Towards a Fair Pennsylvania Corporate Income Tax System

An Analysis of HB 1186

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It is as if on the Pennsylvania Turnpike you have hung a sign that says welcome to Pennsylvania, pick our pockets because you have a very old rickety tax structure.

Dr. Richard Pomp, University of Connecticut School of Law, May 10, 2007[1]

Summary

Pennsylvania has a famously antiquated corporation tax system. This system taxes the profits of some home-grown Pennsylvania corporations at relatively high rates, allows many major multi-state corporations to avoid some or all Pennsylvania taxes, and taxes the profits of a third group of corporations at the state's very low personal income tax (PIT) rate. The end result is a system that is both unfair to some businesses and sufficiently porous to leave individuals paying a growing share of total state revenues.

A current legislative proposal based on the recommendations of a tax commission largely consisting of members of the business community would modernize Pennsylvania's swiss cheese of a tax system, capturing and fairly taxing more of the income of large multi-state corporations but not raising total taxes on the business community. To meet the state's goals of achieving a more equitable business tax system but not shifting even more of total taxes to individuals, this policy brief recommends that the legislature:

- Adopt the proposal's "combined reporting" approach to reducing tax avoidance by large corporations.
- Phase in rather than immediately implement the full proposed cut in the Corporate Net Income Tax rate. This would avoid a shortfall in revenues during the period of uncertainty regarding how much combined reporting will affect taxable income.
- Accompany combined reporting with the closing of another corporate tax loophole that allows companies to avoid taxes on any of their sales in states in which they have little employment and property.
- Consider raising taxes on selected businesses that now pay only the state's PIT.

Background

The Pennsylvania General Assembly is considering a major reform in Pennsylvania's corporate tax system, the adoption of mandatory unitary combined reporting of business income. Combined reporting would reduce the

[1]Dr. Richard Pomp, University of Connecticut School of Law, Testimony before the Pennsylvania House of Representatives Committee on Finance, May 10, 2007, p. 86.

ability of large, multi-state corporations to use sophisticated "tax planning" techniques to lower their reported net income that is subject to Pennsylvania taxation. Such techniques are not available to smaller and less sophisticated businesses, especially those whose operations are limited to Pennsylvania.

The reform is relatively simple. Large, multi-state corporations often consist of a parent corporation and one or more subsidiary corporations. Under current law, each subsidiary files an independent tax return based on the assumption it is a truly independent entity. Under combined reporting, the parent and subsidiaries would file as if they were a single unified entity and income taxes would be assessed against the Pennsylvania income from all of the businesses. Combined reporting limits the ability of companies to use a variety of tax avoidance strategies to shift income to states with no or lower tax rates.

The most famous of these tax avoidance strategies—or corporate tax loopholes—is the Toys "R" Us Geoffrey loophole. Toys "R" Us established a Passive Investment Holding Company (PIC), Geoffrey, Inc., in Delaware. Geoffrey, Inc. holds patents, trademarks, and intellectual property rights that the subsidiaries need and leases this property back to the subsidiary corporations in Pennsylvania and other states in exchange for royalty payments, which are not taxed in Delaware. In Pennsylvania and many other separate company reporting states, royalties are a deductible expense for corporations, thus reducing the subsidiaries' taxable income. Combined reporting would allow companies to use PICs for legitimate purposes, but they would lose their value as tax shelters.

Another way for multi-state corporations to lower taxable income in Pennsylvania is through manipulation of the so-called transfer prices that subsidiaries charge each other when goods or services cross state (or national) lines. When a subsidiary in a low-tax state charges more to a subsidiary in a high-tax state, income is shifted to the lower tax state.

Combined reporting is a comprehensive and 21st century approach to limiting the ability of large corporations to shift reported net income across state lines. Piecemeal reform banning specific abuses is significantly less effective than adopting combined reporting. By the time specific abuses, like the Geoffrey PIC, become public knowledge, they become more risky for companies to employ, so they move on to other techniques. Combined reporting eliminates most of these opportunities, as corporations can no longer easily move profits or losses between subsidiaries and in and out of states.

Why is Combined Reporting Necessary?

The current tax system is unfair to individuals and businesses. Tax loopholes available under separate company reporting currently shelter millions of dollars of income from state taxes. Separate company reporting creates an unfair competitive advantage for multi-state companies that hurts smaller Pennsylvania businesses.

The loss of revenue is considerable. An analysis by Pennsylvania Public Interest Research Group estimates that closing the Passive Investment Corporation (PIC) loophole alone costs Pennsylvania $276 million.[2] The Pennsylvania Department of Revenue estimates that the combined reporting impact (without rate reductions or apportionment changes) would generate an additional $615 million in revenue in tax year 2009.[3]

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[2] Beth McConnell, *The Great Escape: How Corporations Avoid State Taxes* (Philadelphia: PennPIRG, 2003).

[3] Pennsylvania Department of Revenue fiscal estimate of HB 1186, PN 1465. Rate reduction and the adoption of the single sales factor method of apportionment are projected to make the overall package of combined reporting virtually revenue neutral. Due to the manner in which business taxes are levied and paid, it would take several fiscal years to collect projected revenue from a single tax year.

When some businesses avoid their fair share of taxes, the cost of services, which these businesses continue to enjoy, is borne disproportionately by other businesses and by individuals.

A growing number of states are enacting combined reporting laws. In the past three years, four additional states have enacted combined reporting laws (Vermont, Texas, New York, and West Virginia) bringing the total to 20. The governors of four other states (North Carolina, Michigan, North Carolina, and Massachusetts) proposed combined reporting in their 2007 budgets.

There is little evidence that combined reporting hurts economic growth. Economist Robert Lynch examined claims that combined reporting is an impediment to economic growth, finding that most of the states with greatest economic growth in the past 15 years use combined reporting.[4] Lynch looked at two measures, gross state domestic product (GSP) and non-farm employment. Between 1990 and 2005, five of the seven fastest growing states, measured in growth in GSP, were combined reporting states. GSP of 16 combined reporting states grew slightly faster than non-combined reporting states, averaging 3.3% vs. 3.1% per annum for the other 34 states. Similarly, four of the five states with the greatest employment growth require combined reporting, and combined reporting states showed somewhat higher job growth than single company reporting states, between 1990 and 2005, 1.5% vs. 1.3% annually. Lynch does not suggest that combined reporting contributes to economic growth, attributing it to other factors, but argues that it has not interfered with the economic progress of states that employ it.

Why Should Businesses Pay Taxes?

Businesses, just like individuals, benefit from the services provided by state and local governments and should pay for those services through their taxes. For example, public investment in education and training provides businesses with a more qualified workforce. Employees use publicly funded transportation services to get to work. Goods move along publicly funded roads and highways, and police and fire departments respond to calls at stores and factories, just as they do to homes. In short, state investment allows Pennsylvania companies to earn their profits and business taxes are an important source of funding to maintain those services.

Other Provisions of HB 1186

HB 1186 does not increase total taxes on businesses. It is much more generous to the business community than combined reporting proposals recently enacted or proposed in other states—arguably too generous. This bill represents a compromise highly favorable to the business community, which reflects many substantial tax reductions that businesses have requested, including:

- A rate reduction of over 20% (from 9.99% to 7.9%)
- Uncapping of Net Operating Losses (currently capped at $3 million per year)
- Adoption of the single sales factor method of apportionment, rather than using a combination of sales, property, and payroll.

[4] Robert G. Lynch, et. al., *Building A Strong Economy: The Evidence on Combined Reporting, Public Investments and Economic Growth* (Boston: Economic Policy Institute and Massachusetts Budget and Policy Center, 2007).

Strengthening HB 1186

The Governor's Business Tax Reform Commission recommendations offer generous tax treatment for many Pennsylvania businesses. Many already profitable businesses (those that do not use tax planning) would come out as big winners. As a result, revenue from closing corporate tax loopholes that could fund services and reduce the need to increase other taxes is not available. To make the legislation more fair and further improve the tax system, the Pennsylvania Budget and Policy Center recommends the following:

1. Add a throwback rule to close another potentially significant tax loophole. Under the throwback rule, profits from the sales of multi-state businesses in states where those businesses do not have a sufficient presence (property and payroll) to be taxable would be thrown back to Pennsylvania and taxable under our code. This eliminates the incentive for companies to use this potential loophole. Twenty-six of 45 states with corporate income taxes have a throwback rule.

2. Phase-in the CNIT reduction over several years. There is precedent for a phase-out rate reduction with the Capital Stock and Franchise Tax. This would allow the Commonwealth to ensure that combined reporting raises sufficient revenue to pay for itself, rather than forcing other taxpayers to pay the cost of corporate tax cuts.

3. Adopt the commission's recommendation for a pass-through entity tax. This tax would apply to S Corporations and Limited Liability Companies (LLCs), not sole proprietorships or regular partnerships. Pennsylvania has the second lowest top personal income tax rate in the nation. The gap between the CNIT at 9.99% (or even at 8.99% or 7.99%) and the PIT at 3.07% creates a tremendous incentive for companies to incorporate under Subchapter-S of the Internal Revenue Code and pay taxes at the personal rather than corporate tax rate. Adopting the pass-through entity tax would help reduce the artificial tax advantage given to S Corporations and Limited Liability Companies as compared to normal corporations. To eliminate the entire advantage, the pass-through tax would need to eliminate the difference between the personal income tax rate and the corporate rate. If HB 1186 were adopted, this gap would be 4.83%. A 0.5% pass through entity tax would begin to redress this imbalance.

The reason you want to do combined reporting is you want to shut down the game plan. You want to have a fair system. You don't want the people who can afford to hire me to have an edge over mom and pops and the small businesses in the state. It is just fundamentally unfair to further stack the deck against small business.

Dr. Richard Pomp[5]

[5] Dr. Richard Pomp, University of Connecticut School of Law, Testimony before the Pennsylvania House of Representatives Committee on Finance, May 10, 2007, p. 93.