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Tax Foundation Testimony

Corporate Tax Policy Hearing
Pennsylvania Senate Democratic Policy Committee
January 29, 2020

Chairwoman Boscola and Members of the Senate Democratic Policy Committee:

Thank you for this opportunity to speak to you on corporate tax policy in Pennsylvania. There has long been a recognition, by policymakers in both parties, that Pennsylvania's corporate net income tax (CNIT) regime is inequitable and inefficient. That has not, of course, necessarily yielded agreement on possible reforms, but it is important in its own right that there is a consensus that the CNIT as currently constituted does not serve the Commonwealth's interest as well as it could. Governor Wolf has called for reforms, as did former Governor Rendell. This hearing, too, is a testament to that belief.

Concerns about the corporate net income tax are numerous, but to summarize them briefly:

1. The high rate penalizes many businesses which invest heavily in Pennsylvania;
2. Capped net operating loss deductions create inequities and harm some businesses with longer business cycles;
3. Transfer pricing and other tax arbitrage strategies that shrink the corporate tax base, along with less intentional disparities across corporate activities that may insufficiently attribute beneficial economic activity to Pennsylvania for purposes of taxation;
4. Tax nexus standards that may under- or over-reach, in different situations, in determining whether a company is subject to taxation in Pennsylvania; and
5. Stingy provisions regarding capital investment, which tend to discourage capital expenditures in the Commonwealth.

These issues can work in tandem, often in perverse ways. For instance, if the tax base is unduly narrow, failing to capture corporate profits properly attributable to Pennsylvania, this necessitates a higher rate, which in turn encourages more companies to engage in tax planning to expose less of their profitable activity to Pennsylvania and more of it to states with more favorable tax environments.

Combined reporting has long been a controversial issue, but this vicious cycle is one reason why it has its champions. The goal of greater equity in taxation is another.

Critics of combined reporting are right that it increases compliance costs and does not always result in a more accurate apportionment of income. Proponents are also right, however, in observing that the current separate apportionment approach permits some companies to reduce or even eliminate their tax burdens in Pennsylvania despite engaging in productive economic activity here.

This committee is well aware of most of the issues surrounding mandatory unitary combined reporting, but it's often good to start with some baseline analysis and build up from there. States have struggled with how to apportion the income of multistate businesses since the earliest days of corporate income taxes. All states have used formulary apportionment for many decades, where a taxable corporation's profits are attributed to the taxing state in accordance with the share of some proxy for its economic activity in a given state over its activity in all states. Although three factors—property, payroll, and sales—are possible, Pennsylvania is a single sales factor state, and is only concerned with a business's sales in and out of Pennsylvania.

In simplest terms, a company that is owned and operated in Pennsylvania and sells half of its wares in Pennsylvania would have half of its net income subject to the CNIT. Things get more complex, though, when that business is part of a larger group of companies with operations in multiple states, and this is where combined reporting comes in—as do the rules around combined reporting.

It's worth noting that corporate groups exist for a variety of reasons. Some entities are created expressly to gain a tax or regulatory advantage, while many are pursued for other reasons—but not being created as a vehicle of tax arbitrage does not mean they cannot have that effect.

Imagine several scenarios. First, imagine that the business in question is owned by a parent company that has a separate subsidiary, operating in a different state, that produces an entirely different product line, and doesn't share any resources with the company in Pennsylvania. Second, imagine that the businesses do the same things and sell the same products, but are divided out as the Pennsylvania branch and the Ohio branch. Third, imagine that they're different elements of an integrated business, with one company responsible for different aspects of the manufacturing process. And fourth, imagine that they're separate businesses that share certain resources from the parent company, like marketing and sales. Our impressions of these different forms of corporate associations is likely to vary—and so, too, should the way they are treated by the tax code should combined reporting be adopted.

Due to a federal law, P.L. 86-272, which prevents states from establishing nexus with a company that only solicits sales of tangible property in a state, it is possible—either in the normal course of business or due to tax planning—for so-called "nowhere income" to arise, which is not taxable in the destination state due to federal immunity, and not taxable in the state of origin due to the normal workings of apportionment rules, particularly under single sales factor apportionment. From Pennsylvania's perspective, companies could have sales in the Commonwealth but lack nexus, rendering them out of reach of the tax code, even if they have related companies which *do* have taxable nexus with Pennsylvania.

Alternatively, a company might split up its operations or engage in entity isolation. It might, for instance, place its intangible property in a Delaware holding company and have its other entities pay royalties to that company, effectively locating profits in a low-tax states while concentrating costs in higher-tax states. Pennsylvania's addback provisions are designed to address this, and to some extent, it's become harder to do in recent years anyway, but it remains a real issue in state taxation.

Or it might have different parts of the production process, or different but related product lines, divided up into different companies, with less profitable activity transpiring in Pennsylvania, without which more profitable activity elsewhere wouldn't be possible. Unlike the entity isolation example, this one doesn't have to be a deliberate strategy to affect Pennsylvania tax liability.

Or related companies might transact business with each other, which is perfectly reasonable, but the prices they attach to intercompany transactions might be inflated or deflated according to tax rates in the sending and receiving jurisdictions, which is an example of the transfer pricing issue.

These sorts of scenarios are the basic case for combined reporting. Do note, however, that in some cases, the result can be less revenue, not more. It's possible, after all, that a Pennsylvania company's affiliated entities will be less profitable than the Pennsylvania company alone, or that including subsidiaries will dilute the overall share of sales into Pennsylvania, thus undercutting apportionment. Combined reporting cuts both ways: it increases tax liability for some companies and decreases it for others.

In 2000, state analysts matched Pennsylvania companies to a Minnesota tax database and used their information on those companies' activities across states to extrapolate the revenue change for Pennsylvania if combined reporting were in place, assuming no changes to corporate decision-making. They found that it would increase revenue by 25 percent. It is vital to emphasize here that this is very much on the high side of estimates, and some states have estimated actual revenue losses, including Maryland and Indiana. Broader multistate studies have differed on whether combined reporting has a positive effect on revenues overall, and even studies from the same authors have yielded competing conclusions a few years apart. Importantly, though, there are two different questions here: does combined reporting increase tax collections in aggregate across the United States, and would combined reporting increase tax collections here in Pennsylvania specifically?

I would urge some level of caution regarding the estimates, especially with the adoption of an addback provision in the interim, but additional revenue seems entirely plausible in Pennsylvania. If Pennsylvania adopted a combined reporting regime, however, there is no question that tax complexity would rise. It's true, of course, that many companies are already doing combined reporting elsewhere, and federal returns are unified, but different states define the unitary group differently, not just in statute but in practice, so what constitutes a company's group in one state may be different from the combined group in another, with companies and state revenue offices fighting over definitions and liability.

If Pennsylvania goes this route, there should be an emphasis on simple, uniform definitions. The MTC has model language, which can be very helpful since it adopts definitions used in many other states. One vital concern is the actual definition of a unitary group.

A set of companies is not in a unitary group just because they share ownership. They must be interdependent, interrelated, and integrated, with states applying tests of unity of ownership, operations, use, and dependency to determine whether an in-state company is an integral part of the profits of an out-of-state entity. Any state adopting combined reporting should have clear tests of functional integration and apply them consistently, cutting down on lengthy litigation, high compliance costs, and business uncertainty.

Pennsylvania would also have to decide whether to adopt Joyce of Finnigan rules for apportionment. Under Joyce rules, which determine whether a company is subject to tax if another member of the unitary group has nexus.

Under the Joyce rule, the relevant taxpayer is a particular corporate entity making a sale, whereas in a Finnigan rule state, the taxpayer is the combined group. This means that under Joyce, a corporation is determined to be taxable in a state only if the corporation itself possesses taxable nexus, whereas under Finnigan, a corporation is taxable if any member of its unitary group is taxable.

By way of example, imagine three companies, each with a million dollars in sales into a given state—and nowhere else. The three companies are all members of the same unitary group, but only Company A has taxable nexus in the state, whereas the others only sell into the state, with operations located elsewhere. Under Finnigan rules, all $3 million of the company's sales are apportioned to the state, since the nexus established by Company A gives the state the authority to tax Companies B and C as well. Under Joyce rules, however, only the $1 million from Company A is included in a sales factor in the state.

Studies suggest that combined reporting has a deleterious effect on business activity in a state if the corporate income tax is above the national median—and of course, Pennsylvania has one of the highest corporate income tax rates in the country. It is also one of only two states with a low cap on the ability to apply net operating loss carryforwards—most states either offer uncapped carryforwards for 20 years or follow the federal model of unlimited years of carryforwards at up to 80 percent of liability in any given year—and decouples from federal bonus depreciation rules.

Past proposals for the adoption of combined reporting have paired it with rate reductions and uncapped net operating loss provisions. Ideally lawmakers would consider enhancing the treatment of capital investment as well.

The issue you've taken on is complex but merits your attention. I'd like to leave you with a few key takeaways:

1. Any combined reporting regime should favor simplicity and predictability, adopting modest and uniform definitions of the unitary group;
2. Policymakers should be cautious about using existing revenue estimates, particularly those generated before Pennsylvania adopted an addback provision or shifted to single sales factor apportionment; and
3. Any shift on combined reporting should be part of a larger tax reform package to modernize the Pennsylvania CNIT, making it fairer and more competitive.

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