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Pennsylvania General Assembly
House Finance Committee
Select Subcommittee on Tax Modernization and Reform

Re: Pennsylvania's Corporate Net Income Tax (CNIT)

Dear Chairman Evankovich and Members of the Select Subcommittee:

On behalf of the Council On State Taxation (COST), thank you for the opportunity to address the Subcommittee on the issue of the Pennsylvania Corporate Net Income Tax (CNIT) and key issues of comparison with the corporate income taxes of surrounding states and nationwide. COST is a nonprofit trade association consisting of approximately 550 multistate corporations engaged in interstate and international business, including substantial business operations in Pennsylvania. I would like to focus my testimony on five key issues we have identified in COST's research, which is cited as a resource in my written testimony.

- **Pennsylvania's CNIT rate of 9.99% is the second-highest corporate income tax rate in the nation, harming the Commonwealth's competitiveness and depressing job growth and business investment.**

Pennsylvania's CNIT rate of 9.99% is second only to Iowa's 12% rate as the highest corporate tax rate in the nation (for the top bracket in states with graduated corporate tax rates, and not counting corporate "surcharges" or other measures).[1] Meanwhile, the nationwide trend has been to reduce corporate tax rates: since at least 2010, only Illinois has increased its corporate tax rate (again, surtaxes notwithstanding). The lowest corporate tax rate in the country is now North Carolina, at 3% and falling to 2.5% in 2019. Research has shown that corporations reduce the number of business locations per state and the number of employees and amount of capital per plant in response to higher corporate tax rates.[2]

- **Pennsylvania is one of only three states that currently limit the amount of a corporate NOL deduction to a percentage of corporate income.**

Besides Pennsylvania, only Connecticut and Louisiana limit net operating loss deductions as a percentage of corporate income.[3] The net operating loss deduction is

[1] Source: Federation of Tax Administrators, Range of State Corporate Income Tax Rates, February 2018, available at: https://www.taxadmin.org/assets/docs/Research/Rates/corp_inc.pdf.
[2] State Taxation and the Reallocation of Business Activity: Evidence from Establishment-Level Data, Xavier Giroud and Joshua Rauh, National Bureau of Economic Research, September 2015, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2896896.
[3] Source: Bloomberg BNA Corporate Income Tax Chart, Net Operating Losses.

an "important component of the corporate tax system,"[4] and as such, impacts all economic activity undertaken by businesses subject to the CNIT. Limiting the deduction penalizes businesses arbitrarily, particularly harming businesses making long-term capital investments in Pennsylvania. Further, while Pennsylvania has removed its dollar "cap" on net operating loss deductions, it also has failed to assure that such previously capped losses will be fully utilized in future years.

- **Pennsylvania is the only state to deny depreciation deductions until an asset is disposed of, for taxpayers using immediate expensing at the federal level under I.R.C. Sec. 168(k), as amended.**

Roughly two-thirds of states have decoupled from federal "bonus" depreciation under I.R.C. Sec. 168(k). These states, like Pennsylvania in the past, provide for a mechanism to recoup the amount of disallowed federal bonus depreciation for state purposes. However, with Corporation Tax Bulletin 2017-02, the Department of Revenue is taking the novel (and wholly unexpected) position that purchases of property subject to 100 percent expensing at the federal level are already fully depreciated, and thus *no* deductions should be allowed for Pennsylvania tax purposes (at least until the property is disposed of). This position is a strained reading of the law, at best, and wholly inconsistent with the established policy choice of the General Assembly to put taxpayers in essentially the same place they would be absent the federal "bonus" depreciation allowance. No other state has taken a similar position, making Pennsylvania the sole state to adopt this policy.

- **On CNIT administration, Pennsylvania compares well with other states, receiving a "B" grade on the COST Administrative Scorecard, but applies unequal interest rates and does not provide adequate rules for reporting federal corporate tax changes.**

COST regularly "grades" the states on state tax administrative practices.[5] One area where Pennsylvania has improved recently is in providing an independent tax appeals forum. Two areas of potential improvement, however, are in the area of interest rates and reporting federal corporate tax changes. Pennsylvania applies the federal underpayment rate to Pennsylvania tax underpayments, but only pays interest on Pennsylvania tax overpayments at the federal underpayment rate minus two percent. Interest rates should reflect the time value of money (either in the hands of the taxpayer or the state), and thus the interest rates should be equal. Further, specific to the CNIT, Pennsylvania lacks a definition for final federal tax determinations that must be reported to the Department of Revenue, and also lacks sufficient rules regarding audits for potential liabilities arising from such reporting obligations.

- **Conformity to federal tax reform would expand the CNIT base by 14%, which is greater than the nationwide average state corporate tax base increase of 12% from federal conformity.**

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[4] *The Corporate Income Tax System: Overview and Options for Reform*, Congressional Research Service, Mark P. Kneightley and Molly F. Sherlock, December 1, 2014, available at https://www.fas.org/sgp/crs/misc/R42726.pdf.
[5] See COST Scorecard on Tax Appeals & Procedural Requirements, December 2016, available at: http://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/final-scorecard-in-templateupdatedbookmarked.pdf.

COST's research affiliate, the State Tax Research Institute (STRI), commissioned a study by Ernst & Young LLP to determine the impact of federal tax reform on the state corporate tax base.[6] While federal tax reform resulted in a substantial corporate tax rate decrease at the federal level, its "base-broadening" measures will result in a substantial corporate tax base increase at the state level, averaging 12% nationwide. Due to the industry composition of Pennsylvania, its estimated corporate tax base increase will be 14%, assuming conformity to all the federal tax reform provisions except for those specifically decoupled from (*e.g.*, immediate expensing). Notably, this does not even include the novel position taken by the Department of Revenue disallowing depreciation deductions. The largest portion of this corporate tax base increase is the interest deduction limitation enacted under I.R.C. Sec. 163(j). Other potential base-broadening provisions include a new tax on "global intangible low-taxed income," although there could be legal challenges to such inclusion. Pennsylvania should consider decoupling from these provisions to avoid an inadvertent tax increase as well as to incentivize investment in the state. For example, Georgia recently enacted legislation to decouple from both the interest expense limitation and the foreign income inclusion.

I welcome any questions from the Subcommittee, and I thank you for the opportunity to share COST's research on these issues.

Respectfully,

Ferdinand Hogroian

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director

[6] The Impact of Federal Tax Reform on State Corporate Income Taxes, Andrew Phillips and Steve Wlodychak, March 2018, available at: http://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/cost-federal-tax-reform-3-1-2018-cost-v2.pdf.