

TESTIMONY ON COMBINED REPORTING
PRESENTED TO THE SENATE FINANCE COMMITTEE

BY

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Good morning, I am Sharon Ward, Director of the Pennsylvania Budget and Policy Center. The Pennsylvania Budget and Policy Center is a non-profit, non-partisan research project. PBPC provides budget and fiscal analysis and public education in support of policies that improve the economic and social well-being of low and middle income Pennsylvanians.

The purpose of my written testimony is to briefly describe some common corporate loopholes, illustrate how these corporate tax loopholes are hurting tax collections and smaller Pennsylvania-grown corporations, how combined reporting is the best solution to begin fixing the problem, and respond to some of the misconceptions regarding combined reporting.

For years, business groups like the Chamber of Business and Industry and the Allegheny Conference have argued that Pennsylvania's corporate income tax rate at 9.99% puts the state at a competitive disadvantage. In 2004, the Pennsylvania Business Tax Reform Commission recommended that Pennsylvania adopt combined reporting to provide funding to allow a rate reduction, addressing their concerns – while at the same time leveling the playing field for all corporate income tax payers. Six years later Pennsylvania has failed to act upon the issue that business groups argue is the key to the state interest in economic competitiveness, choosing instead to enact tax changes that benefit some businesses, while increasing taxes on others. Now in the midst of the worst economy since the Great Depression, lawmakers must ask if allowing loopholes, tax planning and other efforts to circumvent the income tax is the best use of limited state dollars.

Combined reporting, by eliminating transactions between related companies, slams the door on most tax shifting schemes. It changes the focus of taxation from structure to the economic activity in a state. This is a more logical way to levy taxation.

Combined reporting has withstood the test of time and been upheld by the courts. It was developed in California in the 1930s and has since been adopted by a majority of states with corporate income taxes. In the past four years seven additional states have adopted combined reporting and at least four others are considering it this year. It is required in a majority of the states that impose corporate income taxes.

Today you will hear a variety of arguments against combined reporting that I would like to address:

Continuing tax loopholes will not help manufacturing. Since December 2001, every state in the U.S. besides Alaska has lost manufacturing jobs. However, the 16 states that have had combined

reporting during this entire period have fared better than most of their separate reporting counterparts. All 16 have had fewer manufacturing job losses than 29.4 % that were lost here in Pennsylvania (see Appendix 1).

Keeping these loopholes does not make companies more likely to stay in Pennsylvania.

Hershey Foods recently announced that despite switching to a more heavily weighted sales factor and keeping our separate company filing system, they were closing plants in Pennsylvania and moving jobs to Mexico – not due to taxes or even labor costs, but due to the lower price of sugar.

Pennsylvania businesses already use combined reporting. Of the largest private employers in Pennsylvania, 30 of 31 (or 97%) operate in at least one other state with combined reporting. Most of these corporations (21 out of 31) operate in at least five states that mandate combined reporting (see Appendix 2). Most companies that would be affected by combined reporting in Pennsylvania are already familiar with it.

Overall business taxes in Pennsylvania are not particularly high. According to a recent report of the Council on State Taxation (COST), an industry sponsored think tank in Washington DC, Pennsylvania's state and local business taxes were ranked 31st in 2009 – tied with the “high tax” states of Alabama and Arkansas (see Appendix 3).

Corporate taxes are a very small share of overall business taxes and are unlikely to drive most business decisions. The COST study found that corporate income taxes made up only 13% of state and local taxes paid by businesses in Pennsylvania. Corporate profitability is more affected by the skill of the workforce, access to transportation systems, and energy prices than it is by state corporate tax policy.

Combined reporting is a net revenue raiser. Most recently, Maryland had corporate taxpayers file separate company returns and returns under combined reporting. Overall, combined reporting returns would have brought in between 13% and 20% more revenue in tax year 2006 than under their current separate company tax system. A similar result in Pennsylvania could increase corporation net income tax collections by \$250 million to \$400 million.

Many businesses pay lower taxes under combined reporting. The Maryland study used two different apportionment assumptions, in each case at least a third of businesses paid lower taxes. Combined reporting “rightsizes” corporate tax liability. A 2003 study by the Pennsylvania Public Interest Group estimated that the use of a single common tax planning vehicle - the Passive Investment Company loophole - cost Pennsylvania \$276 million that year.

No matter what happens, there will be lawsuits by companies and by the Commonwealth. An increase in lawsuits is likely when Combined Reporting is introduced, as companies will test the boundaries of what the state calls a unitary group, but that should not be a deterrent. Pennsylvania would benefit from the experiences and case law of the 23 states that have come before it in enacting Combined Reporting.

Corporate income is not truly calculated on a state-to-state basis under any taxation system.

All use some form of apportionment to assign a share of national profit to one state or another. Like separate reporting, combined reporting relies on some combination of three apportionment factors to determine how much activity takes place in a state. Relying on an apportionment of income solely based on sales, as is favored by many in the business community, distorts profit in any given state much more than combining entities within a group.

When making decisions about combined reporting, the Pennsylvania Legislature needs to answer this question: Is allowing tax avoidance a better economic development strategy than increasing the productivity of our people and economy by investing in education, training and infrastructure?

The state's ongoing revenue crisis should be seen as an opportunity for Pennsylvania to modernize its tax system, make it fairer, and help make it more stable. Closing corporate tax loopholes by adopting combined reporting should be part of this effort. It would raise needed revenue now to protect public investments in education, infrastructure, and health care – and permit a tax rate reduction for ALL corporate income taxpayers once the economy and tax revenues recover.

Pennsylvania's corporate income tax system is antiquated and inequitable

The current tax system, based on separate company filing, is out-of-date. This hurts Pennsylvania in a number of ways:

- The current system assumes that each corporation operates independently. The economic reality is that many corporations operate as part of a centrally controlled group of parent corporations and subsidiaries.
- The current system favors large, multi-state corporations to regional firms or those solely based in Pennsylvania. It unfairly forces Pennsylvania-only and regional corporations to pay a high tax rate, while corporate groups, operating a complex array of corporations and subsidiaries across the county – and often across the globe, pay substantially less. This occurs due to the heavy weight on the sales factor. A regional company with much of its sales base in Pennsylvania must pay tax based on that large portion of the sales base. A corporation that only does business in Pennsylvania cannot apportion its income – so they pay 9.99% on their entire taxable income. A company with national sales, however, pays tax on only that small portion of its sales that occur in Pennsylvania – no matter how large or small their presence is here.
- The current system allows corporations operating in several states to use a variety of accounting gimmicks to lower profits in Pennsylvania. These companies can shift profits in and out of states and to and from specific companies within a group using Delaware holding companies, shell corporations, and artificial transfer prices. These transactions lower the corporation's tax bill, leaving others to pick up the tab. States are ill equipped to find these abuses, which are hidden deep within financial statement data.
- The current system of tax loopholes and decades of business tax cuts have shifted more responsibility for funding state government to Pennsylvania families. Business taxes, including the phase-out of the Capital Stock and Franchise Tax, have reduced the state tax bills of

businesses by billions of dollars over the past fifteen years. Meanwhile, the share of taxes paid by Pennsylvania residents is rising.

The Loopholes

One way common, but hard to detect, way to move income out of an otherwise profitable Pennsylvania subsidiary is by manipulating transfer prices. Companies within a group “buy” and “sell” products and services to each other on a regular basis. Transfer pricing allows the members to use market prices to reflect value added by each subsidiary as it moves up the supply chain. However, it is very easy to manipulate. To move profit out of a particular state or out of a particularly profitable part of the company, the group can assign an unusually high cost to raw materials or services the company buys from other group members. As their costs for tax purposes go up, their profits – and taxes go down. The profit is shifted to another subsidiary operating in another state.

Another common practice is using the “Delaware loophole.” This scheme involves setting up a corporate group’s intangible assets, like trademarks or copyrights, in a corporation in Delaware. Often, this corporation is nothing more than a post office box in a building with thousands of other P.O. Box corporations. The parent company then has the Delaware corporation “charge” its other companies for using the company logo, recipes, or other intangible assets. The charges to other companies reduce these firms’ taxable income, leading to lower tax bills. The income brought to Delaware from the charges isn’t subject to its state tax.

There are hundreds of other ways to manipulate income on a separate company basis. States can try to address them, one-by-one, but corporations merely move on to the next technique once the old ones no longer work.

Pennsylvania has some limited experience with trying to close loopholes, most notably Act 46 of 2003, which attempted to reign in the misuse of captive REITs, but it is not clear if the law has acted as even a speed bump for corporate tax planners.

Corporate income taxes provide shrinking support for the General Fund

In 1992-93, the Corporate Net Income Tax made up slightly more than 10% of all tax collections in the General Fund. By 2009-10 (using the Rendell Administration’s revenue estimates), this percentage has dropped to 7%, a reduction of almost a third. During this same period, the portion of General Fund tax collections financed by the state’s Personal Income Tax increased from 33% to 40%.

This means that Pennsylvania families pay for a growing share of the General Fund.

Business tax cuts and an increase in the PIT rate account for some of this change – but only a portion of it. The ability of large corporations to determine how much they want to pay in income taxes is likely a significant factor in the remainder.

Most families pay more in Personal Income Tax than corporations pay in Corporate Net Income Tax – and this inequity is growing

In 1994, three-quarters of corporations in Pennsylvania paid \$1,000 or less in income taxes. By 2003, this figure had increased to 84%. To put this in perspective, a family earning about \$32,600 pays \$1,000 in Personal Income Tax, at a rate of 3.07%. This means that more than five out six corporate filers in Pennsylvania pay less in income tax than a family earning \$32,600. When people of vary modest means are taxed more heavily than five of every six corporations, even the most dispassionate among us would see the need for reform.

Corporations benefit from the public spending financed with tax revenues – from having an educated workforce, a well-developed transportation system, and clean water. They have a responsibility to pay their share of the freight.

Conclusion: Combined Reporting could be a powerful tool for modernizing our corporate income tax system. It slams the door on the most outrageous tax avoidance schemes and better reflects the economic reality of corporate groups. Despite the delay of the phase-out of the Capital Stock and Franchise Tax negotiated in the 2009-10 Budget, it will soon be gone – as will \$800 million in tax revenue each year. Pennsylvania can no longer afford to run an antiquated, inefficient corporate income tax system and the budget cuts necessary to maintain the current, unfair system.