The INSTITUTE for

Public Policy & Economic Development

A partnership among Keystone College, King's College, Luzerne County Community College, Marywood University, Misericordia University, Penn State Wilkes-Barre, The Commonwealth Medical College, University of Scranton, & Wilkes University

PA Business Income Tax Policy Statement

Introduction

In March and April of 2012, The Institute for Public Policy & Economic Development created a policy statement to focus on the economic impacts of corporate tax loopholes in Pennsylvania. The Commonwealth faces budget shortfalls that threaten funding to social services, education, and health care. Local municipalities are struggling to provide basic services and residents' cost of living has increased faster than income. An effective means of stabilizing revenue is preventing the use of legal loopholes to avoid taxation. This policy statement will present the issue of tax loopholes and possible means of addressing corporate tax law weaknesses.

Findings

Net Corporate Tax in Pennsylvania

According to the Pennsylvania Department of Revenue:

> Domestic and foreign corporations are subject to the corporate net income tax for the privilege of doing business; carrying on activities; having capital or property employed or used in Pennsylvania; or owning property in Pennsylvania.
>
> This tax is levied at the rate of 9.99 percent on federal taxable income, without the federal net operating loss deduction and special deductions, and modified by certain additions and subtractions.
>
> Entities exempt from the corporate net income tax include certain qualifying:
>
> - not-for-profit organizations
> - homeowners' associations
> - membership organizations
> - agricultural cooperatives
> - business trusts
> - non-PA companies that limit business activity to solicitation of sales of tangible personal property in PA
>
> Further, corporations subject to bank and trust companies shares tax, gross premiums tax, mutual thrift tax and title insurance company shares tax are exempt from corporate net income tax.
>
> Any entity classified as a corporation for federal income tax purposes is considered a corporation in Pennsylvania.

Three loopholes present in the Pennsylvania business tax structure are presented here.

1. Delaware Corporate Tax Loophole

Businesses that do not conduct business in Delaware are not required to file a Delaware Corporate Income Tax Return, regardless if incorporated under the laws of Delaware.[1] One well-known tax loophole, nicknamed the "Delaware loophole," is routinely utilized by multi-state corporations. It is a way of circumventing Pennsylvania's corporate net income tax, which sits at a flat rate of 9.99 percent of all taxable income. Multistate corporations can avoid paying Pennsylvania's Corporate Net Income Tax by incorporating in Delaware to hold copyrights, patents and trademarks. Multistate corporations that do business in Pennsylvania pay this out of state company to use the copyrights, patents and trademarks, reducing its taxable income in the Commonwealth.[2] In order to do this, first, a multi-state corporation creates a subsidiary in a state with little or no corporate income tax, such as Delaware or Nevada (respectively). Ownership of patents and trademarks is transferred to the subsidiary, which is often simply a P.O. Box. These subsidiaries are termed passive income investment companies, or PICs. The corporation then "pays" to use this intellectual property, the cost of which becomes a business expense and lowers the taxable income of the company. Corporations, through tax loopholes, often escape paying any net income tax. Over 70 percent of multistate corporations in Pennsylvania paid no corporate net income tax in 2011, with an additional 10 percent paying $1,000 or less. This is the amount paid by a family earning $33,000 annually.[3] Stated in terms of lost revenue, the current corporate tax structure in Pennsylvania foregoes an estimated $500 million annually.[4]

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[1] Filing Corporate Income Tax. The State of Delaware. http://revenue.delaware.gov/services/Business_Tax/FilingCIT.shtml

[2] Press release. (2011)Mundy, House Democratic leaders call for true tax fairness http://www.pahouse.com/PR/120030712.asp

[3] Press release. (2011). Mundy introduces bill to close Delaware Loophole, lower corporate tax rate. Retrieved June 3, 2011, from http://www.pahouse.com/pr/120042711.asp

[4] Ibid.

The below map demonstrates the number of state that have taken action towards closing the loophole.

Source: Pennsylvania Budget and Policy Center

Pending Legislation (As of April 2012)

There are two pieces of pending legislation both aimed at closing the Delaware loophole. The first, House Bill 1396, which was drafted in April 2011, was sponsored by Representative Phyllis Mundy. The bill would close many corporate tax avoidance methods by requiring businesses and their subsidiaries to jointly file one tax return and pay taxes according to the amount of business activity in Pennsylvania. Democrats have pushed for this approach in the past. Republicans and business leaders opposed it because they felt it would have resulted in higher taxes for many companies. [5]

The second, House Bill House Bill 2150, drafted in January 2012 is sponsored by Representative David Reed. The legislation's supporters describe it as a revenue-neutral tax reform that cuts corporate taxes and closes the Delaware loophole to pay for it.

[5] Scott, Jason. Pa. Dems eyeing new proposal to close Delaware loophole. (2012), Retrieved from http://www.centralpennbusiness.com/article/20120224/FRONTPAGE/120229893?highlight=Delaware+loophole on April 20, 2012

The sponsors of each bill belong to different political parties setting the stage for a political battle over closing the loophole. The reform would force payment and make up for an estimated annual revenue hole of $500 million. The Delaware loophole enables businesses to avoid paying the 9.9 percent corporate net income tax, the highest flat rate in the nation, while small state-based companies that don't have shell companies are forced to carry more of the tax burden along with individual taxpayers.[6]

2. Transfer Pricing

Another loophole is the practice of transfer pricing. This is the act of several companies, owned by a single corporation, selling goods to each other at sub-market prices. In such corporations, subsidiaries complete transactions with one another to shift large amounts of income from high-tax to low-tax states. This gives conglomerates the ability to determine what stage of product production and distribution is most profitable. Generally, through transfer pricing, corporations will complete inter-subsidiary transactions (such as from manufacturer to retailer) at a low price and the retailer will sell it at a regular market rate in a tax haven. Thus, the retail division of the conglomerate will pay few taxes. The company as a whole pays less in corporate income tax, as the retailer will be located in a tax haven where the bulk of taxable profit has been “transferred.” Currently there are no proposals or pending legislation to outlaw the practice.

3. Nowhere Income

Related to transfer pricing is what some economists call the problem of “nowhere income.” Under Public Law 86-272, a federal law, states are limited in issuing a corporate income tax on the measure of state presence. A corporation can sell its products in a state where it has no or limited physical presence and not be taxed the same as transactions made within its home state. Often, corporations exploiting this loophole are not subject to taxes from any state. Currently there are no proposals or pending legislation to outlaw the practice.

Issues

Funding Cuts

As of January 2011, the Pennsylvania state budget deficit hovered around $4 billion dollars. In contrast, the budget deficit for Pennsylvania as of May 2010 was slightly over $1 billion.[7] The

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[6] Ibid.

[7] Barnes, Tom. Pennsylvania budget deficit $1 billion and growing. (2010). Retrieved June 14. 2011. from http://www.post-gazette.com/pg/10124/1055323-454.stm

state faces massive spending cuts in the area of health care, education, and social services. Corporate income tax contributes to the general fund, the main source of funding for the abovementioned government programs. A lack of proper corporate income taxation leads to the reallocation of funds from services and programs, listed below, assisting the most vulnerable populations.

Education

Under the House 2011-2012 budget, higher education funding is cut by $265 million. Funding for the state higher education system is cut by 15 percent, with state-affiliated schools such as Penn State and the University of Pittsburgh losing 21-25 percent of funding. For basic education (K-12), education funding returned to 2008-09 levels. The proposed 2012-2013 budget cuts education further, especially higher education. For example, The State System of Higher Education appropriation, supporting 14 state universities, is reduced by 20 percent to $330 million.

Health Care

Under the House 2011-12 budget, Medical assistance funding is cut by $295 million. The Long-term care line of medical assistance is reduced by $315 million. The Attendant Care and Services to Persons with Disabilities lines are altogether cut. While there are some additions to healthcare in the proposed 2012-2013 budget, there are significant cuts in medical assistance, and

Social Services

Under the House 2011-12 budget, Child welfare services face a $43.4 million dollar cut. Child care services for working families enrolled in TANF is cut by $38 million. In general, programs in the human services section of the budget receive a 9.1 percent decrease in funding.

Policy Guidelines

Combined Reporting

The highly technical nature of tax laws requires effective reform to be broad, as changes with narrow scope may be easily circumvented. Combined reporting effectively addresses the

Delaware Loophole and transfer income. It requires all subsidiaries of a conglomerate to file taxes as a unified entity and pay taxes based on income earned in Pennsylvania. It has been upheld by the Supreme Court and effectively implemented in 23 states. Additionally, it more accurately reflects the business decisions of corporations with many subsidiaries. House Bill 1396 seems to address this more adequately.

The Throwback Rule

The issue of nowhere income can be ameliorated in a piecewise fashion if all states institute a "throwback rule." This would require corporations with little or no presence in other states to "throw back" a tax to their home state for all business transactions. When all states adopt this law, taxes earned through interstate commerce would be more equally distributed among all states. Twenty-five states with a corporate income tax currently have a version of the throwback rule in effect. Pennsylvania still lacks any such legislation.[8] There is no current legislation to address this.

Policy Statements

1. The Institute for Public Policy and Economic Development supports policies that result in a more fair, equitable, and transparent tax system.

2. The Institute for Public Policy and Economic Development supports policies that improve the existing tax code by closing corporate tax loopholes that deprive the state of valuable revenue and disproportion the tax burden on fewer people.

3. The Institute for Public Policy and Economic Development supports policies that make corporations more accountable when filing corporate taxes.

4. The Institute for Public Policy and Economic Development supports combined reporting which requires companies to combine revenues including those of subsidiaries to ensure that their share of taxes are paid.

[8] Mazerov, Micheal. (2003). Closing Three Common Corporate Income Tax Loopholes Could raise Additional Revenue for Many States. Center of Budget and Policy Priorities.
http://www.cbpp.org/cms/index.cfm?fa=view&id=1868