



## HOUSE COMMITTEE ON APPROPRIATIONS

# FISCAL NOTE

HOUSE BILL NO. 440

PRINTERS NO. 1608

PRIME SPONSOR: Reed

### REVENUE INCREASE / (DECREASE)

FUND	FY 2012/13	FY 2013/14
General Fund	\$0	\$3,000,000

**SUMMARY:** House Bill 440, Printer's Number 1608, amends the Tax Reform Code (TRC), further providing in sales tax for definitions and credit against tax; in personal income tax for definitions, classes of income, partners and partnerships, S-Corporations and shareholders, income of other states and requirements concerning returns, notices, records and statements; in corporate net income tax for definitions, imposition of tax and reports and payment of tax; in realty transfer tax for definitions and impositions; and repealing obsolete provisions in sales tax, in coal waste removal and ultraclean fuels tax credit and inheritance tax.

**ANALYSIS:** This legislation contains the language for the Governor's tax package which reforms the personal income tax, corporate net income tax and realty transfer tax as well as eliminates several obsolete tax provisions in the sales tax, inheritance tax and tax credits. Furthermore, language is added providing for an add-back provision in the corporate net income tax for expenses and interest deducted in association with intangible property.

This legislation provides a phase-down schedule for the corporate net income tax (CNIT) rate to 6.99% beginning in 2015 as follows:

Taxable year 2015	9.89%
Taxable year 2016	9.69%
Taxable year 2017	9.49%
Taxable year 2018	9.29%
Taxable year 2019	8.96%
Taxable year 2020	8.63%
Taxable year 2021	8.30%
Taxable year 2022	7.97%
Taxable year 2023	7.64%
Taxable year 2024	7.31%
Taxable year 2025 and thereafter	6.99%

Currently, net operating loss (NOL) deductions for the CNIT are capped at the greater of \$3 million or 20% of taxable income. This legislation increases the NOL deduction as follows:

Taxable year 2014	Greater of \$4 million or 25% of taxable income
Taxable year 2015 and thereafter	Greater of \$5 million or 30% of taxable income

House Bill 440 provides that for taxable years 2015 and thereafter, no deduction shall be allowed for an intangible expense or cost, or an interest expense or cost, paid, accrued or incurred directly or indirectly in connection with one or more transactions with an affiliated entity for purposes of calculating a company's CNIT liability. An intangible expense or cost is any royalty, license or fee paid for the acquisition, use, maintenance, management, ownership, sale, exchange or other disposition of patents, patent applications, trade names, trademarks, service marks, copyrights, mask works or other similar expenses or costs and any interest expense or cost associated with the intangible expense or cost that is a deduction allowed under section 163 of the Internal Revenue Code.

The add-back of this expense or cost will not apply to the following: (1) a transaction that was directly related to a valid business purpose; (2) a transaction between a taxpayer and an affiliated entity domiciled in a foreign nation which has in force a comprehensive income tax treaty with the United States for the prevention of double taxation and the sharing of information; and (3) a transaction where an affiliated entity directly or indirectly paid, accrued or incurred a payment to a person who is not an affiliated entity, if the payment is paid, accrued or incurred on the intangible expense or cost, or interest expense or cost and is equal to or less than the proportional share of the transaction.

When a taxpayer is engaged in one or more transactions with an affiliated entity that was subject to tax in this Commonwealth or another state or possession of the United States on a tax base that included the intangible expense or cost or interest expense or cost, the taxpayer shall receive a credit against the tax due in this Commonwealth in an amount equal to the apportionment factor of the taxpayer multiplied by the taxes paid or owed to the other state or possession of the United States. Any credit issued shall not exceed the taxpayer's liability in the Commonwealth attributable to the net income taxes as a result of the add-back adjustment.

Currently, sales of services and intangibles are sourced to where the "income producing activity" is located. This legislation requires the utilization of market sourcing for the sales of services and intangibles for purposes of calculating the CNIT apportionment. This change requires the sale to be sourced to the place where the benefit is being derived by the customer.

A non-filer penalty is also added to the CNIT for failure to file a corporate tax return. Specifically, a non-filer penalty of \$500 will be assessed plus 1% of every dollar of tax in excess of \$25,000 which is determined to be due.

This legislation makes changes to the personal income tax (PIT) for small businesses aligning Pennsylvania with federal rules. Under federal rules the recognition of a gain or loss can be deferred when property held for productive use in a trade or business or for investment is exchanged for property of a like-kind and is held for productive use in business or investment. Also, federal rules allow for a \$5,000 start-up business deduction in the year the business is established. Aligning Pennsylvania with the federal start-up deduction provides small businesses operating in Pennsylvania with the same benefit that C-corporations receive. The provision for the start-up deduction shall apply to tax year 2014 and thereafter and the provision for like-kind exchanges shall apply beginning in 2016.

This legislation also includes provisions which do the following: (1) eliminates the resident credit for taxes paid on income to other countries (residents will still be permitted to take a credit for taxes paid to other states); (2) eliminates the provision in the realty transfer tax which allows for a transaction to escape realty transfer tax when 89% of the interest in a real estate company is transferred to the buyer with an option to purchase the additional 11% after three years; (3) deletes provisions in the sales and use tax providing for credit against the tax due for activity associated with call centers; (4) deletes an obsolete provision relating to local receivers of use tax which no longer applies; (5) repeals the coal waste removal and ultraclean fuels tax credit; (6) deletes language in the inheritance tax relating to the transfers of property to a spouse (provisions are no longer applicable since the tax on spousal transfers has been eliminated); and (7) adds language authorizing actions by the Department of Revenue to improve income tax compliance and collection efficiency for pass-through entities such as S-corporations, limited liability companies and partnerships.

The act shall take effect immediately.

**FISCAL IMPACT:** Enactment of this legislation will result in no adverse fiscal impact on Commonwealth funds in fiscal year 2012-13. The provisions contained in this legislation are estimated to generate an additional \$3 million in revenues for the General Fund in fiscal year 2013-14. In future fiscal years the additional revenues generated from the add-back provision, elimination of the foreign tax credit, change to market sourcing, implementation of the non-filer penalty, elimination of the realty transfer tax 89/11 provision, the pass-through business tax compliance, and elimination of the obsolete tax provisions contained in the bill will provide offsetting measures to the reductions in revenues resulting from lowering the CNIT rate, expanding the NOL deduction for CNIT and conforming to federal rules for small businesses providing for like-kind exchanges and start-up business deductions.

The Governor's business tax reform package in his Executive Budget was estimated to generate an additional \$2.3 million in fiscal year 2013-14. The Governor's package included a provision to eliminate the corporate loans tax which was estimated to reduce revenues by \$0.7 million in 2013-14. This provision is not included in House Bill 440 as it is not in the Tax Reform Code. Therefore, the estimated impact of House Bill 440 is \$3 million in 2013-14.

A Multistate Tax Commission (MTC) report done in 2003 estimated that revenues lost to the Commonwealth from all types of tax sheltering to other states ranged from a low of \$209 million to a high of \$449 million. The estimates produced by the MTC report included many more transactions to be treated as add-backs. Some of these transactions involve interest transactions, day-to-day treasury transactions, factoring transactions and discounting transactions which many believe are necessary for the cash flow management of businesses. The provisions of this legislation limit the add-back of intangible expenses to royalties paid for patents, trademarks, copyrights and other similar expenses, including the interest associated with such transactions. Other states have adopted similar add-back provisions as those contained in this bill.

Based on the experience of other states with similar provisions it is estimated that the add-back provisions contained in this legislation will generate an additional amount of tax revenue for the General Fund in the range of \$70 million to \$90 million in any taxable year.

Finally, the Independent Fiscal Office released a special report entitled “Corporate Tax Base Erosion: Analysis of Policy Options” on March 4, 2013. This report examined the add-back provisions for intangible expenses enacted by other states. While the report did not provide a specific estimate of an add-back provision for intangible expenses in Pennsylvania, it did conclude that the denial of deductions from income increases revenues. Furthermore, the report concluded that the other states providing for add-backs of intangible expenses estimated revenue gains roughly two to five percent of current collections attributed to the add-back provision. The specific percentage estimated by each state depended on the breadth of the add-back provision enacted. When applying a range of two to five percent to the current corporate net income tax collections in Pennsylvania of approximately \$2.5 billion results in an estimate of the add-back provision providing additional revenues in the range of \$50 million to \$125 million.

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*Estimates are calculated using the best information available. Actual costs and revenue impact incurred may vary from estimates.*