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To: Editorial Page Editors, Editorial Board Members, Capitol Reporters & Columnists

From: Sharon Ward, Director of the Pennsylvania Budget and Policy Center

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Re: Bill in PA House Won't Close Tax Loopholes But Will Make Major New Business Tax Cut

The Pennsylvania House will take up House Bill 2150 this week which couples a half-hearted attempt to close corporate tax loopholes with nearly a billion dollars in business tax cuts by the end of the decade. These tax cuts will do little to boost the economy but will drain needed resources for education, hospitals and infrastructure in Pennsylvania.

Corporate tax loopholes are a costly problem for Pennsylvania, and House Bill 2150, sponsored by Rep. Dave Reed, is an important acknowledgement of that problem. The state Department of Revenue has estimated that loopholes cost the state more than $500 million a year.

Responsible tax reform should be a priority for lawmakers, but this bill restructures the state's tax system in a way that Pennsylvania cannot afford. It would enact nearly $1 billion in tax cuts by the end of the decade – offset, at best, by $250 million or so in new revenue from closing loopholes. **The full House is expected to debate and vote on amendments to the bill Tuesday, May 1.**

Both House and Senate leaders have signaled displeasure with the Governor's proposed 2012-13 budget, which includes cuts to higher education, county human services, Accountability Block Grants and the General Assistance program, and provides no relief for school district funding cuts enacted last year. The slow economic recovery, aging population, higher pension costs, and rising health care costs will continue to exert pressure on the state budget for several years.

Given this set of long-term fiscal pressures, lawmakers need to act prudently on both the revenue and expenditure side of the budget. House Bill 2150 leans more toward reckless than prudent, promising long-term tax reductions during a period when the commonwealth is likely to face great difficulty paying its bills.

Corporate Tax Loopholes a Costly Problem

Corporate tax avoidance has come under increased scrutiny at the federal and state level as governments have sought to close budget gaps and avoid service cuts. The cost is significant: a study by the Pennsylvania Department of Revenue using available taxpayer data pegged the cost of state loopholes at $550 million.

The most visible of the corporate tax avoidance strategies is the Delaware loophole, which House Bill 2150 purports to close. Here is how it works. A parent corporation transfers ownership of trademarks, logos, and other valuable intangible business property to a wholly-owned subsidiary to "hold" the intangible property. The parent company then pays a fee to the subsidiary for the rights to use the trademarks. These fees are a means to transfer profits earned in Pennsylvania to the out-of-state subsidiary, where income is either not taxed or taxed at a far lower rate. Delaware and Nevada don't tax royalty income, so subsidiaries are often established in these states.

The Bill Would Not Close the Delaware Loophole

House Bill 2150 would require companies to "add back" to Pennsylvania taxable income the costs they have paid to subsidiaries for these intangible expenses. Several states have grappled with this issue recently. There are good statutes and bad ones – those that set clear standards and are difficult to circumvent, and those that set fuzzy standards that are easy to skirt. Unfortunately, this bill falls in the latter category.

A strong bill is not out of the question. New Jersey enacted a strong addback bill in 2002, and the Governor of Mississippi proposed a good bill this year. Thirty-five of the 45 states that levy corporate income taxes have taken steps to crack down on tax loopholes, through addback rules or unitary combined reporting.

The chief flaw in House Bill 2150 is an exception to the addback rule for a transaction "related to a valid business purpose." The language does not offer a clear standard for companies to comply with, leaves room for a great deal of avoidance, and would be difficult for the Department of Revenue to enforce.

The Bill Enacts Costly New Tax Cuts

The bill's sponsors have stated their intent to enact revenue-neutral business tax reform, applying revenue from closing loopholes to reductions in business tax rates. This bill is anything but revenue neutral. Instead, tax cuts costing close to $1 billion are offset by, at best, $250 million or so in new revenue.

Large tax rate reductions required by statute will likely be paid for with further reductions in spending that will undermine rather than strengthen Pennsylvania's economy. The availability of skilled and trainable workers, supported with job training, robust transportation and other infrastructure, and a good quality of life are vital to economic growth and critical to Pennsylvania's communities. All of these will be undermined by an approach that focuses only on tax rates.

The bill also ties the General Assembly's hands by putting the tax reductions in statute. The General Assembly should vote each year on tax rates as they do on spending, weighing the cost of the tax cut expenditure with available revenue and making choices that are affordable and reflect that year's priorities.

Proponents would argue that business tax cuts are necessary to create jobs in this sluggish economy. Most economic analysis suggests that tax cuts are ineffective as economic stimulus, costing much more than they generate and creating fewer jobs than direct public investments. Tax cuts that result in reductions in public spending, especially for education, public safety and transportation, can hurt economic growth.

Rep. Dave Reed has made an important contribution by acknowledging that corporate tax loopholes are a problem that needs to be addressed. Like spending increases, tax cuts must serve some public purpose and be affordable. Legislation to close corporate tax loopholes should, at the very least, do no harm. This legislation does not even meet that modest test.

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