



TESTIMONY

OF

THE PENNSYLVANIA CHAMBER OF BUSINESS & INDUSTRY

ON

MANDATORY UNITARY COMBINED REPORTING

BEFORE

THE PENNSYLVANIA HOUSE DEMOCRATIC POLICY COMMITTEE

HONORABLE MIKE STURLA, CHAIRMAN

JANUARY 20, 2010

On behalf of the Pennsylvania Chamber of Business and Industry and its over 10,000 business members, thank you for the opportunity to present and discuss our views on mandatory unitary combined reporting.

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate corporations with multiple businesses and entities. The debate is framed as a choice between two distinctly different corporate income tax systems used by states to answer this question: separate filing and combined reporting.

The first approach to determining the income of a multistate enterprise, separate filing, treats each corporation as a separate taxpayer - Pa. is currently a separate filing state. Under separate filing, each corporation includes only its income on the corporate tax return it files. The second approach combined reporting, treats affiliated taxpayers (parents and subsidiaries) engaged in a unitary business as a single group for purposes of determining taxable income. In the process of determining tax liabilities of the members of the combined group, the separate incomes of the members are added together or “combined.” In effect, combined reporting treats the members of the unitary business as though they were a single company in determining their income.

Mandatory Unitary Combined Reporting will make Pennsylvania less competitive

As we face an international financial crisis and a recession in the US, it is more important than ever to foster a competitive business climate in Pennsylvania.

Over the last several years, some legislators, Governor Rendell and other administration officials have proposed a major change to how taxes are levied on Pennsylvania businesses. They have proposed that Pennsylvania institute Mandatory Unitary Combined Reporting to increase the revenues that Pennsylvania collects from businesses. This proposal would have far-reaching and harmful effects on large and small employers, with the certain result of lost investment and jobs in Pennsylvania.

Instead of imposing burdensome new taxes and associated requirements on businesses, the most effective single step that Pennsylvania can take to improve our business climate is to improve the uncompetitive corporate net income (CNI) tax. After all if Pennsylvania was a nation, its overall corporate tax rate of 41.5 percent (federal plus state, accounting for state-local deduction) would be the highest in the world. Further, businesses pay one of the highest Capital Stock taxes in the nation and we are only one of the 10 states to impose such a tax. On top of taxes we are not a right-to-work state; we are one of four to have both an estate tax and an inheritance tax; and our legal system is far from reformed.

Pennsylvania businesses pay \$23 billion in taxes.

There are hundreds of thousands of businesses – large and small in our state. They already pay more than \$23.4¹ billion per year in state and local taxes, in addition to innumerable state fees. Taxes paid by employers represent about 42% of all state and local taxes collected in the Commonwealth.

¹ Ernst & Young Study conducted for the Council on State Taxation: *Total State and Local Business taxes: 50 State Estimated for Fiscal Year 2008* and published in 2009.

Proponents of combined reporting who claim that the majority of Pennsylvania businesses subject to the Corporate Net Income tax are not paying their fair share are not providing the full picture. First of all, only C-corporations in Pennsylvania are subject to the CNI. Not every business is a C-corporation. Of the C-corporations registered in Pennsylvania about half of them do not pay state or federal taxes each year, either because they have lost money or because they are inactive corporations.

There are legitimate reasons that a company may not be paying taxes: no assets/income, losses, use of tax credits, etc... The administration has testified that under combined reporting more than half of businesses will still legitimately not pay any taxes. In other words, the type of filing system a state uses does not provide an explanation for the presence of zero or minimum tax filers. In fact a high percentage of companies in both separate and combined filing states pay no corporate income taxes in excess of the minimum tax. When compared to other states, and even states that have enacted combined reporting, Pennsylvania's proportion of corporations who do not pay the CNI is typical. In other states it is typically between 45% and 71%. I note that Utah, a unitary state, and Pennsylvania, a separate filing state, both have the same percentage of no-or minimum tax return.

Combined reporting discourages investment in Pennsylvania

Pennsylvania is already anti-business because of our high CNI rate, tort system, permitting process, regulatory system, archaic local government model, etc. Mandatory unitary combined reporting would create a further disincentive for global companies to operate in Pennsylvania, leading to a loss of investment, economic growth and jobs. We need to give job creators compelling reasons to stay in, or come to, Pennsylvania, rather than another reason to leave the state. Further, combined reporting arbitrarily distorts employers' profits taxed by the state. Business investment—which drives job growth—is negatively affected by the distortions caused by combined reporting. Proponents' claims to the contrary would not pass muster in an introductory statistics course and are refuted by rigorous examination of this issue.²

Industries such as manufacturing, business services and trade will experience tax increases under mandatory combined reporting

Although proponents of combined reporting indicate that overall, combined reporting, together with CNI rate reductions, would be revenue neutral, it would not be revenue neutral for key industry sectors. In fact, some industries and individual businesses would pay significantly more taxes as a result of combined reporting. Based on historical data, the manufacturing, business service and trade industries would see net increases in their tax liabilities of more than \$8 million, \$20 million and \$53 million, respectively. In other words, the proposal would be a tax *increase* for manufacturers, further discouraging these firms from locating and expanding in Pennsylvania. It is easy to find an example of a firm that would pay 50% or even 100% more in business taxes under combined reporting. And that is enough to force a decision to move operations out of our state.

The effect of combined reporting on employers' taxes is also uncertain. The change is dependent upon the profit level of each member of the unitary group relative to the location of the members'

² Williams, Michael G., Charles W. Swenson and Terry L. Lease, "Effects of Unitary vs. Non-unitary State Income Taxes on Interstate Resource Allocation: Some Analytical and Simulation Results," Journal of the American Taxation Association, Vol. 23, No. 1, Spring 2001, pp. 39-60.

apportionment factors. Complicated? You bet it is. The result is that some employers' taxes will go up and that others will go down³ Contrary to proponents' claims, the shift is not from "in-state" to "out-of-state" employers, but rather among multistate employers. In fact, "out-of-state" employers may benefit—in a recent Colorado case, an "out-of-state" employer saved more than \$8 million in one year by combining all of its subsidiaries.⁴ If combined reporting simply "closed loopholes," such a result would be impossible.

Combined reporting creates uncertainty in revenue forecasts and will result in increased administration and litigation costs for the Commonwealth

Substantial details remain unclear as to how combined reporting would be instituted. For example, the concept of a 'unitary business' is usually poorly defined, and therefore prone to litigation. California, the first state to impose combined reporting, should have had all the wrinkles in the system ironed out by now. But, in fact, California currently has unresolved taxpayer disputes that are literally decades old. In short, if combined reporting is instituted, it's not clear who should be paying taxes and how much they should pay. That uncertainty means further drops in an already eroding revenue forecast and further potential reductions in collections. Furthermore, the Department of Revenue would need to hire additional auditors and provide them with substantial training in order to institute this type of tax change, further increasing the size of Pennsylvania's state government. In combined reporting states, an employer may not receive a final determination of taxes for a given year until 20 or more years after the fact. If that represents the "best" corporate income tax system, one can only imagine what the worst system is. The Chamber believes that the additional compliance and administrative costs associated with combined reporting should be included in a balanced evaluation of the benefits and costs of adopting combined reporting.

Combined Reporting is not a remedy

Combined reporting is a tax system, not a "loophole closer." State revenues from corporate income taxes have grown at an unprecedented rate in non-combined reporting states over the past few years, giving way to the assertion that in those states such taxes are "optional." State revenue agencies already have sufficient authority to address any transactions designed solely to avoid tax, including the authority to require combined reporting. If the real intent of proposing combined reporting is—as many proponents claim—to address intercompany payments, targeted legislation can be adopted instead, as has been the case in 16 non-combined reporting states.⁵ Finally, if the intent is to see increased revenues – there is no statistical evidence that states enforcing combined reporting collect more tax revenues than states that employ separate accounting, given the other characteristics of the tax structure (such as rate) and the state's economy.⁶

³ Research by the Pennsylvania Department of Revenue for the Pennsylvania Business Tax Reform Commission found that combined reporting would increase taxes on 2,100 Pennsylvania employers and reduce taxes on 2,730 other Pennsylvania employers.

⁴ *Cendant Corp. & Subsidiaries v. Colo. Dep't of Revenue*, Dist. Ct., City & County of Denver, Colo., No. 07 CV 676, 1/7/08.

⁵ Sixteen states—AL, AR, CT, DC, GA, IN, KY, MD, MA, MS, NJ, NC, OH, RI, SC and VA—have adopted statutes requiring taxpayers to add back to income certain expenses paid to related parties.

⁶ William F. Fox, Director, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," The University of Tennessee Center for Business and Economic Research, January 2009

2004 Business Tax Commission Recommendations

1. Reduce CNI to between 6-7%
2. 1% tax on net profits of pass through businesses
3. Eliminate Net Operating Loss cap
4. Continue CSFT phase-out
5. Single sales factor
6. Market based sourcing – Corporate Net Income Tax
7. Tax appeals process reform
8. Mandatory combined reporting
9. Recommendations should be presented as a comprehensive plan – the commission does not endorse any of the recommendations individually.