PICPA
Pennsylvania Institute of Certified Public Accountants

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(PICPA)

Testimony

to

Pennsylvania House of Representatives Finance Select Subcommittee on Tax Modernization and Reform

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On behalf of the Pennsylvania Institute of Certified Public Accountants (PICPA), thank you for the opportunity to discuss Pennsylvania's corporate net income tax law.

My name is Drew VandenBrul. I am managing director in Grant Thornton's state and local tax practice in Philadelphia. I am also a current member of the PICPA State Taxation Committee.

Grant Thornton LLP (Grant Thornton) is the U.S. member firm of Grant Thornton International Ltd., one of the world's leading independent audit, tax, and advisory firms. Grant Thornton operates 58 offices across 30 states and the District of Columbia.

The PICPA, founded in 1897, is the second-oldest and the fourth-largest CPA organization in the United States. Membership includes more than 22,000 practitioners in public accounting, industry, government, and education. The PICPA has worked closely with governors, legislators, and the Department of Revenue on various tax issues and policies through the years. We are proud of this working relationship, and believe that we have contributed to making Pennsylvania a better place to live and operate a business.

The PICPA believes that the first goal for any state tax policy discussion should be that it meets the 10 Guiding Principles of Good Tax Policy. These principles were developed by the American Institute of Certified Public Accountants' Fundamental Tax Reform Task Force. These 10 principles are recommended by the PICPA, and they should be considered when tax proposals are analyzed. The 10 Guiding Principles of Good Tax Policy are:

1. Equity and Fairness
2. Certainty
3. Simplicity
4. Convenience of Payment
5. Economy of Collection
6. Neutrality
7. Economic Growth and Efficiency
8. Transparency and Visibility
9. Minimum Tax Gap
10. Appropriate Government Revenues

Although each principle is afforded equal importance, the Principle of Certainty is particularly important with regard to corporate tax policy. Certainty is defined as knowing when a tax is to be paid, how it is to be paid, and how the tax is to be determined. To be certain, the tax base, apportionment, and tax rate must be determinable. The Principle of Certainty is tied to the use of estimated payments and safe harbors that taxpayers use to prepay their tax liabilities. Unexpected and sudden changes to the calculation of the tax base or to the tax rates violate the Principle of Certainty and should be avoided at all costs to maintain good tax policy as well as a good business and economic environment for taxpayers.

Every business wants to be able to accurately estimate its expenses from year to year so it can properly plan its business activities. Taxes are typically a substantial expense item. Being able to accurately plan and account for state and local tax expenses ahead of time can have a dramatic impact on business decisions. With all other factors being equal, the state with the most certain tax regime provides the most stable option.

Pennsylvania's corporate net income tax rate is 9.99 percent, and the computation of taxable income starts with federal taxable income on a separate company basis. Pennsylvania has the highest corporate income tax rate (except for Iowa, which has a 12 percent tax rate on taxable income over $250,000, but which offers a deduction for federal income taxes, reducing its rate below Pennsylvania).

Another important aspect when discussing corporate taxes is how a state's tax laws conform with the Internal Revenue Code (IRC). State conformity generally falls into one of three categories: (1) rolling conformity, in which states conform to the IRC as currently in effect; (2) fixed date conformity, in which states conform to specific sections of the IRC as in effect on a certain date; (3) selective conformity, in which states conform to specific IRC sections as of specific dates, which may be different dates depending on the IRC section or may pick and choose specific provisions of the IRC to which they conform. Pennsylvania is a rolling conformity state.

As a state that conforms to the current IRC, Pennsylvania will be affected by the corporate net income tax provisions of the federal Tax Cuts and Jobs Act enacted in December 2017. This federal tax reform legislation adds complexity and uncertainty to tax codes at both the federal and state levels. Some of this uncertainty will require state legislative action to resolve, and will impact many Pennsylvania corporate net income taxpayers. We encourage the General Assembly to consider the need for appropriate legislative action to provide taxpayers with as much certainty as possible so that they may properly file tax returns and report the financial statement impacts.

With all three types of IRC conformity, it is common for states to decouple from certain sections of the IRC. An example might be that certain deductions or types of income are not considered when calculating taxable income subject to state apportionment for a multistate business (i.e., the state may choose not to include by reference the particular item of income or deduction specified in a section of the IRC either by outright exclusion of the income or by a subtraction modification -- or addback -- of the deduction in determining the state tax base).

Attached is a chart comparing key corporate net income tax aspects of Pennsylvania and its immediate surrounding states. This goes beyond the statutory tax rates and shows similarities and differences in how the tax is reported (filing methodology), modifications to federal taxable income (bonus depreciation and intercompany expense disallowance), apportionment (factor weighting and sourcing of service receipts), and net operating loss carryovers and limitations.

These factors are key to understanding the true impact of the net income tax imposed on corporations operating in, or considering expansion into, Pennsylvania. You will see that a number of these factors are similarly treated by states in this region. For example, a number of the states have moved to single sales factor apportionment in an attempt to improve the tax structure for in-state businesses selling products or services outside of the state.

In contrast to these similarities, there are a few factors which remain unique to Pennsylvania. These factors are often highlighted as potentially unfriendly to business development and growth in Pennsylvania. In particular, the net operating loss limitations and the treatment of federal bonus depreciation have created significant uncertainty for Pennsylvania taxpayers.

Pennsylvania is the only state in this comparison to limit the use of net operating losses. This imposes significant tax burdens that are not seen in other states and has been the subject of recent litigation in the *Nextel* and *RB Alden* cases. This combination of uncertainty and unfavorable tax treatment has a negative impact on Pennsylvania -- both in actual terms and in perceptions across the taxpayer community.

Similarly, Pennsylvania's treatment of federal bonus depreciation makes it an outlier, and is currently the subject of significant uncertainty pending enactment of legislation to clarify its treatment. Under federal tax reform, the IRS allows certain property to be fully expensed in the year of acquisition (i.e., 100 percent bonus depreciation). Due to the negative revenue impacts, most states have, or will, decouple from these provisions and allow taxpayers to use federal depreciation without the bonus depreciation provisions. Pennsylvania's statute was enacted to decouple from the 30 percent bonus depreciation effective after Sept. 11, 2001, and was never updated. The impact has been uncertainty about how this applies to later versions of bonus depreciation, including the current 100 percent bonus.

Pennsylvania taxpayers are now faced with the prospect of having <u>zero depreciation</u> on property placed in service between September 2017 and December 2022. Legislation has been introduced to correct this (see HB 2017 and SB 1056, for example , but taxpayers' financial statements and potentially their tax return filings have been negatively impacted due to this uncertainty. This is a good example of where Pennsylvania can improve on the imposition of its corporate net income tax and provide taxpayers with more certainty.

Pennsylvania has taken numerous steps to improve its corporate net income tax structure, including elimination of the capital stock/franchise tax and enactment of single sales factor apportionment. These have moved Pennsylvania more in line with other states, including its neighbors. Addressing tax rate, net operating losses, and bonus depreciation represent opportunities to further improve the tax structure and provide certainty to taxpayers regarding administration of the tax.

Thank you, and I will be happy to answer questions.

Corporate Net Income Tax Factors - Pennsylvania and Surrounding States (current as of April 4, 2018)

Corporate Net Income Tax Issues	PENNSYLVANIA	NEW JERSEY	NEW YORK	OHIO	DELAWARE	WEST VIRGINIA	MARYLAND
Corporate Net Income Tax Rate	9.99% (7)	9.00% ($500-$2,000 minimum tax)	6.50% generally; 0% for qualified manufacturers;5.5% for qualified emerging technology companies (1)	N/A	8.70%	6.50%	8.25%
Apportionment Weighting	Single sales factor	Single sales factor	Single sales factor	N/A	Single sales factor (3)	Three-factor with double-weighted Sales	Three-factor with double-weighted Sales (6)
Net Operating Loss Rules	20 year carryforward; utilization limited to 40% of taxable income for 2019 and beyond	20 year carryforward	20 year carryforward	N/A	Federal NOL carryforward	20 year carryforward	Federal NOL carryforward
Franchise/Gross Receipts Tax	N/A	N/A	N/A	Commercial Activity Tax (CAT) (2)	N/A	N/A	N/A
Filing Methodology	Separate Company	Separate Company	Unitary/combined	Unitary/combined	Separate Company	Unitary/combined	Separate Company
IRC Conformity Date	Current	Current	Current	N/A	Current	Adopts changes to federal law made after Dec. 31, 2016 but prior to Jan. 1, 2018	Current (4)
Sourcing of Service Receipts	Market-based Sourcing	Cost of Performance	Market-based Sourcing	Market-based Sourcing	Cost of Performance	Cost of Performance	Market-based Sourcing
Treatment of Bonus Depreciation	Decouples from bonus depreciation (5)	Decouples from bonus depreciation	Decouples from bonus depreciation	N/A	Allows federal bonus depreciation	Allows federal bonus depreciation	Decouples from bonus depreciation
Intercompany Expense Disallowance	Certain intangibles and related interest	Intangibles and interest	N/A - unitary/combined	N/A	None	N/A - unitary/combined	Intangibles and interest

(1) Fixed dollar minimum tax up to $200,000
(2) .26% on gross receipts over $1 million; annual minimum tax between $150-$2,600; financial institutions tax imposed at the greater of $1,000 or .8% on the first $200 million in apportioned total equity capital
(3) Delaware phasing into single sales factor in 2019 and adopting single sales factor beginning in 2020
(4) Maryland temporarily decouples from any federal tax law that reduces MD tax revenue by $5 million or more
(5) Disallows all depreciation on 100% bonus assets per Corporation Tax Bulletin 2017-02. HB 2017 proposes to allow federal depreciation without bonus
(6) Single sales factor for manufacturers
(7) Highest state rate. Iowa 12% rate is reduced for 21% federal tax deduction (equivalent of 9.48% rate).