

**Testimony in Opposition to Mandatory Combined Reporting
To the Pennsylvania Senate Finance Committee
Submitted on Behalf of Comcast Corporation**

May 26 2010

**Thomas J. Donnelly, Esq., CPA
Vice President – State and Local Tax
Comcast Corporation
Philadelphia, Pennsylvania**

I. Introduction

Thank you for the opportunity to offer this testimony on behalf of Comcast Corporation regarding mandatory unitary Combined Reporting. Comcast Corporation appreciates the time and effort that Chairman Browne and the Senate Finance Committee will spend reviewing this important issue. As discussed more fully below, Comcast Corporation opposes the adoption of mandatory unitary Combined Reporting (“Combined Reporting” or “CR”) in Pennsylvania.

Combined reporting is Constitutional. But what is legal and what is good tax policy for Pennsylvania are two completely different questions.

Tax policy decision makers must ask how this radical policy change will impact Pennsylvania’s economy. The evidence is clear. Combined Reporting states run larger budget deficits and create less jobs. A recent January 2010 study by Ernst & Young shows that Combined Reporting states have, on average, substantially higher percentage general fund deficits, 41% higher in Combined Reporting states versus separate filing states.¹ A similar study found that job growth in separate reporting states was higher than in Combined Reporting states.

Comcast favors an incremental enhancement to Pennsylvania’s current separate filing corporate regime. Comcast believes that relatively simple and straight forward clarifications to the current regime’s accounting and enforcement rules can adequately address any current concerns, and provide the desired enhanced revenue results without the disruptive, destructive and unfair changes that come with Combined Reporting.

II. Overview of Mandatory Unitary Combined Reporting

Over the last several years many states have adopted, or considered adopting, mandatory unitary Combined Reporting. Combined Reporting is a fundamental change to a state’s tax regime – not merely a revenue raising or decreasing measure. Specifically, combined reporting

¹ See “*Comparison of State Economic and Fiscal Performance During the Recession*” (E&Y January 12, 2010).

is a corporate income tax reporting method used to determine state taxable income for unitary affiliated corporations.

At its most basic level, Combined Reporting ignores that the profits earned by one line of business may differ from another. Combined Reporting treats commonly controlled corporations engaged in a “unitary business” as a single taxpayer, notwithstanding that such taxpayer may operate multiple lines of business with varying degrees of profitability. Combined Reporting, as practically applied, will treat those multiple lines of businesses as one business; ignoring traditional notions of economic or corporate separateness.

The main rationale for adopting CR is closing perceived corporate tax “loopholes” – despite the availability of appropriate alternative mechanisms to combat perceived “abusive” tax planning strategies without many of the adverse consequences of CR. Instead of closing so-called loopholes, CR permits a state to tax income earned outside of its boundaries. Further, CR creates additional administrative burdens for reporting corporations and state tax administrators, as well as substantial tax litigation, as has notoriously been the case, for example, in states such as California and Illinois.

CR is far from the panacea suggested by its proponents. Rather, CR remains the minority rule on a national level – contrary to the implications made in the Pennsylvania Business Tax Commission Report (Nov. 30, 2004) “Commission’s Report”.² Indeed, states have not overwhelmingly rushed to adopt CR regimes in the five years since the Commission issued its Report. While several states have considered adopting Combined Reporting of late (primarily in a misguided attempt to remedy unprecedented budget shortfalls), only two out of fifteen states that have considered CR ultimately adopted the regime.³

II. The Uncertain Fiscal Impact of Mandatory Unitary Combined Reporting

A. No Guaranteed Increase in Tax Revenue

Multiple studies have shown that CR does not result in an increase in corporate income tax revenue. Specifically, the CR revenue estimates found in the Commission’s Report are outdated and based on suspect methodologies. In particular, the CR estimated corporate net income tax revenue increases ranging from \$497 million to \$447 million from tax years 1999 through 2001 had Pennsylvania adopted CR during those tax years. These figures are likely inaccurate as applied to Pennsylvania’s current economic environment for several reasons.

² The Commission’s Report asserts, “Pennsylvania’s use of separate company reporting is in the minority.” Pennsylvania Business Tax Commission Report (Nov. 30, 2004), at 1; available at www.projectmanagement.state.pa.us.

³ In addition to Pennsylvania, the following states have considered – and rejected – various forms of MUCR: Alabama, Connecticut, Florida, Idaho, Iowa, Louisiana, Maryland, New Mexico, North Carolina, Rhode Island, Tennessee, and Virginia. Only Massachusetts and Wisconsin have recently adopted MUCR regimes. MUCR proposals are being debated in Pennsylvania, Rhode Island, and the District of Columbia.

First, the Commission admitted the Report “lacks sufficient internal data necessary to directly measure the effect of combined reporting.”⁴ The Commission therefore decided to use data obtained from the Minnesota Department of Revenue (taxable income information based on Minnesota’s CR filed by taxpayers) to calculate the Report’s estimates. Second, the years “studied” by the Commission represented the peak of the “Dot.com” economic bubble, thereby skewing results that would likely apply in the post “Great Recession” economy. Finally, and most notably, the Commission’s Report shows revenue growth figures of an approximate 30% increase in general fund revenue from corporate net income taxes.⁵ As detailed below, such generous estimates for increases in corporate net income tax revenue are not supported by past history or empirical research.

Contrary to the Commission’s Report, recent statistical analysis does not show that states that have adopted CR regimes collect additional revenue as compared to states with separate entity reporting, all other factors being equal.⁶ In an often cited study prepared for the Tennessee Legislature by Dr. William Fox, University of Tennessee, Dr. Fox found that New York State experienced a significant decline in corporate income tax revenue during 2008; the year after CR became effective.⁷ The “Fox Report” also found that corporate income tax revenues in New York State decreased by \$680 million the year the state enacted CR.⁸ While one could argue that the decrease was as a result of the economic collapse, other states experienced similar results prior to those events. For example, Vermont saw a \$2.7 million decrease in corporate income tax revenues from 2006 to 2007 the first year following Vermont’s enactment of CR.⁹

The reasons for these results include the fact that Combined Reporting includes income earned outside the state, but also includes losses earned outside the state. Another reason for this result is the apportionment factor dilution that may occur with the combination of multiple entities’ apportionment factors. This may have a negative effect on a business’s overall taxable income apportioned to a state. Finally, as incomes from different companies are combined, net operating losses (“NOLs”) and credits that could not be used by separate companies may be “unlocked” and actually reduce taxes for the combined group. With the current recession generating a large stock of unused NOLs and credits it is expected that aggregate losses are almost as big as aggregate taxable incomes. Thus, Combined Reporting at the state level is expected to unlock a significant amount of the current stock of unused offsets and reduce or eliminate the taxable income base for many companies filing in states adopting this filing method.

⁴ Commission’s Report at 16.

⁵ *Id.*

⁶ William Fox et al., *An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes* (October 30, 2009), available at <http://www.tn.gov/comptroller/shared/pdf/CBER%20Combined%20Reporting%20Revised103009.pdf>.

⁷ Corporate net income tax revenue for Pennsylvania’s 2001-2002 General Fund was approximately \$1.4 billion. *Id.*

⁸ *Id.*

⁹ *Id.*

B. Other States' Analyses

In the last two years, several states have considered adopting CR while only a couple states have ultimately enacted Combined Reporting. A number of these states published highly speculative and suspect figures stating that revenue growth will increase dramatically under a CR regime. For example, during the 2008 legislative session, New Mexico's Legislative Finance Committee estimated a twenty percent corporate tax revenue increase would result from Combined Reporting.¹⁰ Just two years later, however, the New Mexico Legislative Finance Committee adjusted its methodology, stating: "recent econometric research using multiple years of data across states, indicates that mandatory combined reporting has no effect on state corporate income tax revenues."¹¹

Conversely, Maryland clings to inaccurate data that suggests a twenty percent increase in revenue is plausible for periods of normal economic growth.¹² Maryland based its revenue estimates on 2006 data – the year in which the most recent economic bubble was at its apex. State tax revenues almost always show a dramatic spike for years in which the economy is booming. As a result, Maryland's data is highly suspect. The authors of the Maryland study acknowledged this limitation, and further noted that the estimate did not reflect the impact of net operating losses and other changes that could reduce tax revenue.

III. Mandatory Unitary Combined Reporting and Tax Avoidance

While the Commission's Report recommended CR as a means of reducing tax avoidance, adopting CR to combat abusive tax avoidance transactions is not the best methodology to curb such abuses. Studies have shown that CR is an inefficient and unproven method of combating perceived tax loopholes. A recent study by Ernst & Young LLP of CR states revealed, on average, substantially higher "tax gaps" – to 20.9% for MUCR states versus 14.8% for separate filing states.¹³ Further, the study showed that the average general fund tax gap is 41% higher in CR states.¹⁴

Pennsylvania has various legal options at its behest to combat perceived tax loopholes other than CR. For example, Pennsylvania could consider enacting statutes narrowly tailored to disallow abusive transactions – which may be a more effective way to address tax loopholes (e.g., related party expense disallowance or "addback" statutes). "Addback" statutes—which require companies to add-back to income certain expense that are ordinarily deductible—can

¹⁰ Compare Michael Mazerov, *Corporate Lobbyist's Case Against Combined Reporting In New Mexico: A Rebuttal* (Dec. 1st, 2009), available at: <http://www.cbpp.org/cms/index.cfm?fa=view&id=3012> with The Council On State Taxation, *Mandatory Unitary Combined Reporting: A Rebuttal to the Center on Budget and Policy Priorities* (February 12, 2010); available at www.cost.org.

¹¹ Fiscal Note, H.B. 215, Second Session, 49th Legis. (N.M. Feb. 11, 2010).

¹² *Id.*

¹³ Ernst & Young LLP, *Comparison of State Economic and Fiscal Performance During the Recession* (Jan.12, 2010).

¹⁴ *Id.*

only increase tax revenues; unlike CR they cannot reduce revenues. Addback statutes are comparatively simpler to administer and, when drafted properly, are more equitable than CR.

Further, the judicial doctrines of economic substance, business purposes, and sham transaction allow Pennsylvania to challenge perceived tax avoidance transactions. Several states have been successful in attacking taxpayers' perceived illegitimate structures using these legal principles. States use these legal vehicles with success, without adopting CR regimes that create economic distortions, significant compliance burdens, and enforcement problems for state tax administrators. If the Department of revenue doesn't believe that it currently has the power to take such steps, legislation to clarify that the Department has such power should be drafted and adopted.

A. Constitutionality of Addback

Addback has been widely adopted and successfully implemented in most states that do not utilize MUCR. There are no constitutional limitations or restrictions on states disallowing all taxpayers from deducting certain types of expenses. Although a few constitutional challenges have been mounted against certain addback statutes, no addback statute has been struck down in whole or in part.¹⁵

B. Addback Does Not Violate Uniformity

Under Pennsylvania law, the party challenging a tax statute based on the Uniformity Clause (Section 1 of Article VIII) must show that there is *no* reasonable difference between the classes of taxpayers sufficient to justify different tax treatment. *English v. Commonwealth*, 845 A.2d 999, 1004-1005 (Pa. Commw. Ct. 2004). So long as the classification is based on "some standard capable of reasonable comprehension," it will not violate the uniformity requirement. *Id.* Addback statutes limit the ability of all taxpayers to deduct certain related party expenses - the limitation is not limited to certain classes of taxpayers. Therefore, addback statutes would be based on a "standard capable of reasonable comprehension."

IV. Unnecessary Complications and Unintended Consequences

A. Administrative Costs Will Increase

Adoption of CR imposes a significant compliance burden on taxpayers. In addition, CR creates correlative enforcement problems for state tax administrators. Comcast Corporation, like other taxpayers doing business in CR states, spends significant resources on corporate income tax compliance in CR states. Likewise, tax administrators in CR states expend scarce resources becoming familiar with such a major change to their respective state tax codes and regulations. For example, significant amounts of case law that clarified or preserved the integrity of the separate entity tax system may be rendered meaningless. States must publish new tax forms and

¹⁵ See *VFJ Ventures, Inc. v. Surtees*, 8 So.3d 983 (Ala. 2008).

other administrative guidance. Further, a state adopting CR would have to invest significant time and money in educating auditors, legal counsel, and other department personnel about the audit and legal issues resulting from CR.

B. Tax Litigation Will Increase

The Commission's Report naively states:

[W]ith a change to mandatory unitary combined reporting, there is a risk of litigation. To limit that risk, the Commission recommends that before mandatory combined reporting is adopted, great care be given to defining a "unitary business."¹⁶

The Commission's belief that the risk of litigation may be meaningfully limited by merely defining "unitary business" with "great care" is misplaced. Defining a unitary business for combined group purposes remains the subject of litigation in states such as Illinois and California where significant guidance has been published. Published guidance only increases litigation in this area because the limits of the unitary business principle are contained within the Constitution and interpreted by the U.S. Supreme Court. Indeed, the most significant state tax case heard by the U.S. Supreme Court case over the last three years was a case defining the contours of what constitutes a unitary business.

C. Additional Considerations

Because CR is a fundamental change to a state's tax regime – and not merely a revenue raising measure – CR adoption requires state policy makers to consider numerous versions of the regime. While some of these considerations may appear minor at first glance, they may impact taxpayers and/or the state in very significant ways. For example, states considering CR must decide how a unitary group's sales factor is computed (the so-called *Joyce* and *Finnigan* distinction). In addition, a CR regime must consider how tax attributes (credits and net operating losses) earned by separate members will be combined and used to offset the unitary group's combined income. These decisions will greatly impact a corporation's tax liability in a CR state, depending on the structure of a corporation. However a state comes down on these issues, however, CR will likely create disparities among competing businesses merely as a result of their respective organizational structures. Because of variances among corporations in similar business lines, CR may give one corporation a competitive advantage over another. Therefore, CR nearly always creates an unlevel playing field among CR "winners" and CR "losers."

¹⁶ Commission's Report at 15.