

Prepared Statement  
of

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Chair Boscola and members of the Committee, I am Michael Mazerov, Senior Fellow with the State Fiscal Policy Division of the Center on Budget and Policy Priorities in Washington. The Center is a non-profit, non-partisan research institute that focuses on federal and state budgets, programs, and tax policies, with a particular emphasis on how they affect low-income families. I appreciate the opportunity to present testimony this afternoon regarding the need to reform Pennsylvania's corporate income tax by requiring combined reporting.

**Combined Reporting Is Needed to Nullify Forms of Corporate Tax Sheltering to Which Pennsylvania Remains Vulnerable**

Combined reporting remains an essential tax policy reform for Pennsylvania if it is to have a fair and robust corporate income tax. Year in and year out, the Commonwealth suffers significant erosion of its corporate tax base because of corporate tax avoidance techniques that exploit the absence of combined reporting. The technique that has received the most attention here is the so-called "Delaware Loophole" – the formation of passive investment company subsidiaries in that state to which are transferred corporate trademarks and patents. The parent corporation pays deductible royalties for the use of those intangible assets, which reduces its Pennsylvania taxable income and the tax it owes. But there are several other well-known income-shifting strategies in addition to this one to which non-combined reporting states are vulnerable. Most of them can't be stopped at all — or in a sufficiently cost-effective manner for it to be realistic — through any policy reform other than combined reporting.

Let me give you one example, which goes by the name of "entity isolation." That strategy is used when, for example, an out-of-state manufacturer with Pennsylvania sales needs to have some physical presence in Pennsylvania, but the manufacturing itself is done outside the state. The corporation forms a separate subsidiary to employ the people that have to enter Pennsylvania, but the profit on the sale in Pennsylvania of the manufactured items themselves remains locked in the out-of-state manufacturing arm that Pennsylvania can't tax because of a federal law that bars the state from taxing companies that only solicit sales here (Public Law 86-272). Entity isolation is Corporate Tax Avoidance 101, it's perfectly legal, and it prevents Pennsylvania from taxing profits that are earned through sales to Pennsylvania customers. Pennsylvania enormously increased the incentive for out-of-state manufacturers to shelter their income in this way when it enacted a single sales factor apportionment formula.

We know that entity isolation is a widespread corporate tax shelter that is likely costing Pennsylvania substantial revenues thanks to the data that Maryland compiled for several years from hypothetical (or "pro-forma") combined reporting returns mandated by 2007 legislation. Those data showed that the so-called "Finnigan" "flavor" of combined reporting would have raised substantially more revenue for the state than would the alternative, so-called "Joyce" approach. The Finnigan version of combined reporting nullifies entity isolation, while the Joyce approach does so only partially.

## **Combined Reporting Will Help Level the Playing Field – Especially for Small Corporations**

Needless to say, not many small businesses have the resources or sophistication to set up and operate the kinds of tax avoidance strategies I've just described that require multistate operations or the formation of subsidiaries in low- or no-tax states. But small corporations often compete with large corporations that can do this. Large corporations that are willing and able to engage in this kind of aggressive tax avoidance may be able to attract capital at a lower cost than their in-state competitors or use their tax savings to undercut the prices of smaller corporations. By nullifying many forms of tax avoidance, combined reporting can thus help smaller, locally based corporations compete on a more level playing field and thereby preserve more local jobs.

Furthermore, by no means do even all large corporations engage in aggressive income-shifting strategies. They may not be well-positioned to do so because, for example, they do not own significant valuable intangible assets, or because they are service businesses that are not covered by Public Law 86-272 and can't easily engage in the "entity isolation" strategy I described. Or it may simply be the case that the company's culture does not prioritize aggressive tax avoidance. Regardless, states simply should not maintain a tax structure that gives unfair advantage to those companies most willing and able to push the envelope, but that is precisely what not requiring combined reporting does.

## **Not Requiring Combined Reporting Is Inconsistent with States' Use of Formula Apportionment to Tax Multistate Corporations**

Tax avoidance potential aside, not requiring combined reporting is fundamentally inconsistent with the way states tax multistate corporations. As you know, states do not seek to measure the profits realized on the sale of specific items within their borders. This would require the tracking of the receipts from the in-state sale of specific products and the specific expenses incurred in supplying those goods and services. Not only would that be an administrative nightmare for companies to comply with and for states to audit, it would be fraught with conflict because there is no objective way to assign to a specific state overhead expenses that are shared among all production locations or the savings in expenses arising from economies of scale. That is why states use a formula to assign to themselves a reasonable share of the nationwide profit of a multistate corporation. But not requiring combined reporting is conceptually inconsistent with formula apportionment. As soon as a state recognizes for tax purposes the profit reported by geographically isolated entities merely because they are separately incorporated, it has nullified what it was trying to achieve through the use of formula apportionment.

As it did decades earlier with respect to formula apportionment, the U.S. Supreme Court twice upheld the constitutionality of combined reporting as a reasonable and fair means of determining the share of a multistate corporation's income a state may tax. The same cannot be said of some of the other approaches to preventing abusive interstate income-shifting that are sometimes put forward as alternatives to combined reporting – such as trying to tax directly the royalty income of a Delaware intangible holding company.

## **A Growing Number of States Are Recognizing the Benefits of Combined Reporting**

Whether or not to require combined reporting is a key policy choice that is relevant to the tax systems of 45 states plus the District of Columbia (all states except Nevada, Ohio, South Dakota,

Washington, and Wyoming). More than three-fifths of those jurisdictions — 28 plus DC — have recognized the compelling case for combined reporting and now require it. Twelve states and DC have enacted combined reporting in the last 15 years – a rapid rate of adoption for such a significant change in state tax policy. Combined reporting has long been required and non-controversial in many generally Republican-controlled states, including Alaska, Arizona, Utah, Idaho, Montana, Kansas, and Nebraska. It was a Republican Governor, Jim Douglas, who started the post-2004 wave of combined reporting adoption with his recommendation that Vermont switch. Combined reporting was enacted under Republican Governor Matt Bevin and a Republican-controlled Kentucky legislature in 2018. Wisconsin Governor Scott Walker campaigned on repealing combined reporting but chose to retain it after he was elected. Ronald Reagan did not try to repeal combined reporting while he was governor; neither did Sarah Palin or Sam Brownback.

### **Combined Reporting and State Economic Growth**

Over the many years that the adoption of combined reporting has been considered in Pennsylvania, members of this committee have undoubtedly heard claims that it would discourage corporations from investing in the state in the future and perhaps even cause corporations already here to leave. Leaving aside the fact that some of the projected revenue gain from its adoption may be used to reduce the corporate tax rate – which, under the same argument, should attract corporate investment – these claims simply should be given little credence. Between 2008 and 2010 I conducted research in four states to document all the states in which the largest private sector employers in those states maintained physical facilities, unquestionably subjecting them to those states’ corporate income taxes. The most recent study I did looked at Maryland’s largest 120 largest corporations (as measured by their Maryland employment). I found that a large majority of those companies quite willingly subjected themselves to combined reporting in other states:

- At least 108 of the 120 largest Maryland employers maintained facilities in at least one combined reporting state or were members of a corporate group that had a facility in at least one combined reporting state. The “compliance burdens” and additional tax liability arising from combined reporting could not be that unreasonable if these companies — or the parent corporation that controls their decision-making — willingly maintained a facility in one or more combined reporting states.
- A large majority of the corporations I examined maintained facilities in multiple combined reporting states. Three-fourths of them — 90 out of 120 — had facilities in five or more combined reporting states. More than half — 67 out of 120 — had facilities in ten or more such states, and more than one-fourth — 34 out of 120 — had facilities in 20 or more combined reporting states.
- Eighteen companies had facilities in all 23 states that mandated combined reporting at that time.
- Ninety-three had a facility in California, the state that pioneered combined reporting and — as any corporate tax manager will attest — enforces it most aggressively.
- Thirty-two of the companies maintained their headquarters in combined reporting states.

I found comparable results in my Iowa, North Carolina, and New Mexico studies, as did two other organizations that conducted similar research in Connecticut and Wisconsin.

If corporations willingly subjected themselves to combined reporting in other states year-in and year-out, there simply is no reason to believe that they would shun Pennsylvania as a place to invest were it to adopt combined reporting.

I have also looked at the record of combined reporting states in retaining manufacturing jobs. This may be a reasonable indicator of whether combined reporting has a negative impact on the attractiveness of a state for investment, since manufacturers in theory don't need to be as close to their customers as retailers, construction contractors, and other types of service businesses need to be and therefore can choose to locate where state and local tax policies are more to their liking. These data show that combined reporting states do no worse in manufacturing job retention and growth than separate filing states do. (I exclude from this analysis those states that don't levy a corporate income tax at all.)

Four of the five states with the highest rate of manufacturing job growth over the last 10 years required combined reporting throughout the period, as did the state with the highest rate of manufacturing job growth – Michigan. Twenty-one states with corporate income taxes experienced at least 10 percent manufacturing job growth over the past 10 years. Eleven of the 21 had combined reporting in effect throughout the period, and a twelfth state had enacted but not yet implemented it. Thirty-six states had net positive manufacturing job growth over the past 10 years; 19 of them had combined reporting in effect throughout. In short, there is no obvious correlation between a state's adoption of combined reporting and its relative success in attracting or retaining the most potentially footloose firms and their jobs.

Nor does academic research demonstrate that combined reporting has an adverse impact on state economic performance; as with many subjects, studies can be found on both sides of the question. For example, a 2007 study concluded that “there is no evidence that these [combined reporting] requirements diminish economic activity in states.” A 2012 study actually found that “States with more aggressive corporate income taxes, specifically those that include combined reporting requirements, tend to have higher entrepreneurship rates.” A 2014 study concluded that “Combined reporting has no discernable effect on personal income, G[r]o[s]s[S]tateP[roduct], or employment after controlling for tax rates, apportionment, and throwback rules.” A 2016 study found that “Other tax policy measures (the throwback rule, required combined reporting, the personal income tax, and corporate license fees) are typically statistically insignificant” in affecting corporate investment in states. Another 2016 study found that “Combined reporting only reduces the economy in states with the greater origin taxation associated with throwback rules” – a policy that Pennsylvania has not implemented. On the other hand, a 2003 study found that “The effect of the income tax burden on [corporate investments in] property is more pronounced for states mandating [combined] unitary taxation (although it should be noted that the analysis only covered a period up to 1996 and misclassified three combined reporting states as having not adopted the policy.)

There is a good explanation for why combined reporting does not appear to have a significant impact on state economic and job growth one way or the other. All state and local taxes paid by corporations represent on the order of 2-4 percent of their total expenses, on average. State corporate income tax generally represent less than 10 percent of that already small share. And most

states that have prepared estimates predict that requiring combined reporting will boost corporate tax collections between 10 and 20 percent. It therefore shouldn't be surprising that the evidence I've just cited suggests that combined reporting has not been a disincentive for corporations to continue investing and creating jobs in states that adopt it.

### **The Alleged “Complexity” of Combined Reporting**

Corporate opponents of combined reporting also object that combined reporting is complex and burdensome to comply with, particularly because of the subjectivity entailed in determining which subsidiaries of a multi-corporate group are and are not engaged in a so-called “unitary business” with the parent and/or subsidiar(ies) subject to corporate income tax in a state. Such a claim compares combined reporting to the current system under which the state is largely powerless to stop many forms of interstate income shifting. If the state actually had the resources and attempted to adjust the prices that one member of a corporate group located in Pennsylvania charged and/or paid other out-of-state members for intra-corporate sales of goods and services to prevent such shifting, then the subjectivity, litigation, and compliance burden flowing from such an effort would exceed that of combined reporting many times over.

Corporations already file consolidated tax returns for federal tax purposes and consolidated financial statements for financial reporting purposes; they know how to do the accounting. The only potential complexity that arises from combined reporting is determining which corporations are and are not part of the unitary group. As discussed previously, most major corporations are filing combined reporting-based tax returns in numerous states, so they appear to be figuring out how to do that. That said, Pennsylvania could consider emulating Massachusetts and several other states by allowing corporations to make a long-term election to determine the combined group strictly on the basis of common ownership with no subjective determination of whether a particular subsidiary is part of a “unitary business.” This is the so-called “consolidated reporting” option. Such an election eliminates any argument that combined reporting imposes a significant or unreasonable compliance burden on corporations. (It must be offered as an election because the courts have held that combined reporting can only be mandated when the related corporations are economically integrated or “unitary.”)

With regard to the issue of state enforcement burdens, it is only necessary to observe that small population states with small revenue department staffs – states like Alaska, Idaho, Montana, New Hampshire, and Maine – have managed to successfully administer combined reporting-based corporate income tax structures for decades.

Finally, opponents of combined reporting sometimes argue that combined reporting will be burdensome and should not be enacted in a state because other combined reporting states have divergent laws concerning which kinds of corporate subsidiaries are included in the combined group and other fine points of the policy. This is a red herring and, quite frankly, a disingenuous argument. Pennsylvania cannot be responsible for divergent policy choices that other states have made nor should it reject an otherwise sound tax policy change because of those choices. The multistate corporate tax community is free at any time to encourage combined reporting states to harmonize their combined reporting laws to reduce business compliance burdens.

## **Combined Reporting and International Profit Shifting**

As policymakers consider the adoption of combined reporting in Pennsylvania, one key decision they face is whether to structure the tax law to mitigate tax avoidance arising from international as well as interstate profit-shifting. The same kinds of strategies that are used to artificially shift profits into low- and no-tax states – such as charging inflated prices for imported inputs sold from one member of a corporate group to another – can be and are used to shift profits into low- and no-tax foreign countries. Numerous academic studies have found that international profit shifting is depriving countries of substantial corporate tax revenue, and the U.S. federal government’s loss flows through to states as well. Even most combined reporting states are completely vulnerable to this because they are so-called “water’s edge” states in which combined reporting is limited to members of the corporate group legally incorporated in the United States. That is, the profits of foreign parent corporations and foreign subsidiaries are not combined.

States that wish to address international profit shifting through combined reporting have a few options. First, they can require full worldwide combined reporting, that is, the inclusion of all unitary foreign subsidiaries and parents in the combined group. Several states mandated worldwide combined reporting in the 1970s and early 1980s before the Reagan Administration pressured them into withdrawing to the water’s edge and, indeed, the two Supreme Court cases that addressed combined reporting actually upheld the constitutionality of worldwide combined reporting. Although only Alaska currently mandates worldwide combined reporting – and even there only for oil companies – there has been growing discussion in some states of moving to worldwide given the ever-growing attention to international profit shifting.

Second, several states have taken a limited step toward worldwide combined reporting by requiring the inclusion in the combined group, not of all foreign subsidiaries, but only of subsidiaries formed or doing business in notorious foreign tax havens like Bermuda and the Cayman Islands. Most of these states made this choice at the time they first adopted combined reporting.

Third, states can offer corporations the option to calculate their tax liability using worldwide combined reporting while giving them an incentive to make this election by requiring them to include in their apportionable tax base the income of their foreign subsidiaries through a mechanism other than combined reporting. Specifically, Pennsylvania could conform to the new “Global Intangible Low-Taxed Income” (or “GILTI”) provision of the 2017 federal tax restructuring bill. GILTI essentially seeks to impose a minimum tax on the foreign-source income of the foreign subsidiaries of U.S. parent corporations on the presumption that some of that income represents profit that was actually earned in the U.S. but shifted abroad. Pennsylvania is decoupled from the GILTI provision, that is, GILTI is not included in the apportionable income of U.S. multinational corporations subject to the Commonwealth’s corporate income tax. But Pennsylvania could reverse that policy and conform to GILTI, as several other states have done. GILTI would not apply to corporations electing to be taxed using worldwide combined reporting, and some corporations likely would pay less tax if they made the worldwide election than if they filed on a water’s edge basis with GILTI included in their apportionable income.

## **Now Is the Time**

The enactment of combined reporting can make an important contribution to preserving Pennsylvania’s tax base from further erosion and ensuring that multistate and multinational

corporations compete on a level playing field with their counterparts that do not seek to push the tax-avoidance envelope and with wholly in-state corporations. It could also generate additional revenue with which to finance public investments in education, worker retraining, and physical infrastructure. These kinds of investments are critical to Pennsylvania's economic future, and they benefit Pennsylvania businesses as well as Pennsylvania families. Pennsylvania's adoption of combined reporting is long overdue.