

Testimony before the Senate Finance Committee
Dan Hassell, Secretary
Pennsylvania Department of Revenue
Wednesday, May 26, 2010

Chairman Browne, Chairman Ferlo and members of the committee, thank you for the opportunity to appear before you today. My name is Dan Hassell, Secretary of the Department of Revenue. With me at the table is Deputy Chief Counsel, Donald Geyer. We are here to discuss the Governor's business tax reform proposal.

The Governor's proposal reduces the corporate net income tax (CNI) rate, adopts a single sales factor for the calculation of CNI tax, and removes the cap on a business' allowable net operating loss deduction. These taxpayer benefits are paid for by adopting combined reporting as the method of calculating taxable income. This package achieves a fairer and more competitive business atmosphere in the Commonwealth by reducing the tax rate and broadening the tax base. The proposed reforms seek to:

- ❖ Level the playing field by determining tax liabilities by the substance of business activities, rather than by the business' organizational structure;
- ❖ Clearly define the tax base;
- ❖ Deter the use of tax avoidance strategies under the current system, such as the use of a Delaware Holding Company;
- ❖ Present a more accurate measure of a business' net income by removing distorted transactions taken by affiliated businesses under the present separate company method of reporting;
- ❖ Allow for the implementation of business-friendly measures such as lowering the corporate net income rate from 9.99 percent to 8.99 percent, adopting a single sales factor, and removing the cap on net operating losses.

I would like to spend a few minutes explaining how the current CNI tax works, and how it would be affected by combined reporting. Under the current tax structure, a corporate group can reduce its state taxes based on the way that it sets the prices for goods and services that are sold among its member corporations. Simply stated, smart tax planners will overcharge the affiliates which operate in Pennsylvania in order to reduce the taxable profits of that company. Those profits show up instead on the books of the affiliates operating in lower-tax jurisdictions. However, none of these transactions affect the profits of the corporate group as a whole since the gains and losses of the separate companies are totaled.

A "Delaware Holding Company" is the most extreme example of this practice. This is a tax planning device that allows a corporation to shift income to its out-of-state

subsidiary, often established in Delaware or another state where it will pay little or no corporate income tax. Often, Delaware Holding companies employ no one and produce nothing. They only exist on paper or will simply be a post office box address.

Here is how it works. The parent corporation transfers ownership of trademarks, logos, and other valuable intangible business property to the subsidiary. The parent company then pays a fee to the subsidiary for the rights to use the trademarks. These fees transfer profits earned in Pennsylvania to the out-of-state subsidiary, where income is either not taxed or taxed at a far lower rate.

In fact, in these arrangements the money paid by the PA corporate taxpayer usually is paid back either as a non-taxable dividend, or in the form of a loan, creating more tax deductions for interest payments. This type of aggressive tax planning is relatively easy to set up and is not clearly illegal; however, it is a flaw in Pennsylvania's business tax structure and allows companies to avoid paying tax on money that is earned in Pennsylvania.

What is combined reporting? Combined reporting would require the members of a unitary business to combine their income and expenses for tax purposes. This would require the business to pay its taxes on an apportioned share of the combined income of the entire corporate group. Under this system, any transactions between affiliated companies simply wash out and are ignored. This would make the state tax base more like the way corporations report results to their shareholders and to the IRS for federal tax purposes.

For all of these reasons, more states have adopted combined reporting in the last few years. Pennsylvania is now in the minority of states that have not adopted this measure. As a result, it is likely that most businesses that operate across state lines already have experience with filing combined state tax returns.

As I mentioned, the increased revenue that is gained by implementation of combined reporting would allow for a one-point tax rate cut, an uncapped NOL deduction and adoption of a single sales factor. It would also generate an estimated \$66.6 million in FY 2010-11, increasing to \$188.4 million by FY 2013-14.

Combined reporting does not affect all corporations. Over 40 percent of CNI taxpayers would not be affected by combined reporting because they are not part of a corporate group. These smaller companies *would* benefit from the lower tax rate, uncapped NOL deductions, and single sales factor apportionment.

Almost 60 percent of corporations *are* part of a combined group and would be affected by combined reporting. However, even among this group, less than a quarter would pay more corporate net income tax.

Combined reporting would benefit some businesses by allowing the loss of one unitary member to offset the income of another. Under the current system, a

Pennsylvania company may be paying tax on its profits even though the company is part of a corporate group that is losing money overall.

Combined reporting does more than eliminate tax abuses. It creates a fairer and more equitable tax system. Simply, it eliminates inter-company transactions in determining a combined income for each member of the unitary business. It arrives at the same answer that one would arrive at had the unitary business consisted of one corporation that was made up of divisions doing business with one another. Therefore, it produces uniform treatment of a unitary business whether such unitary business is one corporation or several corporations. In addition, combined reporting eliminates the advantage obtained by corporate groups that can afford to pay for inter-company tax avoidance schemes.

In conclusion, the Governor's reform proposal would ensure that smaller companies who conduct all of their business in Pennsylvania are not carrying the tax burden for those that hide their profits in tax haven states or offshore. It will lead to a system that is fairer, less subject to manipulation, and better for all Pennsylvanians. It will allow us to reduce the tax rate and enact other pro-growth initiatives within the tax code.

Thank you for the opportunity to discuss this very important proposal with you and I look forward to answering any questions that the Committee members may have.