



Pennsylvania Business Council

Policy Roundtable
PEG Political Action Committee
PBC Education Foundation

Testimony
David W. Patti, President & CEO
Pennsylvania Business Council
Senate Finance Committee
May 26, 2010

Good morning. My name is David Patti. I am the President & CEO of the Pennsylvania Business Council (PBC) – a business organization that represents among its membership the largest employers in the Commonwealth. In addition to testifying this morning on behalf of PBC, I will also provide for the record, a written statement from the CompetePA Coalition – an organization of more than 130 firms and business associations representing millions of Pennsylvania jobs.

PBC envisions a Commonwealth in which residents enjoy a very high quality of life in sustainable communities, where those who are seeking employment find high quality jobs with good compensation, and where those who invest their capital and hard work can grow firms that flourish and are profitable.

I want to thank Chairman Pat Browne and the members of the Senate Finance Committee for the invitation to appear here this morning to discuss a public policy proposal that could have significant ramifications for Pennsylvania's competitive position relative to other states and nations.

I think the best cautionary statement about taxation – and the statement that should be a guiding principle of this Committee in its every deliberation – was made by US Supreme Court Chief Justice John Marshall in 1819 when he wrote in his decision to the case *McCulloch v. Maryland*, "... the power to tax [is] the power to destroy."

We have long understood in America the regulatory power of taxation. We use high taxes to try to dissuade people from smoking and drinking alcohol and as recently as this past year, we watched the Obama Administration use tax incentives to try to "stimulate" the purchase of new homes and new automobiles.

PBC opposes the imposition of Mandatory Unitary Combined Reporting (MUCR) because it is a policy that in so many ways runs counter to the mission of creating sustainable communities with high employment. We believe the regulatory effect of MUCR will be to dissuade firms from investing in Pennsylvania.

For many firms this change to the calculation of the corporate tax base in Pennsylvania would amount to a very large tax increase in the guise of "reform." To be sure, there are undoubtedly some firms who would see only a negligible direct impact from a change of current tax policy to a system based on MUCR, but as a stand-alone measure without meaningful simultaneous tax reforms, only a few would see any benefit. And, even firms that saw a reduced tax liability from MUCR would incur significant expense for new, more complicated record keeping, accounting, and tax preparation.

Firms that see a reduced tax liability from MUCR might realize long term harm as other firms which are customers or vendors face higher taxes because of the policy change. Introducing additional complexity into a system seldom improves performance. Increased complexity will make compliance more costly and more difficult for taxpayers. Increased complexity will make collection and enforcement more difficult for the Department of Revenue. Increased complexity will make tax planning services more difficult and less certain for professional advisors. Increased complexity will increase litigation costs for the Attorney General's office.

The Pennsylvania Business Tax Reform Commission, created by Governor Rendell in 2004, acknowledged that MUCR amounts to a tax increase. Specifically the body's report said, "The Commission supports the adoption of mandatory unitary combined reporting *only in* conjunction with a reduction of the Corporate Net Income Tax (CNI) rate to between 6 and 7 percent." The Commission also recommended full deductibility of Net Operating Losses (NOLs) and a 100 percent sales factor for the apportionment of Corporate Net (CNI) taxes. The Commission was charged with making a revenue-neutral proposal. To generate the same revenue from the CNI after providing NOL and SSF reform, means the imposition of MUCR would increase corporate income tax liabilities by some 60 percent to 87 percent.

Let me say that again, but differently: Governor Rendell's Business Tax Commission believed that we could have a Single Sales Factor (SSF), complete deductibility of NOLs and still lower the CNI rate 30 percent to 40 percent and break even on revenues to the state. For that to happen – for the math to work – means that MUCR increases the corporate tax base to which the CNI is applied by a factor of about 60 percent (for a 30 percent rate reduction) to 87 percent (for a 40 percent rate reduction). I have attached to my testimony a small table with my "back of the envelope" of this expansion of the tax base. For my calculations, I assumed a total value of \$300 million in revenues for the 100 percent NOL and SSF changes. You might score these policy changes a little differently, but the order of magnitude of the tax base increase from MUCR is relatively the same.

Please understand, furthermore, that the proposal from the Governor's Business Tax Reform Commission was in no way revenue-neutral for all firms. Many firms would have seen a significant tax increase as a result.

And, as I explained a few minutes ago, there would be ripple effects through the economy. Firms which would suffer a tax increase from the imposition of MUCR might pass along this cost in the form of higher prices to firms for which they are a supplier, or in the form of lower purchases from firms to which they are a customer.

Large multi-national firms with operations spanning the globe, but a relatively small presence in Pennsylvania – relative to their standards of "small" – 300 or 400 employees at a single manufacturing operation – might find that MUCR so increases their tax liability in Pennsylvania that the only logical step is to sell or close the Pennsylvania plant. A proposal that costs Pennsylvanians jobs would not be – in the eyes of the newly unemployed workers – "revenue-neutral."

Moreover, recent proponents of MUCR – Governor Rendell, Senate Democrat Appropriations Chair Jay Costa, House Democrat Appropriations Chair Dwight Evans, the Pennsylvania Budget and Policy Center and others – are making no pretense of a "revenue-neutral" proposal. Their call is for a tax increase on job creating employers, pure and simple.

I would like to take a few minutes to address the arguments from the proponents of MUCR:

ALLEGATIONS THAT FIRMS ARE NOT PAYING THEIR “FAIR SHARE.” Governor Rendell likes to say that a very high percentage of corporations do not pay tax in Pennsylvania. He and other proponents of MUCR reporting use this statistic to bolster their arguments. The statistic is false. First, there are a good number of corporations on the books in Pennsylvania that have had no economic activity in years. They were created for a specific project or purpose long since achieved or abandoned, but the corporations were never dissolved.

Secondly – and especially relevant in recent times – they paid no “bottom-line tax” such as the corporate net income tax because they did not have taxable profits. These firms still paid Capital Stock and Franchise taxes, wage taxes, local property taxes, and other taxes.

Third – and a point acknowledged by the liberal, pro-combined reporting Center on Budget and Policy Priorities – a *“Most large multistate corporations are composed of a ‘parent’ corporation and a number of ‘subsidiary’ corporations owned by the parent.”* I know there are those who will argue, “But firms do this to avoid taxes.” No, in fact, the corporate organizational structure of subsidiaries is not made solely on the basis of tax planning. It is usually, much more commonly, an outgrowth from a strategy for managing tort liability; a manifestation of the acquisition and consolidation of what were once free-standing businesses; or a management tool for effective direction of entities with distinct missions and objectives. Over the last 30 years or so, firms have acquired, sold, spun-off, and joint-ventured divisions of their overall firm with great rapidity and frequency. Maintaining separate subsidiary corporations allows a firm to stay agile in times of global competition and economic uncertainty.

Let’s talk, for a minute, about the economic realities of multiple subsidiaries owned by a single-parent corporation. Many businesses – and especially commodity manufacturing businesses of which Pennsylvania is home to so many historic firms – are cyclical. There are years of high sales and strong profits and there are years of low sales and sizable operating losses. A large corporation seeks to remain profitable for its stockholders and operational for its customers and employees by balancing risks and sales cycles. Ideally, when one business line – a particular subsidiary corporation – is suffering an economic downturn; another is having a good year. Those various parts of the firm may or may not be located in Pennsylvania.

MUCR seeks to punish these firms for using strategies to remain viable by pulling into the Commonwealth’s tax base all of the components of the firm, whether or not their revenues are derived from Pennsylvania operations.

MANY STATES HAVE IMPLEMENTED MUCR, SO WHAT'S THE HARM? Many proponents of combined reporting say, “Half of the states have combined reporting. Where’s the harm?” I would ask in counterpoint, “**Where’s the strategic advantage?** Should Pennsylvania join the ‘crowd’ or try to maintain as competitive a tax climate as possible?” Moreover, most Southern states – those we often look to as competitors – do not have combined reporting laws. The states that do have combined reporting are generally northern and western states. While proposals have also been made in other states, at present about half of the states with an applicable corporate tax do not have MUCR. Nor for that matter, does much of the world. If Pennsylvania imposes MUCR, foreign-owned firms with Pennsylvania operations would have an advantage over domestically headquartered firms.

The Pennsylvania Department of Revenue conducted a study in 2005 to evaluate the impact of MUCR.¹ Matching over 6,000 Pennsylvania C-corporation tax returns with their Minnesota (a combined reporting state) tax returns, the Department of Revenue analysts sought to simulate the impact of such tax policy in Pennsylvania. According to the Revenue Department’s analysis, most industries would see a significant tax increase if the CNI rate is left at 9.99 percent while combined reporting is implemented. Even if the CNI rate would be cut to 7.99 percent, says the Department of Revenue in Table 6 (page 8) of its report, firms involved in manufacturing or trade would still pay more CNI tax.

I noted in my opening remarks that Congress and the Obama Administration have used tax policy to try to stimulate economic activity in the United States. How would MUCR stimulate economic activity in Pennsylvania given the Revenue Department’s own analysis that most industries would see a significant tax increase?

The Commonwealth of Pennsylvania has, for years, acknowledged that the high CNI tax rate is a deterrent to the attraction and retention of job creating companies. For this reason, we have created numerous programs and “incentives” to compensate for Pennsylvania’s poor business tax climate. We offer grants, loans, job training, and tax abatements to lure firms to Pennsylvania. Pennsylvania has even provided firms with the confidential assistance of tax professionals to assist them with tax planning in order to reduce their tax liability to the Commonwealth. How do we reconcile all of these efforts with a proposal to increase tax liabilities? MUCR might help pizza shops and dry cleaners, but it would do so by shifting the burden to the manufacturing and trade industries that provide high paying jobs for employees and opportunities for locally-based support industries.

¹ Read the full report on PBC’s website at: <http://data.memberclicks.com/site/pfeg/CombinedReportinginPA.pdf>

MUCR WILL CLOSE THE “DELAWARE LOOPHOLE.” Passive Investment Corporations (PICs) are a legal construct for managing the value of intra-company transfers for interest on cash flow, royalties on intellectual property, or other financial transactions between subsidiary corporations of a parent corporation. Some interest groups and policymakers are critical of the establishment of PICs in low-tax states such as Nevada or Delaware. Since the assets transferred to PICs are often very valuable, the subsidiary would incur high taxes if they were not incorporated in low-tax states. Corporations take lawful deductions for payments made to PICs. This is no different than a homeowner who takes the mortgage interest deduction on their IRS 1040. Government policymakers have provided a tax deduction and taxpayers have availed themselves of it.

If the Department of Revenue believes that a corporation is abusing the system with a deduction that has no business purpose other than the avoidance of tax liability, PBC believes there is existing statutory authority to disallow the deduction. MUCR is the nuclear response to a border skirmish. The fallout will do harm everywhere. If the Department insists that it lacks statutory authority to deny deductions, the gap could be remedied with language based on the Federal statutory authority given to the Secretary of the US Treasury under Section 482 of the IRS Code. PBC would not oppose legislation identical to the Federal counterpart.

MUCR WILL PROVIDE MUCH NEEDED NEW REVENUE TO THE STATE Don't count on it! Many states that have imposed MUCR have seen state tax revenues fall – at least in the short-run – as firms make the most conservative interpretations and litigation drags on over years for issues that are ill-defined in legislation and regulations.

The definition of “unitary business” is a thorny and subjective determination. The Governor’s Business Tax Commission was aware of these concerns when it issued its report warning, “With any change in the tax system, but in particular with a change to mandatory unitary combined reporting, there is a risk of litigation. To limit that risk, the Commission recommends that before mandatory unitary combined reporting is adopted, great care be given to defining a ‘unitary business.’”

Even where critical factors are well defined, disagreements in other states over what should be included in a combined return have often needed to be decided by costly and time-consuming litigation. All of this means greater uncertainty for firms doing business in Pennsylvania. Uncertainty is crippling to investment and job creation decisions.

And, as the Committee is aware, the Department of Revenue does not have the information technology required to implement MUCR without significant investment and several years to build and test systems, and train personnel. Similarly, it would take corporate taxpayers several years and a great expense to transition to a MUCR system.

The bottom-line of MUCR is this: it will not produce new revenues to Pennsylvania immediately. It could do significant harm to Pennsylvania’s economy. MUCR will result in a tax increase for some firms and some industries regardless of true and much needed business tax reforms. And it will increase administrative costs in the Department of Revenue and taxpaying firms.

Calculation of impact of MUCR as conceived by Governor Rendell's Business Tax Commission based on the Commission's assumption that a rate reduction to "six percent or seven percent" would yield the same revenues even after the adoption of 100% NOL and SSF. Based on rounded 2005 values.			
		30% Rate Reduction	40% Rate Reduction
CNI Rate	9.99%	6.99%	5.99%
Revenue Impact of 100% NOL and SSF		(\$300,000,000)	(\$300,000,000)
CNI Revenues (held constant)	\$ 2,500,000,000	\$ 2,500,000,000	\$ 2,500,000,000
Tax Base for rate to generate revenue	\$ 25,025,025,025	\$ 40,057,224,607	\$ 46,744,574,290
=(CNI Revenue + NOL & SSF value)/ CNI rate			
Implicit change in tax base from MUCR		60%	87%

Mandatory Unitary Combined Reporting Will Make Pennsylvania Less Competitive

In these economic times, Pennsylvania needs to create a business climate that encourages job creation and retention along with new capital investment in the Commonwealth. A major structural change to the tax reporting system, like that required to implement and maintain mandatory unitary combined reporting, raises uncertainty as to the cost of investing in Pennsylvania and increases administrative costs to the Commonwealth without a proven ability to increase tax revenues.

Instead of imposing new taxes and associated requirements on businesses, the most effective steps that Pennsylvania can take to improve our business climate is to make the current corporate net income (CNI) tax more competitive with other states that compete with Pennsylvania for jobs. Removing the cap on net operating loss (NOL) carryforwards, and creating a single sales factor (SSF) apportionment formula are two significant ways in which the Commonwealth can improve the business climate.

Here are a few reasons why mandatory unitary combined reporting will make Pennsylvania less competitive for business investment:

Combined reporting creates uncertainty in revenue forecasts and collection and will result in increased administration and litigation costs for the Commonwealth.

- Combined reporting is complex to implement as well as to administer.
- Business operations, including entities that have losses outside the state, will be included in the Pennsylvania combined tax return. Also, historically, the uncertainty associated with the determination of what constitutionally comprises the combined reporting group will increase long-term litigation costs for the Commonwealth.
- Recent independent studies of the effects of combined reporting on tax revenue collections have indicated that combined reporting may not increase overall tax revenues. Instead, the incidence of tax is redistributed to primarily the manufacturing and service based industries, which in turn decreases the ability of those industries to invest in Pennsylvania operations.
- The lack of definite increases in tax revenue streams coupled with the historical certainty of additional administrative costs and litigation expenses for the Commonwealth and affected businesses would indicate that mandatory unitary combined reporting would not achieve growth in Pennsylvania.

Pennsylvania businesses pay \$23 billion in taxes.

- There are hundreds of thousands of businesses – large and small in our state. They already pay more than \$23.4 billion per year in state and local taxes, in addition to innumerable state fees. Taxes paid by employers represent about 42% of all state and local taxes collected in the Commonwealth.
- There is a misconception that many corporations in the state do not pay the CNI. The fact is that many expanding companies invest significant capital in the Commonwealth and therefore have operating losses. Other companies are still registered with the state but are inactive. As a result, about half of the 120,000 C-corporations registered in Pennsylvania that are subject to the CNI do not have an income tax liability for state or federal purposes, either because they have operating losses or because they are inactive corporations. When compared to other states – even states that have enacted combined reporting – Pennsylvania's proportion of corporations that do not have an income tax liability is typical.

In these times, a competitive business climate must be our first goal.

- Pennsylvania has the second highest CNI tax rate in the country. To make Pennsylvania more competitive in these difficult times, the most effective step that the Governor and the General Assembly can take is to improve the CNI tax regime by enacting the single sales factor and removing the cap on net operating loss carryforwards. These changes would encourage job creation and investment in Pennsylvania.