out-of-state presence, have had to pay more than their share to compensate for the tax avoiders. The bill has come due.

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.