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Combined Reporting

What is it?

How does it benefit Pennsylvania?

January 29, 2020

Corporate Taxation 101

- All 44 states (+ DC) that have a corporate income tax, base their tax on federal income.
- Under the US Constitution, states may only tax income earned within their borders, which can be difficult to determine for a business operating in multiple states.
- As a result, states “apportion” federal income by a formula to determine how much is taxable - usually on the basis of sales, property, payroll, or some combination. This is the share of total income the state can tax.

Corporate Taxation 101

- Example:
  Company A US reported taxable income: $10 million
  Company A activity "apportioned" to State B: 3%
  State B tax rate: 10%

- State B tax calculation: US income X apportionment X State B tax rate

  $10M X 3% X 10% = $30K tax

PA corporate net income tax (CNIT)

- In PA, apportionment is determined based solely on sales (Single Sales Factor method of apportionment)
- PA apportionment formula:
  PA Apportionment = Sales in PA/Sales in US
- Tax rate: 9.99%
- 2019-20 forecast: $3.558 billion (Roughly 10% of General Fund taxes)

PA Requires Separate Company Reporting

- Pennsylvania uses a strict “separate company” rule for corporate tax – each corporation must file its own return, even if it is part of a group of corporations.
- Typically, corporate groups file a single federal return with the IRS which adds together all of the income and expenses of the group.
- PA CNIT relies on a “pro-forma” federal return, which breaks out a single company from the combined federal tax return. The pro-forma return is not filed with the IRS.

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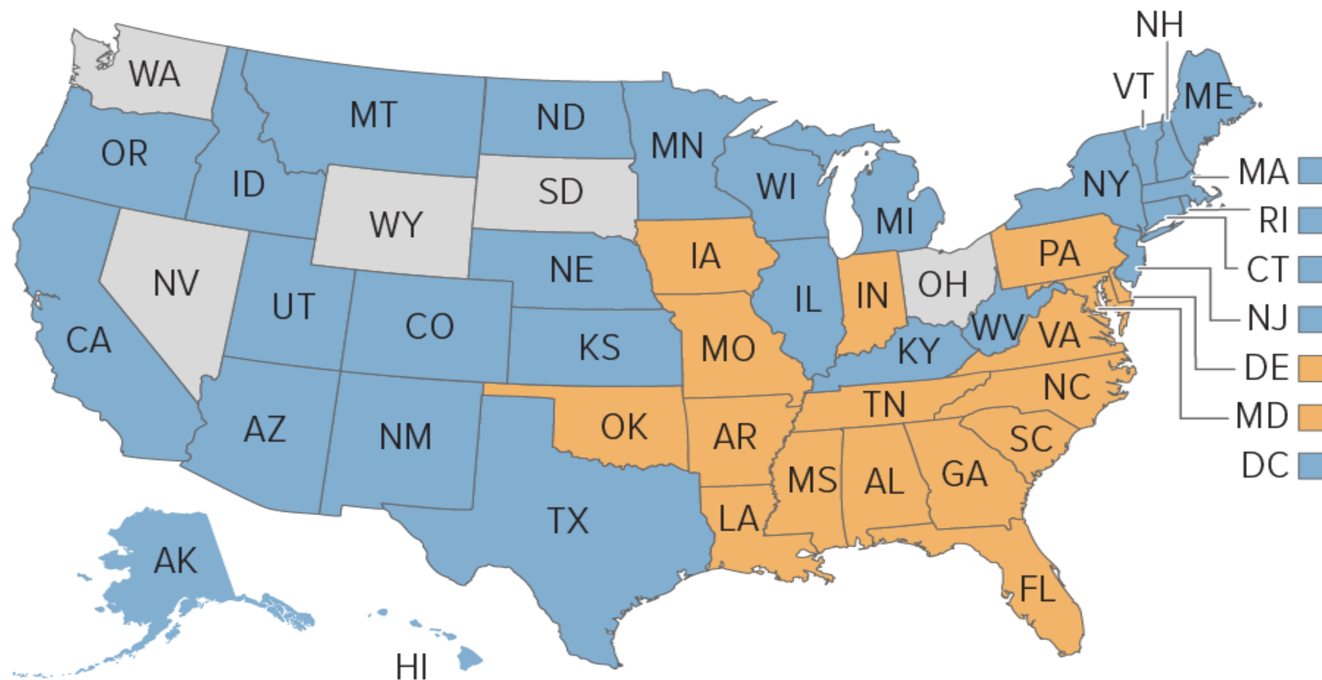
28 States Plus DC Require Combined Reporting for the State Corporate Income Tax

- Combined reporting required
- Combined reporting not required
- No corporate income tax; combined reporting not applicable



Source: John C. Healy and Michael S. Schadewald, “2019 Multistate Corporate Tax Guide, Vol. 1,” Kentucky HB 487 (2018), effective January 1, 2019; New Jersey AB 4262 (2018), effective July 1, 2019; New Mexico, HB 6 (2019), effective January 1, 2020.

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What is Combined Reporting?

- Recognizes that many corporations are part of a larger group of centrally-controlled companies – and taxes as one entity, rather than the parts.
- Combined reporting requires a corporation that is part of a group to add together profits of the companies in the unitary group.

Separate Company Reporting gives companies the opportunity to shift income and lower their tax bill

Companies can minimize the income of PA companies within a group by:

- Having the PA subsidiary pay for services or intangibles (such as royalties) from its affiliates in other states.
- The PA subsidiary then claims the charge as an expense – lowering its pro-forma income and its PA tax.
- When combined, the total income of the corporate group remains the same, but PA company has less profit and pays less tax.

Not just limited to intangibles like licensing

Companies can shift money from one related company to another using:

- Intercompany loans
- Transfer pricing (one sub changes another an artificially high or low charge for raw material)
- Management fees
- Accounting fees
- Computer fees
- Leases of equipment
- Shipping charges

All can be legitimate charges, used to determine performance and manage costs within corporate group – but can also be used to shift funds. Impact often not known until audited by revenue agency.

What is an Addback and how does it compare to Combined Reporting?

- Addback laws attempt to deny a tax deduction for a transaction between related companies if it meets certain criteria, by “adding back” the deduction to income.
- Apply to one transaction at a time, considering the purpose of the transaction, whether it is priced at a market rate, and other details.
- States typically only use addbacks to prevent abuses of intangibles like patents, copyrights and trademarks.
- **Because of these limitations, addbacks can be a weak substitute for combined reporting – and used to support the claim that it has already been fixed.**

PA Addback Statute: Act 52-2013

- Act 52 of 2013 included addback provisions for CNIT
- Disallowed deductions with an affiliated entity for the following:
  - Intangible expense or cost (patents, trade names, trademarks, copyrights, etc.)
  - Interest expense
- Provides a credit based on tax paid by the affiliate on the disallowed expense
- Add-back requirement does not apply to:
  - Transaction that did not have the principal purpose of tax avoidance and done at arm's length rates and terms
  - Transaction with affiliated entity in a nation with a comprehensive tax treaty with US
  - Transaction where affiliate passed it on to an unaffiliated entity (conduit)

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Why shift to Combined Reporting?

- **Levels playing field for corporations**
  - Small companies do not have the ability or resources to devote to tax planning. If operating completely in Pennsylvania, must pay 9.99% on all income. Under current law, big corporations have much more ability to determine their own tax.
- **Helps stop corporate tax avoidance**
  - Eliminates intercompany transactions – these are the primary vehicles to shift profit from company to company and from place to place.
- **Modernizes the tax system**
  - Most corporations part of a group of companies. CR better reflects and taxes activity of the entire group.
- **Helps pay for corporate tax rate cuts**
  - Expanding the tax base helps provide the ability to lower the rate (and still yield similar amounts of total tax collected)

Responding to common complaints about Combined Reporting

- **Too complicated?**
  No, a majority of states already do this and companies are filing returns there

- **Picks winners/losers?**
  While every proposal has winners and losers, the winners in this case are small PA based corporations that would benefit from a rate cut

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More responses to common Combined Reporting complaints

- **Already fixed by the addback law?**
  No, addback laws are a weak substitute for combined reporting. PA's law is especially weak with its exceptions.

- **Will trigger lawsuits?**
  It may, but PA can learn from other states and limit the litigation as much as possible.

More responses to common Combined Reporting complaints

- **Makes Pennsylvania less business friendly?**
  Only for tax avoiders. It will help small PA based corporations if coupled with a rate cut.

- **Causes a loss of jobs?**
  There is no evidence for this in the 28 states that already use combined reporting.

Many things to consider for the plan

- Treatment of “Net Operating Losses”
- Which companies are included
  - Treatment of banks and insurance companies
- Size and timing of rate cuts
- Filing requirements
- DOR administrative issues – revamping computer system, retraining of corporate tax analysts, auditors, attorneys to implement new reporting regime, regulation review and updates

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Revenue Estimates

- Based on real tax return data
- PA corporate returns were compared to actual combined returns filed by the same company in a combined return state – Minnesota
- Several years of tax return data have been examined
- Adjustments were made for unique PA features like the NOL cap and regional companies
- DOR won FTA award for our method

Background

- Tax year 2015 with 2019 law
- Returns used for analysis
  - Pennsylvania separate company returns
  - Pro-forma federal information
    - Schedule 7004 or Form 851
  - Minnesota returns
- Methodology change
  - Focus on individual corporations instead of combined groups

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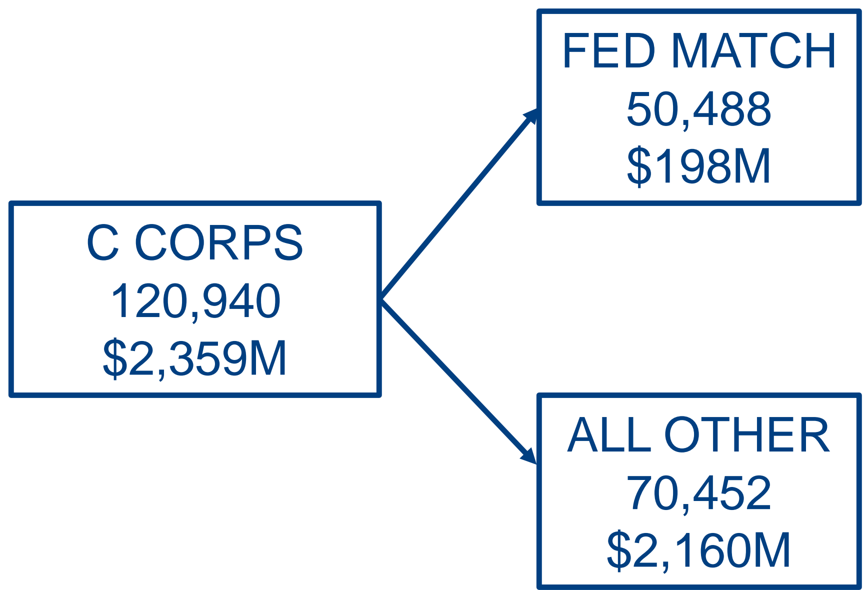
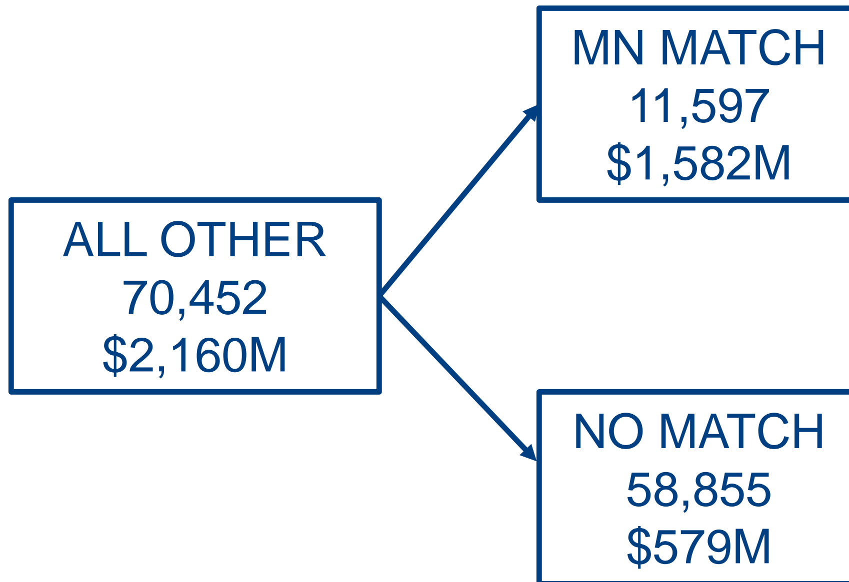
Flowchart



- If EIN matches federal data (both tax period and income), then it is assumed that the corporation is unaffected by combined reporting.

Flowchart



- If EIN matches the MN returns, it is possible to directly calculate CR impact.
- MN Information needed
  - Income to be apportioned
  - Apportionment denominator
- PA information needed
  - Apportionment numerator
  - Net operating losses

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Results

GROUP	COUNT	CURRENT	COMBINED	% CHANGE
IN MINNESOTA	11,935	$1,600M	$2,104M	31%
IMPORTANT	1,110	$370M	$445M	20%
OTHER	20,803	$190M	$288M	52%
FED MATCH	50,488	$199M	$199M	0%
NON-C?	36,604	$0	$0	0%
TOTALS	**120,940**	**$2,359M**	**$3,036M**	**29%**

- 9.99% rate
- 40% cap on net operating losses

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Other Considerations

- Rate Reduction
  - The results are at the current law rate of 9.99%.
  - As a result of the expansion of the base, the rate could be reduced.
  - The revenue neutral rate is 7.76%
- Treatment of NOLs
  - The results use the current law cap of 40% of taxable income
  - The NOLs are not permitted to be shared within the group
  - The current amount of the NOL bank is estimated to be more than $220 billion.
  - Uncapping the NOLs or allowing sharing would significantly reduce (if not eliminate) the revenue gain.

REVENUE NEUTRAL RATE EFFECTS

CLASS	COUNT	CURRENT	CR NEUTRAL
DECREASE	40,073	$2,038.8	$1,136.4
NEUTRAL	74,427	$0.0	$0.0
INCREASE	6,440	$320.7	$1,222.3
TOTAL	**120,940**	**$2,359.4**	**$2,358.7**

- It's important to note these numbers don't reflect any particular proposal.
- Majority of corporations owe $0 under both separate and combined reporting (NEUTRAL).
- In the DECREASE category, many of these corporations are not affected by CR and so just see the rate cut.
- Only 5% of corporations would see their liabilities increase with CR at the 7.76% rate.

Q&D Method - Publicly Available Data

Can publicly available data be used to estimate an increase from combined reporting?

Many shortcomings in this methodology

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Q&D Method - Publicly Available Data

- Alternate calculation using publicly available information
  - Corporate net income tax collections from Census Bureau
  - Gross State Product from BEA
- Tax collections are first divided by the CNIT rate in effect in that state for the period (yielding taxable income).
- The comparison is then done on a ratio:
  - TAXABLE INCOME / GROSS STATE PRODUCT
- If combined reporting is successful in expanding the CNIT base, then the ratio for CR states will be larger than for those that do not have CR.

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Q&D Method – Publicly Available Data

	RATIO	INCREASE
CR STATES	0.0432	
NON-CR STATES	0.0366	18%
PENNSYLVANIA	0.0321	34%

- CR states have a RATIO that is 18% larger than non-CR states.
- Pennsylvania is about 12% below other non-CR states.
- If Pennsylvania can become an average CR state, that would imply that liabilities would increase by 34%.
- Current estimate – 29% increase.

SUMMARY – COMBINED REPORTING

- Pennsylvania is a state with a very narrow base and a high rate for CNIT. Combined Reporting could have larger effect here for these reasons.
- PA DOR has done four studies using MN tax return data – the results have been roughly consistent. The 2015 estimate is a 29% increase in the base at the current rate.
- The treatment of NOLs is crucial to revenue gains from combined reporting.
- PA does plan to request other state's data – NJ is of most interest as it is a border state.

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