BEFORE THE SENATE DEMOCRATIC
POLICY COMMITTEE OF THE PENNSYLVANIA LEGISLATURE

Testimony of Bruce J. Fort, Senior Counsel, Multistate Tax Commission[1]

Dear Chairwoman Boscola and Members of the Committee:

It is my honor to be here today to discuss the potential benefits to Pennsylvania's current corporate income tax structure from the adoption of combined filing. This reform has now been adopted by 28 states and the District of Columbia, including the states with the country's largest populations and commercial centers.

As the name suggests, under combined reporting all commonly owned U.S. corporations engaged in the same "unitary" business enterprise are required to file a single return in the state, including all income and losses of those entities. The overall income of those combined entities is then apportioned among the states based upon the relative amounts of sales ("receipts") occurring in each state. This methodology has proven to be effective in reducing inappropriate income-shifting and in more fairly reflecting in-state earnings.

As you have heard today, there are two principal mechanisms for determining how much of multi-jurisdictional taxpayer's income is generated within a state or country. The first is separate accounting or what is known as "transfer pricing", where a business' in-state profits are calculated by assigning an arms-length price to every transaction and activity occurring within and without the taxing jurisdiction.

The second method is called formulary apportionment, which measures in-state income by reference to the percentage of business activity within the state. All states use formulary apportionment instead of separate accounting for calculating a corporation's in-state earnings, because the former methodology "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."[2]

While the federal government has long used separate accounting and transfer pricing at the international level, the system has proven to be unreliable, inefficient and difficult to administer.[3]

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[1] The author has been involved in state corporate income tax issues as an attorney, administrator, trainer, and advisor for almost three decades, first as Special Assistant Attorney General for the state of New Mexico and, for the last thirteen years, as counsel to the Multistate Tax Commission. The views and opinions expressed in this testimony are the author's alone, and do not necessarily reflect the positions of the Multistate Tax Commission or its member states.

[2] *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 164-5 (1983).

[3] In recognition of those drawbacks, Congress has now incorporated formulary apportionment concepts into some of the new international tax provisions in the *Tax Cuts and Jobs Act* of 2017, including GILTI and FDII.

Currently, Pennsylvania relies on formulary apportionment to gauge the in-state profits of the corporations subject to tax in the state, but relies on separate accounting and transfer pricing to determine how much income those corporations make in relation to the other members of the corporate structure who are not subject to tax in Pennsylvania. Combined filing is nothing more than an extension of formulary apportionment principles applied across formal legal structures to all members of that corporate family engaged in the same business enterprise. Combined filing has been recognized as a natural extension of formulary apportionment theory since the 1930's.

The Multistate Tax Commission has endorsed the states' use of combined reporting for all domestic corporations as the most efficient and fair means for the states to measure in-state earnings for large and small taxpayers alike. We have a model statute on our website for potential use by the states, www.mtc.gov, and we are close to finishing work on a new and updated model as well. States that have recently adopting combined filing, including New Jersey, Kentucky and New Mexico, used the MTC model as the starting point for their own legislation.

Combined reporting is particularly beneficial for the effective administration of the states' corporate tax systems because it aligns the state tax base with the federal "consolidated filing" tax base.[4] That is, virtually all U.S. corporations file a single federal tax return combining all the income and losses of its domestic C corporations, eliminating intercompany transactions and expenses—just like combined filing. The federal government accordingly has little incentive to audit the transfer pricing of intercompany transactions among domestic subsidiaries and affiliates.

In addition, the federal tax code actually encourages transfers of property between related domestic entities through what are known as "non-recognition" exchanges of stock for assets.[5] This sets the stage for many corporate tax structures designed to defeat tax systems like Pennsylvania's that rely on separate entity filing. Intangible assets can be transferred to a subsidiary in a low tax state like Delaware, allowing the Delaware subsidiary to charge the parent for the use of that intangible property, reducing and in many cases eliminating the operating company's separately reported income.[6]

Because the Committee may hear that the problems of income-shifting and base erosion can be addressed through other means, I would like to briefly address the states' experiences with those other means to date.

Add-Back Statutes.

Beginning in the early 2000's, many separate-entity states like Pennsylvania adopted "add-back" statutes intended to defeat the "Delaware holding company" ploy identified above, by authorizing tax commissioners to disallow deductions for royalties and interest expense paid to related parties operating in low tax jurisdictions.[7]

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[4] I.R.C. § 1501-1504, and related regulations.
[5] I.R.C. § 351.
[6] See, e.g., *Geoffrey, Inc. v. South Carolina*, 437 S.E.2d 13 (S.C. 1993)(intangible holding company for Toy's R Us); *Acme Royalty v. Director of Taxation,* 96 S.W.3d 92 (Mo. 2002)(Gore Industries).
[7] See, e.g., 72 Pa. Stat. § 7401(3)(1)(t)(1), effective for tax years beginning after 12/31/2014.

Unfortunately, these statutes proved to be easy to plan around. Instead of paying easily identified royalties to paper subsidiaries in Delaware or Nevada, taxpayers have re-structured their payments as "management fees" or "procurement fees" and directed those payments into established corporate entities operating in combined filing states. (This is sometimes called an "East-West" strategy since the western states were the first to adopt combined filing.)[8] State add-back statutes have certainly helped with income-shifting, but even with those statutes in place, separate-entity reporting states like Pennsylvania must still resolve disputes over the legitimacy and proper amount of such payments. As the federal government has discovered in the international realm, the resolution of such disputes is difficult, expensive, time-consuming and may not result in an appropriate determination of tax liability.

Other State Responses to Income-Shifting.

In addition to add-back statutes, states have tried a number of other approaches to reduce inappropriate income-shifting, including asserting nexus on remote entities[9], challenging the economic substance of various arrangements,[10] and the use of statutes permitting re-allocation of income among related parties.[11] All of these approaches have legal or practical limitations. The primary problem with these approaches, however, is that they are *ad hoc* remedies, requiring discovery, audit and potentially litigation on a case-by-case basis. It is a game of sharks and swimmers, requiring the states to allocate limited compliance resources as best they can.[12]

Combined Filing Significantly Reduces Litigation; Determining the Make-up of the Combined Group is Rarely a Point of Dispute.

State policymakers have been told in the past that adoption of combined filing will lead to litigation, particularly because the determination of the combined filing group is said to an arbitrary process. Neither statement is accurate. The contours of the combined filing group have been established through regulation, administrative guidance and occasional litigation over many decades; both the states and taxpayers now benefit from that expertise. There is every reason to think that taxpayers could rely on their experiences filing in other states in determining the make-up of the group in Pennsylvania.

The claim of increased litigation is also not borne out by the experiences of other states or the available public records of tax proceedings. Cases concerning the make-up of the combined reporting group are few and far between. By contrast, many questions regarding business purpose, economic substance, transfer pricing, nexus to tax, or the "reasonableness" of an expense deduction can only be resolved

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[8] See, e.g., *Staples, Inc. v. Comptroller, Md. Ct. of Special Appeals,* No. 2597 (8/9/18), *cert. den*., _U.S._ (11/4/19); *Columbia Sportwear USA Corp. v. Indiana Dept. of State Rev.,* 50 N.E.3d 147 (In. Tax Ct. 2016); *Rent-a-Center East, Inc. v. Ind. Dept. of State Rev.*, 42 N.E.3d 1043 (Ind. Tax Ct. 2015); *CarMax Auto Superstores West Coast, Inc. v. South Carolina DOR,* 767 S.E.2d 195 (S.C. 2014).

[9] See, e.g., *Lanco v. Director, Dept. of Taxation,* 908 A.2d 176 (N.J. 2006); *A&F Trademark Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004); *KFC, Inc. v. Iowa Dept. of Rev.,* 792 N.W.2d 308 (Iowa 2010).

[10] See, e.g., *Sherwin-Williams v. Comm. of Rev*., 778 N.E.2d 504 (Ma. 2001); *Hormel Foods Corp. v. Wisconsin Dept. of Rev.*, Wisc. Tax Appeals Bd. No. 7-17 (2009). https://www.wisbar.org/forPublic/INeedInformation/Tax%20Appeals%20Commission/2010/07-i-17.htm

[11] See, e.g., *Wal-Mart Stores East, Inc. v. Hinton*, 676 SE2d 634 (N.C. App. 2009); *Delhaize America, Inc. v. Lay*, 731 SE2d 486 (N.C. App. 2012).

[12] The MTC has partnered with several of its member states to create the State Intercompany Transactions Advisory Service (SITAS),[12] offering connections to transfer pricing experts, specialized training for auditors and lawyers, and exchange of audit information. See http://www.mtc.gov/The-Commission/Committees/SITAS

after a full factual inquiry.[13] It should not be a surprise, therefore, that several states including Massachusetts, Wisconsin and New Jersey have chosen to move to combined reporting after years of litigation over their add-back statutes and economic substance.

Consolidated Reporting Election as an Alternative to Combined Filing.

I was asked about the state's experience with "consolidated filing" or "affiliated group" filing as an elective alternative to combined filing. Consolidated and affiliated filing is similar to water's edge combined filing in that the filing group is limited to commonly-owned domestic C corporations, except the filing group can include corporations that are not necessarily engaged in a unitary business with the entities filing in the state. Approximately 30 states allow some form of consolidated or affiliated group election.

A consolidated filing election typically includes only those entities included on the taxpayer's federal consolidated return (requiring 80% common ownership). An affiliated group includes all domestic entities with 50% or more common ownership. Because the members of these filing groups may not be engaged in a single unitary business, it is unlikely a state could mandate such a return, because it could result in an overstatement (or understatement) of the amount of income earned from operations in the taxing jurisdiction.

The MTC's legal staff has prepared a whitepaper on the subject that should be available soon on our combined reporting statute page.[14] We concluded that the two filing elections do not appear to have a material impact on combined filing revenues, because the filing groups under these elections include all of a taxpayer's domestic C corporate entities. That is, the filing elections appear to provide roughly the same protections against domestic income shifting as combined filing statutes alone, while providing taxpayers with greater certainty as to the make-up of the group return.

I am happy to answer any of the Committee's questions.

[13] See, e.g., *Kohl's Department Stores v. Virginia*, 803 S.E.2d 336 (Va. 2017)(reasonableness of add-back); *In re VFJ Ventures, Inc.,* 8 So.3d 983 (Al. 2008)(same); *Kimberley-Clark Corp. v. Comm. of Rev*., 981 N.E. 2d 208 (Mass. App. Ct. 2013)(economic substance and reasonableness of add-back).

[14] http://www.mtc.gov/Uniformity/Project-Teams/Model-Option-for-Combined-Filing