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Briefing Paper

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The Truth About Business Taxes in Pennsylvania, Part Two - The Uneven Distribution of the Business Tax Burden

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Summary

A previous Keystone Research Center paper found that, contrary to conventional wisdom, the amount in taxes that Pennsylvania businesses pay, on average, to state and local governments is not high when compared with other states. In this paper, we highlight a second truth about business taxes in Pennsylvania – the uneven distribution of corporate tax burdens. Under the two major Pennsylvania business taxes, a small number of companies pay heavily, while many businesses contribute little or nothing. This uneven distribution raises questions about the equity of the current corporate tax structure in Pennsylvania.

Using data published in December 2002 by the Pennsylvania Department of Revenue, we find:

- fewer than one in five corporations doing business in Pennsylvania pay anything under Pennsylvania's major corporate profits tax — the Corporate Net Income (CNI) tax;
- only one in 17 corporations obligated to file a return for the CNI tax pay more than $10,000;
- 170 corporations doing business in Pennsylvania – an estimated one out of every 1,265 – contribute half of the total CNI tax revenue and 0.8 percent of companies pay 81 percent of the total CNI tax revenue;
- turning to Pennsylvania's second major corporation tax, the Capital Stock and Franchise (CSF) tax, which is imposed on a combination of the value of a corporation's net worth and average net income, only one in 12 corporations filing a CSF return pays more than $5,000;
- ninety-seven corporations account for nearly a third of CSF tax revenue and 0.6 percent of companies filing returns pay 59 percent of the total revenue.

With only a small fraction of corporations paying significant amounts under the CNI and the CSF taxes, Pennsylvania tax revenue collected from all corporation taxes has declined over time.

- Revenue from all corporation taxes fell from 29.9 percent of General Fund revenue in fiscal year 1971-72 to 25.1 percent in fiscal year 1994-95 to a projected 18 percent in fiscal year 2002-03.

- The steepest decline in revenue is from Pennsylvania's CNI tax, which dropped from 14.2 percent of General Fund revenue in fiscal year 1971-72 to 11.7 percent in fiscal year 1994-95 to a projected 7.3 percent in fiscal year 2002-03.
- Tax revenue from the CSF tax went from 6.3 percent of General Fund revenue in fiscal year 1971-72 to 5.5 percent in fiscal year 1994-95 to a projected 4.4 percent in fiscal year 2002-03.

Today, the fall in revenues from corporation taxes exacerbates the state's fiscal crisis. Over the longer haul, Pennsylvania's unevenly distributed business taxes are unfair to those businesses that pay most heavily and perpetuate the myth that business taxes are high overall. The end of the paper outlines four options for distributing the Pennsylvania business tax burden more evenly. We also recommend that the Pennsylvania Department of Revenue produce a public report that would provide basic information on corporations that pay different amounts in CNI and CSF taxes.

Pennsylvania's Budget Deficit

Our examination of the second truth about Pennsylvania's business taxes comes in the context of the state's current budget shortfall. In his inaugural address on January 21st, 2003, incoming Governor Ed Rendell said this deficit "could reach $2 billion or more" next fiscal year.

This projection is in line with those of the National Conference of State Legislatures (NCSL). In a November 2002 analysis of state budgets, NCSL labeled Pennsylvania's revenue outlook "pessimistic" and one of the nine worst in the nation. NCSL estimated one-time funding sources used in the fiscal year 2002-03 to add up to $1.8 billion.[1] Without these one-time sources, the budget shortfall would have been $1.8 billion this year. Even with one-time boosts, projected revenues have trailed state appropriations enacted under the 2002-03 budget by $558 million (and rising). This has necessitated spending cuts and further dipping into the state's Rainy Day Fund.[2]

Overview of Pennsylvania General Fund

Table 1 provides an overview of the General Fund of Pennsylvania. The General Fund is the major operating fund of the Commonwealth and receives all tax receipts and other revenues not specified to be placed in special funds. (The two largest special funds that are not part of the General Fund are the motor license fund and the lottery, the latter set aside for programs that benefit seniors.)

The General Fund in fiscal year 2002-03 is estimated to be nearly $21.8 billion.[3] Three major classes of taxes account for 91.2 percent of General Fund revenue.

- Consumption taxes – sales and use, cigarette, malt beverage, and liquor – are estimated to generate nearly $8.6 billion in revenue in fiscal year 2002-03, or 39.3 percent of the General Fund.[4]
- Personal Income taxes are estimated to generate $7.4 billion in revenue in fiscal year 2002-03, or 33.9 percent of the General Fund.
- Corporation taxes – which include, in addition to the CNI and CSF taxes, the utility gross receipts tax, utility property tax, insurance premium tax, and various financial institution taxes – are estimated to generate $3.9 billion, or 18 percent of the General Fund (Table 2).

Table 1. Projected Pennsylvania General Fund Revenue in Fiscal Year 2002-03		
Tax Type	**Amount ($ thousands)**	**Share of General Fund Revenue**
General Fund	$21,812,100	
Consumption Taxes	$8,575,800	39.3
Personal Income Taxes	$7,395,800	33.9
Corporation Taxes	$3,924,200	18.0
Other Taxes	$1,114,700	5.1
Nontax Revenue	$801,600	3.7

Source: Keystone Research Center (KRC) analysis of Pennsylvania Department of Revenue (DOR) projections made at the beginning of Fiscal Year (FY) 2002-03.

- The Corporate Net Income (CNI) tax is the largest source of corporate tax revenue in Pennsylvania, estimated to generate $1.6 billion in fiscal year 2002-03, or 7.3 percent of total General Fund revenue.
- The Capital Stock and Franchise (CSF) tax is the second largest source of corporate tax revenue, estimated to generate $957 million in fiscal year 2002-03, or 4.4 percent of total general fund revenue.
- The Gross Receipts tax — a sales tax on selected transport and utility services – is estimated to generate $769 million in fiscal year 2002-03, accounting for 3.5 percent of total general fund revenue.

Table 2. Projected Pennsylvania Corporation Taxes in Fiscal Year 2002-03		
Tax Type	**Amount ($ thousands)**	**Share of General Fund Revenue**
General Fund	$21,812,100	
Total Corporation Taxes	$3,924,200	18.0
Corporate Net Income	$1,597,800	7.3
Capital Stock & Franchise	$956,600	4.4
Gross Receipts	$768,600	3.5
Utility Property	$41,900	0.2
Insurance Premium	$326,000	1.5
Financial Institution	$220,800	1.0
Other Selective	$12,500	0.1

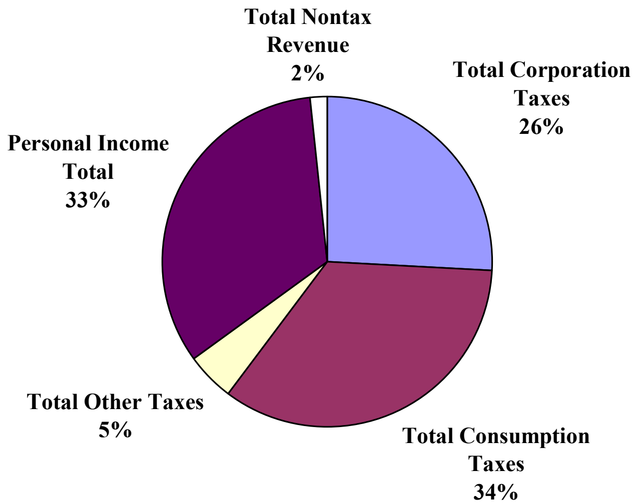
Source: KRC analysis of PA DOR projections made at the beginning of FY 2002-03.

Corporation Taxes in Pennsylvania: A Declining Source of Revenue

Over the past three decades, but particularly since 1995, General Fund revenue from corporate taxes has declined.[5] Figures 1 and 2 provide a snapshot of General Fund revenue sources in fiscal year 1991-92 and fiscal year 2002-03. It shows that the share of General Fund revenue from corporation taxes declined from 26 percent to 18 percent in this period.

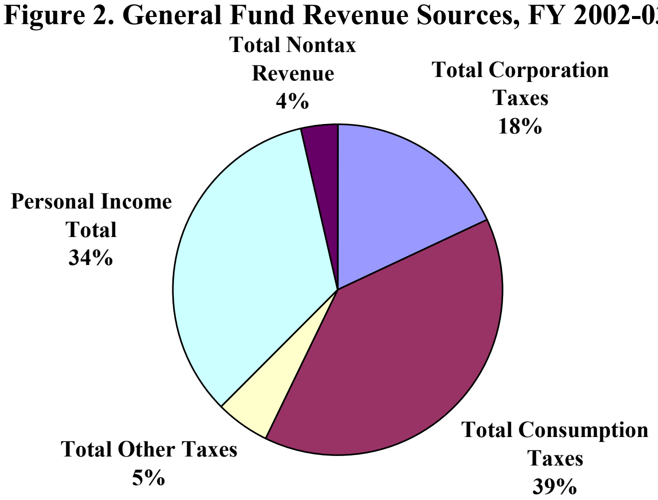
Figure 3 provides data on the three main components of corporate taxation – CNI, CSF, and Gross Receipts – as well as total corporation taxes as a share of General Fund revenue from fiscal years 1971-72 through 2002-03.

Figure 1. General Fund Revenue Sources, FY 1991-92



Source: Keystone Research Center (KRC) analysis of PA Department of Revenue data (The Statistical Supplement for the Pennsylvania Tax Compendium).

Figure 2. General Fund Revenue Sources, FY 2002-03



Source: KRC analysis of PA Department of Revenue data.

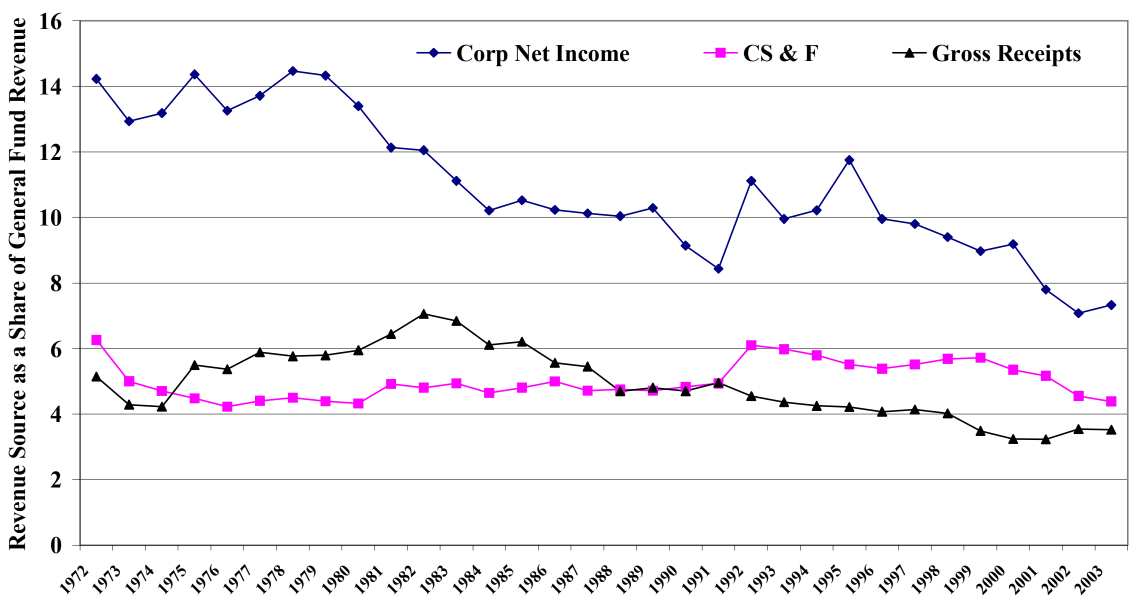
- Revenue from all corporation taxes has declined from 29.9 percent of General Fund revenue in fiscal year 1971-72 to 25.1 percent in fiscal year 1994-95 to 18 percent in fiscal year 2002-03.
- The steepest decline in revenue is from Pennsylvania's Corporate Net Income (CNI) tax, which dropped from 14.2 percent of General Fund revenue in fiscal year 1971-72 to 11.7 percent in fiscal year 1994-95 to 7.3 percent in fiscal year 2002-03.
- Tax revenue from the Capital Stock and Franchise (CSF) tax went from 6.3 percent of General Fund revenue in fiscal year 1971-72 to 5.5 percent of General Fund revenue in fiscal year 1994-95 to 4.4 percent of General Fund revenue in fiscal year 2002-03.

Across the 50 states, a decline of revenue from corporate taxes is a widespread phenomenon. From 1989 through 2001, 39 of the 44 states with corporate income taxes saw a drop in revenue from this tax as a share of state tax revenues (Figure 4). The decline ranged from 12.7 percentage points in Connecticut to 0.5 percentage points in New York, with Pennsylvania in the middle of the 39 states with a 3 percentage point drop.

Four factors appear to explain the decline in corporate tax revenue share. First, the Pennsylvania legislature made a conscious decision to lower corporate contributions to the state's revenue by lowering corporate tax rates. In Pennsylvania, the CNI rate was lowered from 11.99 percent to 9.99 percent in 1995. Additionally, the CSF tax is scheduled to be phased out by 2010.

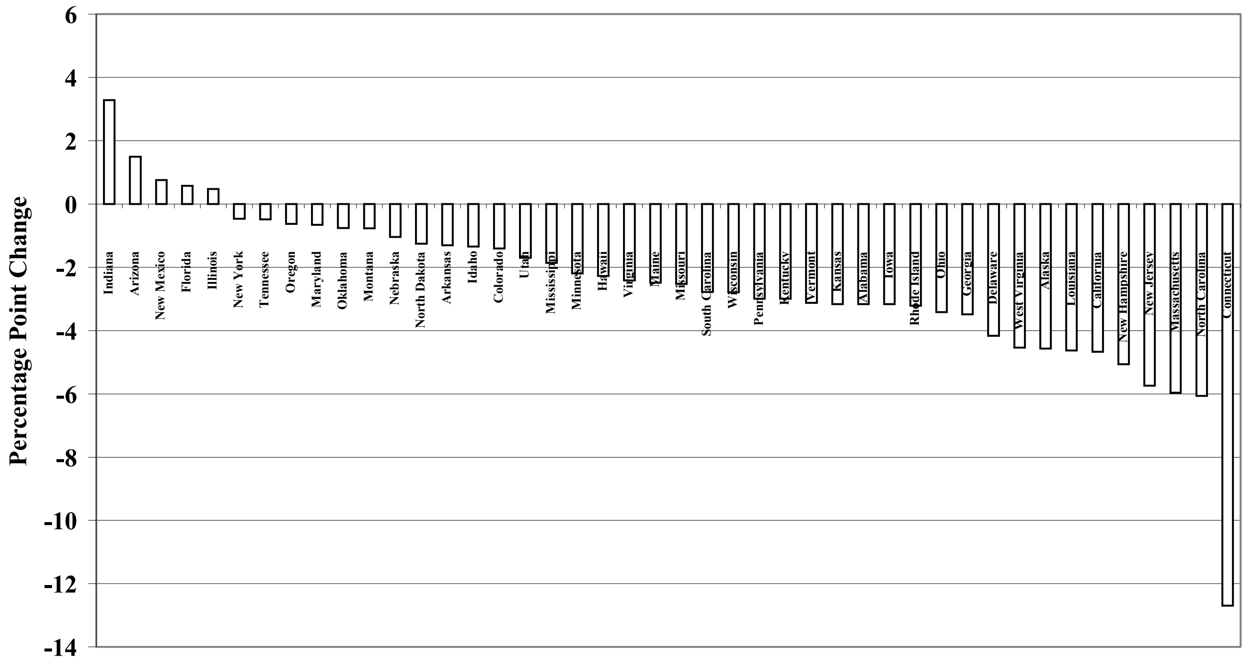
Second, some of the decline is likely due to more corporations becoming Subchapter S corporations. In the current fiscal year, the fact that Pennsylvania only collects the 2.8 percent PIT on Subchapter S profits (rather than 9.99 percent) cost the Commonwealth an estimated $500 million.[6] Third, some of the decline in the corporate share of tax revenues in the last few years is due to the recent recession.

Figure 3. Pennsylvania's Main Corporation Taxes as a Share of General Fund Revenue, 1972-2003 (percent)



Source: KRC analysis of PA Department of Revenue data.

Figure 4. Change in Corporate Net Income Tax Revenue as a Share of Total State Taxes, 1989-2001



Source: KRC, based on U.S. Census Bureau data.

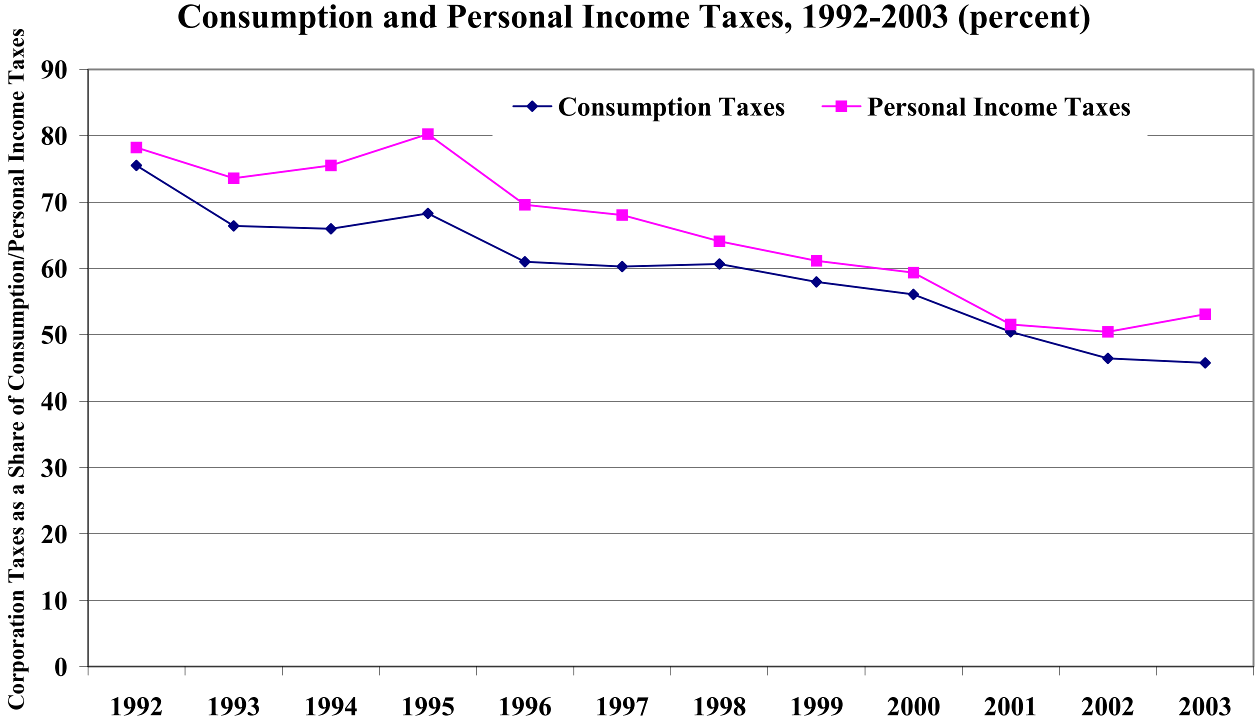
Fourth, it is likely that part of the decline in the corporate tax share of state revenues is due to the growing sophistication of corporations' tax planning. Corporations have become more adept at finding ways to lower their tax liability for any given level of profit and operations. Across the United States, the executive director of the Multistate Tax Commission recently suggested that as much as 80 percent of the decline in the past two decades of corporate income tax revenue is due to tax planning or "weakened standards of income accountability."[7] We detail near the end of the paper some of the ways corporations lower their taxes.

Compared to the other two main sources of General Fund revenue – consumption taxes and personal income taxes – the decline in corporation taxes is striking. Figure 5 presents data showing corporation taxes as a share of consumption and personal income taxes. In 1992, corporation tax revenue in Pennsylvania was 78 percent of personal income tax revenue and 75 percent of consumption tax revenue. With the slowdown in the economy, the ratio of corporate tax revenues to consumption and personal income tax revenues dropped to 46 percent (consumption) and 53 percent (personal income) in fiscal year 2002-03.

Who Pays Corporate Taxes in Pennsylvania?

Pennsylvania Department of Revenue data allow us to explore the distribution of CNI and Capital Stock and Franchise tax liability.[8] For the tax year 1997, data are available on what corporations paid on the CNI plus the CSF. In that year, 63 percent of corporations filing a CNI and/or CSF tax form — 135,373 of 215,078 corporations – paid $0 to $300. We now consider the distribution of payments on each tax separately.

Figure 5. Pennsylvania Corporation Taxes as a Share of Consumption and Personal Income Taxes, 1992-2003 (percent)



Source: KRC analysis of PA Department of Revenue data.

Corporate Net Income Tax

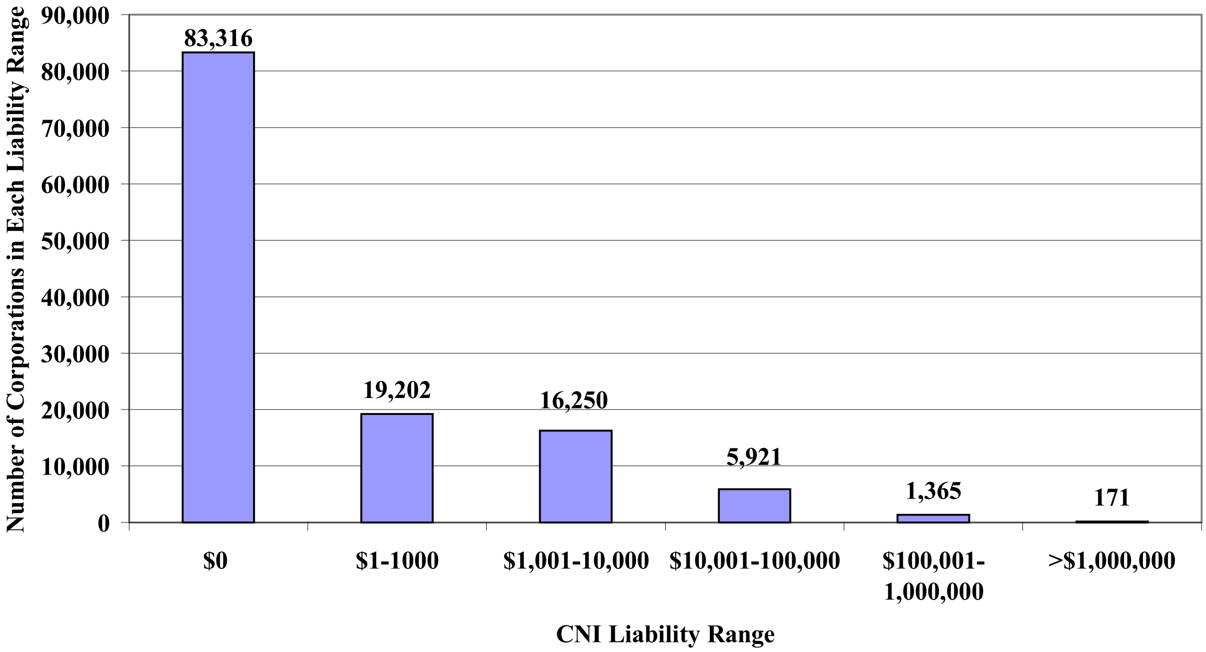
Fewer than one in five corporations doing business in Pennsylvania (42,909 of 228,514) paid any CNI in 1999. (Technically, the CNI tax is 9.99 percent times federal taxable income, with some adjustments specific to Pennsylvania, multiplied by an "apportionment" factor that depends on what fraction of the company's U.S. sales, property, and payroll are in Pennsylvania.[9])

- An estimated 45 percent of the 228,514 corporations filing returns for the CSF tax were Subchapter S corporations or other entities not subject to the CNI. Subchapter S corporations do not pay corporate tax on their profit. Instead, the profit is "passed through" to shareholders who pay the 2.8 percent Personal Income Tax on it. The huge gap between the 9.99 percent CNI and the 2.8 percent PIT is a major source of tax inequity between Subchapter S corporation and C corporations.
- Of the 126,225 corporations subject to the CNI in tax year 1999, only 42,909, or 34 percent, paid any CNI tax.

Figure 6 shows the liability distribution for the 126,225 corporations filing CNI returns in tax year 1999.

- Of this group, 83,316, or 66 percent, paid no CNI tax.
- Another 19,202, or 15 percent of 126,225, paid between $1 and $1,000 in CNI tax.
- Only 7,457, or 5.9 percent of CNI liable corporations, paid $10,001 or more in CNI tax, with 171 of these corporations paying over $1 million each.

Figure 6. Distribution of Liability for PA Corporations Subject to CNI, Tax Year 1999



Source: KRC analysis of PA Department of Revenue data.

Precise information is not disclosed on what individual corporations pay in the CNI. However, the Department of Revenue does report the total paid by corporations paying within different ranges (e.g., over $1 million, $100,001 to $1 million). In data published in December 2002 (for Tax Year 1997):

- 170 Pennsylvania corporations, representing 0.13 percent of all corporations liable for the CNI tax, supplied 51 percent of the total CNI tax revenue of $1.43 billion;[10]
- 132,247 Pennsylvania corporations, or 98.7 percent of all corporations filing returns for the CNI tax, paid just 18.8 percent of the total CNI tax revenue.

Capital Stock & Franchise Tax

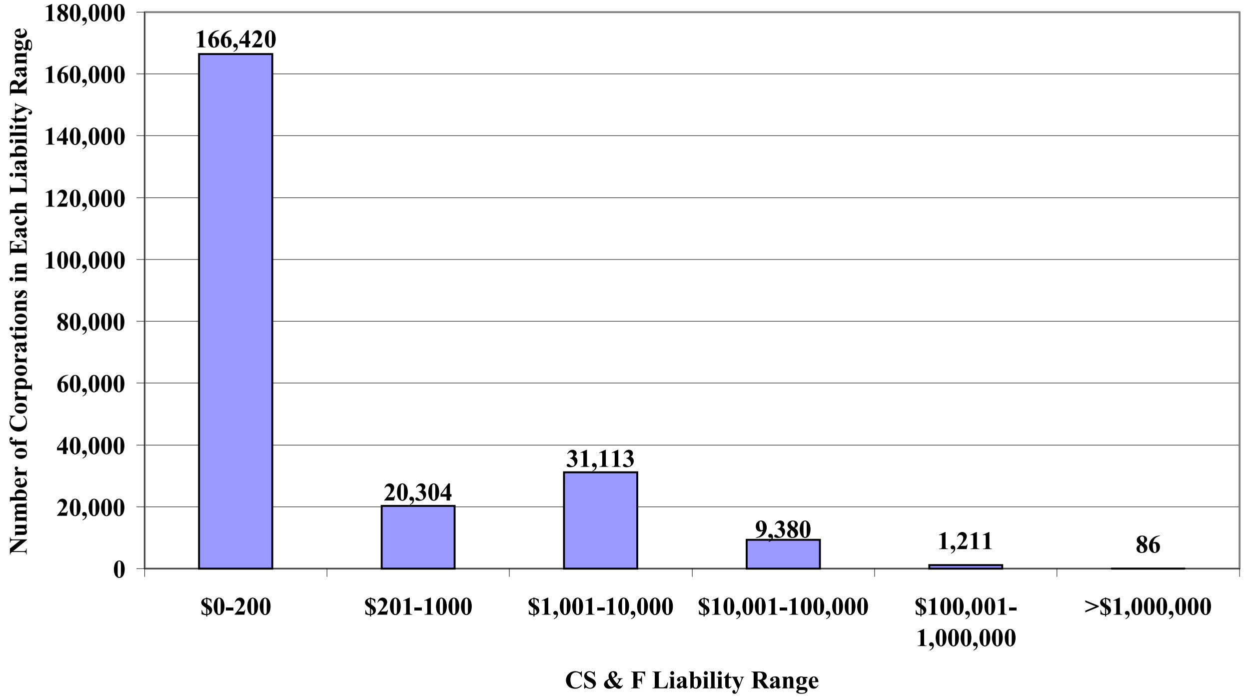
Although the Capital Stock and Franchise (CSF) tax works differently than the CNI tax, the distributional pattern for each is remarkably similar. (The CSF tax is derived by the following formula: {[.5 x (average net income/.095 + (.75)(net worth))] - $125,000}times an apportionment factor based on the extent of the company's Pennsylvania operations times the tax rate (which equaled 6.99/1,000). Average net income is a five year average. Manufacturing operations are not counted in evaluating the extent of the company's Pennsylvania operations and are, therefore, exempt from the CSF tax.[11])

In tax year 1999 (the latest year for which data are available), 228,514 corporations were obligated to file returns for the Capital Stock and Franchise Tax. As the text and figures below demonstrate, only 27 percent of corporations doing business in Pennsylvania (62,094 of 228,514) paid above the statutory minimum of $200 in CSF tax in 1999. The remaining 166,420 corporations (73 percent) paid $0-200 in tax year 1999.[12]

Figure 7 shows data on the liability distribution for the 228,514 corporations liable for the CSF tax in 1999.

- 20,304 corporations, or 9 percent, paid between $201 and $1,000 in CSF tax.

Figure 7. Distribution of Liability for CS & F Tax, Tax Year 1999



Source: KRC analysis of PA Department of Revenue data.

- 17,955, or 8 percent, paid $5,001 or more in CSF tax, with 86 of these corporations paying over $1 million each in CSF tax.

Similar to the CNI, the Department of Revenue reports the total paid by corporations paying within different ranges (e.g., over $1 million, $100,001 to $1 million). In data published in December 2002 (for Tax Year 1997):[13]

- 97 corporations doing business in Pennsylvania, representing 0.05 percent of all corporations filing returns in that year, supplied 31 percent of the total CSF tax revenue of $1.05 billion;
- 213,767 corporations doing business in Pennsylvania, or 99.4 percent of all corporations filing returns, paid 41 percent of the total CSF tax revenue.

Although the CSF tax still generates around $1 billion per year in revenues, it is scheduled to be phased out by 2010. What Keystone Research Center predicted in 2000 is in imminent danger of coming to pass: "[P]hasing out [the CSF tax] without creating an alternative source of revenue is a time bomb for the state's next Governor. Only unexpectedly rapid growth will prevent the cut from derailing investments in education or in reducing worker insecurity …"[14]

In 2002, KRC reemphasized that, "[T]he CSFT phase-out passed without any consideration of whether the state would end up unable to fund its schools, expand quality pre-school programs, buttress its underfunded community colleges, or invest in other public goods of importance to businesses making expansion and location decisions."[15] In a sluggish economy facing budget shortfalls, any serious discussion of tax reform in Pennsylvania must address the impending loss of revenue from the CSF tax.

Box 1. Lifting the Veil of Secrecy on What Individual Corporations Pay in Taxes[16]

Despite the importance of corporate taxes, it is nearly impossible for the public to determine the amount of state taxes an individual corporation pays. Corporations are required to disclose federal taxes paid in Securities and Exchange Commission filings, but are not required to disclose individual state tax information.

In his first budget address on March 26th, 2002, Governor James E. McGreevey of New Jersey partially lifted the veil of secrecy from what some of the state's biggest companies pay.[17]

- Of the 50 largest companies in New Jersey, 30 paid only the minimum corporate tax of $200 per year.
- The 50 largest companies (measured by number of employees) combined to pay a total of $345 million in corporate income taxes in 1999. Ten of these companies paid $314 million (or 91 percent), while 30 of these companies paid a collective total of $6,000 ($200 per company).
- Corporate profits in New Jersey doubled from 1991 to 2001, rising from $15.6 billion to $31.2 billion. In the same period, corporate business tax collections went only from $1.1 billion to $1.4 billion (27 percent increase), even though the business tax rate remained unchanged.

In the legislative hearings on the proposed New Jersey Business Tax Reform Act, three different grocery stores revealed their corporate tax burdens.

- A&P, with $1.5 billion in sales and 11,380 employees in New Jersey, paid $200 in corporate income tax in 2001.
- QuickChek, with$275 million in sales and 1,700 employees, paid $210,000 in corporate taxes.
- Pagano's IGA – single supermarket store in Bayonne – paid $3,000 in corporate taxes.

Corporate Tax Policy Options for Pennsylvania

This paper so far has shown that the share of Pennsylvania taxes accounted for by corporations has declined over time. Second, corporate taxes are highly unevenly distributed – some corporations undoubtedly pay a lot, while the majority of corporations pay very little, and a large number pay nothing on one or both of the CNI and CSF tax. This final section discusses four possible approaches to achieving more equitable Pennsylvania corporate taxes. These options could help address the short-term budget crisis and avoid future crises by replacing revenue lost via the CSF phase-out.[18]

Income Shifting

One strategy that companies employ to lower their taxes relies on the creation of "passive investment companies" or PICs. Companies using this strategy establish PICs in a state that does not tax royalties, interest, or similar types of "intangible income." They then have the PIC charge one or more corporate entities in another state for use of its trademark or patent. The royalty paid to the PIC is deducted as a business expense, reducing the profit in the state or states with a CNI (Box 2).

While it is not possible to estimate the prevalence of PICs, since the information is confidential, documents from court cases and investigative journalism provide insight into some specific cases.

Box 2. How the PIC Game Works

Step 1: A parent corporation sets up a PIC in a state without a corporate income tax (Nevada) or a state that does not tax corporations whose only income is from intangible assets (Delaware).

Step 2: The parent corporation transfers to PIC its patents, trademarks, "know-how," and other intangible assets.

Step 3: The PIC licenses back to the parent corporation the right to use patents, trademarks, etc. in exchange for royalties.

Result: Payment of royalties from the parent corporation to the PIC reduces, or perhaps eliminates, the taxable profit of the parent corporation, while the PIC is not subject to tax on its profit.

Step 4: The PIC then lends its profit to the parent corporation in exchange for interest payments, which further reduces the parent corporation's profits.

Adapted from Michael Mazerov, Two Key State Corporate Income Tax Reforms, presented at "10th Annual Funding State Services Conference" December 8th, 2002, Washington D.C.

- In perhaps the most notorious PIC case, the Delaware PIC of Toys R' Us received $55 million in royalties and other passive income in 1990 from charges to the corporation's stores for use of the company name, trademarks (such as Geoffrey Giraffe), and "merchandising skills."[19]
- K-Mart's Michigan PIC earned $1.25 billion in royalty income from 1991 to 1995. In this case, the K-Mart PIC also earned an additional $78 million in the same period by lending its royalty receipts back to K-Mart, "usually within two or three days from when they were received."[20]
- A recent Wall Street Journal article documented 33 PICs, including such major corporations as Home Depot, Staples, American Greetings, Budget Rent-A-Car, Burger King, Kohl's, CompUSA, ConAgra, Tyson Food, Gap, and Urban Outfitters.[21]
- In Nevada, there are about 132,000 incorporated businesses with no employees. Many of these are probably PICs.[22]

What can be done to prevent tax reduction via PICs? The most comprehensive approach is "combined reporting." This not only nullifies income shifting via PICs but also other tax reduction strategies: e.g., shifting profits to states with lower or no CNI using intra-company "transfer" prices (e.g., for supplies, managerial, or professional services); changing two corporate entities legal relationship to evade anti-PIC provisions; and ensuring that corporate entities have too little presence (or "nexus") in a state to be taxed (see next section for more on nexus). How does combined reporting address these issues?

- All corporations across the country (or world) that are tightly-interconnected with a company in the state in question are essentially treated as one taxpayer.
- Profits for all these related businesses must be added together and then a formula is used (based on the share of the combined company's sales, payroll, and/or property in the state) to "apportion" how much of the combined profit will be taxed in the state. As a result, the corporation gains little or no advantage by shifting the profit between various corporations in the corporate group.

Sixteen states currently require combined reporting – Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah.

Short of the comprehensive reform of combined reporting, seven states – Alabama, Connecticut, Massachusetts, Mississippi, New Jersey, North Carolina, and Ohio – have enacted legislation that deals directly with artificial income shifting via PICs.[23] Though not as comprehensive as combined reporting, these "anti-PIC" provisions do not allow a deduction from gross income for royalties and interest paid to related corporations. In New Jersey, the Business Tax Reform Act enacted in 2002 limited the ability of corporations to deduct royalty payments and other intangible expenses paid to affiliates, but continued to allow these deductions for "non-tax avoidance" situations. The New Jersey approach makes disallowance the general rule, the effect of which is that a company must secure prior approval for the deduction.[24]

Given that the formula used to compute Pennsylvania's second CSF tax includes net income, both the CNI and the CSF tax in Pennsylvania are eroded by income shifting strategies.

Nexus and "Nowhere Sales"

A federal law (Public Law 86-272) prohibits states from subjecting a corporation to income tax on profit earned in the state unless the state has a sufficient presence or "nexus" in the state (defined by having property or non-sales employees in a state). Thus states cannot tax the profits from corporations that only make sales in a state. As a result, the possibility exists that these profits will not be taxed in any state, leading to what is called "nowhere income."

To tax some of what would otherwise be "nowhere income" states may establish what is called a "throwback rule." For corporations that do produce a good or service in a state (and thus have sufficient nexus to be taxed), such a rule "throws back" to the state a share of the income from other states where the corporation does not have nexus. (The share is set, or apportioned, based the corporation's share of sales, payroll, and/or property in the state as a portion of the totals in all states where the corporation has nexus.) Without a throwback rule, as much as 60 percent of the profits of a resident Pennsylvania corporation may be "nowhere income"— profit not subject to tax in any state.

Twenty-five states – Alabama, Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Kansas, Maine, Mississippi, Missouri, Montana, New Jersey, New Hampshire, New Mexico, North Dakota, Oklahoma, Oregon, Texas, Utah, Vermont, West Virginia, Wisconsin – have a throwback, or similar rule, in effect.

Minimum Tax

With the elimination of the $200 minimum for the Capital Stock and Franchise tax beginning in 2000, Pennsylvania now imposes no minimum tax on corporations. There are thus many Pennsylvania corporations that pay nothing under the CNI or the CSF tax. Along with other changes to make the system of corporate taxation more equitable, the enactment of a corporate minimum tax would ensure that all corporations make a contribution to funding the variety of public services that enable them to operate successfully in Pennsylvania. New Jersey recently raised its minimum corporate tax on C corporations from $200 to $500.

Subchapter S Corporations

As noted above, there is a large difference between the CNI tax rate of 9.99 percent and the PIT rate of 2.8 percent. As a recent report on corporate taxation noted, limited liability companies "offer new means for corporations and other businesses to engage in tax avoidance."[25] Preventing artificial income shifting, with the result that corporations pay more under the CNI, would encourage more companies doing business in Pennsylvania to become Subchapter S corporations to reduce their income tax liability. Pennsylvania could impose an entity level tax on Subchapter S corporations to narrow the gap between the CNI tax rate and the rate paid by Subchapter S corporations.

Conclusion

This paper establishes that Pennsylvania taxes on corporations are unevenly distributed and that the share of state tax revenues collected by taxes on corporations alone has fallen steadily over time. Two factors contributing to the fall in the corporate tax share of state revenues have been cuts in the CNI and CSF tax rates and a rise in the number of S corporations that do not pay the CNI. Another factor likely contributing to falling CNI and CSF tax revenues is more widespread use of PICs and other mechanisms that shift corporate profit, on paper, away from Pennsylvania.

We do not know more about the importance of income-shifting to lowering Pennsylvania's corporate tax collections because companies are not required to disclose state taxes. For the same reason, we do not know the characteristics of corporations that do pay substantial taxes, especially on the CNI. In some respects, it is something of a puzzle that any corporation pays a sizable CNI tax, given that consultants have become so proficient at shifting reported profit to where it will be taxed lightly or not at all. Are some companies paying substantial CNI tax medium-sized, home-grown companies less inclined to hire sophisticated tax planners? Are other corporations, which might be held out as model corporate citizens, paying because they have an ethical distaste for tax avoidance?

What we do know is that diminishing collections under the CNI and the CSF tax exacerbate the current state budget crisis. Over the longer run, phasing out the CSF and watching as revenues under the CNI dwindle further could create a gaping "structural deficit" in Pennsylvania. To point this out does not mean that we take a strong position against the idea of lower business taxes in the long run. As we noted in our previous business tax paper, "[A] case can be made for lower taxes on corporate profits and capital IF adequate revenues can be collected in other ways to meet the state's development needs."[26]

In the short run, we have three recommendations.

1. The Pennsylvania Department of Revenue should make a public report, by the end of March, on the characteristics of corporations that pay different levels of CNI and CSF tax. At minimum, this report should indicate, by company size (measured by number of employees in Pennsylvania) for various ranges (top 50 companies, second 50, next 100 and so on) how many companies pay nothing, little, or more substantially under the CNI and what total revenues collected are from those who pay substantially in each company size group.[27] Using federal data sources, the reported U.S. profits of the groups of companies that pay different amounts under the Pennsylvania CNI should be reported. Finally, DOR should also profile the companies that pay most substantially under the CNI.

2. Policymakers should consider the options presented here for reducing the number of companies who pay little or nothing under the CNI (and CSF). This could ensure more equitable corporate taxes and make a modest contribution to closing the state's budget deficit.

3. Over the longer run, the state needs fundamental reform of corporate taxes as well as of the tax system as a whole. In conjunction with some of the options proposed here, long-term reform might include lowering the CNI rate and phasing out the CSF as a separate tax. Any such changes must be accomplished in a package that is seen as equitable in terms of the total tax burden on corporations vs. individuals and with regard to the distribution of the tax burden across corporations and the tax burden across individuals at different income levels. Any comprehensive tax reform must also raise revenues adequate to the state's educational, infrastructure, and other needs.

ENDNOTES

[1] National Conference of State Legislatures, *State Budget Update: November 2002* (Washington D.C.: National Conference of State Legislatures), pp. 12 and 21.

[2] Reported in John Sullivan, "PA's Budget Deficit Is Getting Worse," *The Philadelphia Inquirer*, February 8, 2003, p. B01.

[3] This General Fund figure is based on projections made at the beginning of Fiscal Year 2002-03 (July). Monthly revenue projections from the Department of Revenue indicate that revenues will fall considerably short of this projection. See footnote 2.

[4] The total for consumption taxes reflects the increased cigarette tax from $0.31 to $1.00 per pack enacted in 2002.

[5] While the share of General Fund revenue from corporate taxes has declined, there has not been an absolute decline in corporate tax revenues in Pennsylvania. In nominal terms, corporate tax revenue in Pennsylvania has risen from $1 billion in fiscal year 1971-72 to a peak of $4.2 billion in fiscal year 1999-00 to a projected $3.9 billion in the current fiscal year (although this latter figure will likely be lower, see Footnote 3). In inflation-adjusted terms, revenues in 1999-00 and 1971-72 were virtually identical.

[6] Estimate provided in Commonwealth of Pennsylvania, *Governor's Executive Budget 2002-03* (Harrisburg: Office of the Governor, 2002), p. D13.

[7] Dan R. Bucks, "Trends and Issues in State and Local Taxation," Testimony before the Committee to Study State and Local Taxes (Ohio), September 17, 2002, cited in Zach Schiller, *Ohio's Vanishing Corporate Franchise Tax* (Policy Matters Ohio, October 2002), p. 10.

[8] Data on the distribution of corporate tax liability are from the Pennsylvania Department of Revenue, *The Statistical Supplement for The Pennsylvania Tax Compendium Fiscal Year 2000-01* (Harrisburg: Department of Revenue, March 2002).

[9] See Pennsylvania Department of Revenue, *The Tax Compendium* (Harrisburg: Department of Revenue, June 2001), p. 3.

[10] See Pennsylvania Department of Revenue, *Tax Year 1997 Statistics on Capital Stock/Franchise Tax, Corporate Net Income Tax* (Harrisburg: Department of Revenue, December 2002), p. 12.

[11] See Pennsylvania Department of Revenue, *The Tax Compendium* (Harrisburg: Department of Revenue, June 2001), p. 4.

[12] While the statutory minimum for the CSF tax was $200 in 1999, the range of $0-200 includes "taxpayers with partial tax years paying an apportioned minimum tax, as well as taxpayers paying the statutory minimum tax ($200)." See Pennsylvania Department of Revenue, *The Statistical Supplement for The Pennsylvania Tax Compendium Fiscal Year 2000-01* (Harrisburg: Department of Revenue, March 2002), p10, fn 1.

[13] See Pennsylvania Department of Revenue, *Tax Year 1997 Statistics on Capital Stock/Franchise Tax, Corporate Net Income Tax* (Harrisburg: Department of Revenue, December 2002), p. 2.

[14] Stephen A. Herzenberg and Howard Wial, *Steal This Agenda: A Blueprint for a Better Pennsylvania* (Harrisburg: Keystone Research Center, 2000).

[15] Stephen A. Herzenberg and Eileen H. McNulty, *The Truth About Business Taxes in Pennsylvania, Part One – Are Business Taxes Really High in Pennsylvania?* (Harrisburg: Keystone Research Center, June 2002), p. 10.

[16] This section based primarily on Mary E. Forsberg, *A Question of Balance* (Trenton: New Jersey Policy Perspective, January 2003).

[17] Cited in Forsberg, *A Question of Balance*, p. 19.

[18] For a more thorough discussion of the causes of stagnating and declining corporate revenue see Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue For Many States* (Washington D.C.: Center on Budget and Policy Priorities, April 2002), available online at http://www.cbpp.org; Mary E. Forsberg, *A Question of Balance* (Trenton: New Jersey Policy Perspective, January 2003), available online at http://www.njpp.org; Peter Fisher, *Tax Incentives and the Disappearing State Corporate Income Tax*, State Tax Notes, March 4, 2002, Vol. 23, No. 9.

[19] See *Geoffrey, Inc. v. South Carolina Tax Commission*, State of South Carolina Supreme Court, Opinion No. 23886, July 6th, 1993.

[20] Cited in Mazerov, *Closing Three Common Corporate Income Tax Loopholes*, p. 7 and fn 11.

[21] Glenn Simpson, "A Tax Maneuver in Delaware Puts Squeeze on Other States," *Wall Street Journal*, August 9th, 2002, p. 1.

[22] "Corporate Fee Bills Aim to Raise $65 Million," *Las Vegas Review-Journal*, May 16th, 2001.

[23] The Massachusetts legislature just passed anti-PIC legislation, although it has not yet been signed into law.

[24] See Forsberg, *A Question of Balance*, p. 21.

[25] William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," Paper prepared for the 32nd annual spring symposium of the National Tax Association, Washington D.C., p. 15-16.

[26] Herzenberg and McNulty, *Are Business Taxes Really High in Pennsylvania?*, p 11.

[27] Recent reports in Alabama and New Jersey revealed that many profitable companies were paying either nothing or very little in state income taxes. In Alabama, 619 companies doing business in the state paid no state income taxes on a total of $850 million in profits. Cited in Shailagh Murray, "Business-Friendly Alabama Puts Brakes on Tax Breaks," *The Wall Street Journal*, September 30, 2002.