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June 28, 2023

Hon. Steve Samuelson, Chair
Hon. Keith J. Greiner, Republican Chair
Finance Committee, Pennsylvania House of Representatives

Via Email

Re: Opposition to Mandatory Unitary Combined Reporting Provisions in House Bill 1462

Dear Chair Samuelson, Republican Chair Greiner, and Members of the Committee:

Thank you for the opportunity to provide testimony on behalf of the Council On State Taxation (COST) in opposition to House Bill 1462 that would impose mandatory unitary combined reporting (MUCR), institute a tax haven list, and make several other significant changes to Pennsylvania's corporate net income tax that would make the State's tax code one of the worst in the nation.

MUCR arbitrarily assigns income to a state, negatively impacts the real economy, has an unpredictable effect on state revenue, and imposes significant administrative burdens on both the taxpayer and the State. This conclusion has been supported by Maryland's Commission in 2016 and Virginia's Work Group in 2021[1]—both validated by estimated revenue reports from actual informational unitary combined reporting filings for the respective states. The Maryland Economic Development and Business Climate Commission, established at the request of the General Assembly's leadership, recommended that Maryland not adopt MUCR because it would: (1) create revenue volatility, (2) pick winners and losers among taxpayers, and (3) lead to additional litigation and administrative costs. Virginia's Work Group, established by the Virginia General Assembly, concluded that "[a]t this point in time, Virginia should not proceed with further study into the implementation of unitary combined reporting in the Commonwealth[.]"[2]

House Bill 1462 also includes "tax haven" provisions that would target corporations with

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[1] In 2021, Virginia required corporations that are members of a "unitary business" to file informational unitary combined reporting filings, and the Division of Legislative Services and the Department of Taxation established a work group to study the administrative feasibility and the projected impact on Virginia's tax revenue of adopting mandatory unitary combined reporting. H.B. 1800 (Va. 2021); H.J.R. 563 (Va. 2021 Special Session 1). The 25-member work group was composed of state officials, tax administrators, business representatives and tax practitioners.

[2] Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes, published November 1, 2021, p. 40. This recommendation was centered on "the additional complexity of combined filing compared with Virginia's current system, the uneven impact the transition may have on certain taxpayers, and the potential damage to Virginia's business climate. Additionally, Work Group members argued that current provisions in Virginia law such as its add-back statute already address the common tax shifting strategies that combined reporting is intended to remedy." *Id.* at 4.

affiliates incorporated in so-called "tax haven" jurisdictions by requiring these foreign affiliates to be included in the water's edge filing group for Pennsylvania corporate income tax purposes.

COST has long advocated against punitive tax haven designations. The tax haven blacklist approach is arbitrary and misleading and fraught with Constitutional infirmities. The current trend among states that had previously adopted these tax haven provisions is to repeal them. Colorado is now the only state in the country to maintain such a list and adding these provisions in Pennsylvania would make the State an outlier among its sister states.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of over 500 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. Many COST members have operations in Pennsylvania that would be negatively impacted by this legislation.

COST's Position on Mandatory Unitary Combined Reporting

The COST Board of Directors has adopted a formal policy statement on MUCR. COST's policy position is:

> *Mandatory unitary combined reporting ("MUCR") is not a panacea for the problem of how to accurately determine multistate business income attributable to economic activity in a State. For business taxpayers, there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State. A switch to MUCR may have significant and unintended impacts on both taxpayers and States. Further, MUCR is an unpredictable and burdensome tax system. COST opposes MUCR.*

Problems with Mandatory Unitary Combined Reporting

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and business taxpayers is the breadth of a state's corporate income tax base. The first approach, "separate entity reporting," treats each corporation as a separate taxpayer. This is the method Pennsylvania currently uses; it is also used by Pennsylvania's regional competitor-states, including Delaware, Maryland, and Virginia. The second approach, MUCR, treats affiliated corporations (parents and subsidiaries) engaged in a "unitary business" as a single group for purposes of determining taxable income.[3] MUCR has several serious flaws.

- **Reduces Jobs** – Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge the evidence that adopting MUCR hinders investment and job creation. Even if MUCR results in only a relatively small increase in net corporate tax revenue, there will be significant increases and decreases in tax liabilities for specific businesses. Depending on the industry distribution of winners and losers, adopting MUCR may have a negative impact on a state's overall economy. Moreover, economic theory

[3] The concept of a "unitary business" is a constitutional requirement that limits the states' authority to determine the income of a multistate enterprise taxable in a state. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state.

suggests that any tax increase resulting from adopting MUCR will ultimately be borne by labor in the State through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.

States that use MUCR have experienced lower job growth than have states that use separate entity reporting. From 1982-2006, job growth was 6% lower in states with MUCR than states without it (after adjusting for population changes).[4] Furthermore, MUCR has been found to reduce economic growth, especially when the tax rate exceeds 8%.[5]

- **Uncertain Revenue** – Implementing MUCR would have an unpredictable and uncertain effect on Pennsylvania's revenue. The corporate income tax is the most volatile tax in every state in which it is levied, regardless of whether MUCR is employed. A study conducted by the University of Tennessee found no evidence that states with MUCR collect more revenue, and a later study found that MUCR may or may not increase revenue.[6]
    - ***Maryland*:** Maryland's commission found similar uncertainty and volatility, with MUCR increasing revenue in some years and reducing it in others. Maryland presently has five years of data on combined reporting, and, depending on which type of apportionment is used, MUCR may have resulted in less revenue than the State's current corporate income tax structure in two or three of those years.[7]
    - ***Virginia*:** Based on informational unitary combined reporting filings for the 2019 tax year, Virginia's 2021 Work Group found that "73% of corporations showed essentially no change in tax liability, 13% showed an increase in tax liability, and 14% showed a decrease in tax liability before tax credits were applied."[8]
    - ***Indiana*:** The Indiana Legislative Services Agency conducted a study in 2016 finding that any potential positive revenue impact from adopting MUCR would be only short-term and would likely decline to zero in the long-term.[9]
- **Regional Outlier** – Most of the states that utilize MUCR are west of the Mississippi River or in the Northeast. Apart from New Jersey, New York, and West Virginia, few of Pennsylvania's regional competitor states currently utilize MUCR; *i.e.*, it is <u>not</u> used in Virginia, North Carolina, Delaware, or Maryland.
- **Administrative Complexity** – MUCR is, by definition, complex, requiring extensive fact-finding to determine the composition of the "unitary group" and to calculate combined income. This

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[4] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young, May 30, 2008, p. 16.
[5] William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," University of Tennessee, Center for Business and Economic Research, October 30, 2009, p. 39. Another study by the two lead authors commissioned by the National Conference of State Legislatures reached similar conclusions.
[6] *Ibid.* 3, p. 34.
[7] Andrew Schaufele, Director, MD Bureau of Revenue and Estimates, Report on Combined Reporting to Governor, President and Speaker, March 1, 2013.
[8] Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes, published November 1, 2021, p. 17.
[9] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal and Management Analysis, Indiana Legislative Services Agency, October 1, 2016.

complexity results in unnecessary and significant compliance costs for both taxpayers and the State.

- *Determining the Unitary Group*: The concept of a "unitary business" is uniquely factual and universally poorly defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

- *Calculating Combined Income*: Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors. From a financial reporting perspective, adopting MUCR is a significant change that requires states to consider ways to mitigate the immediate and negative impact those tax changes have on a company's financial reporting.[10]

- **Arbitrary** – Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State.

Tax Haven Designations Are Misguided and Unconstitutional Tax Policy

The COST Board of Directors has approved a policy position opposed to all state tax haven provisions, which provides in part: *State "tax haven" designations are arbitrary and overly broad, reflect a discarded "worldwide" approach to state taxation, and are inappropriate to address income shifting or other tax avoidance concerns. Punitive treatment of multinational businesses with affiliates in countries designated by states as "tax havens" interferes with the U.S. Government's ability to "speak with one voice" on*

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[10] ASC 740 (formally FAS 109) requires a recordation of tax expense under certain circumstances that can negatively impact a company's stock price and value. *See* Dr. Lauren Cooper and Joel Walters, "Mitigating the Impact of State Tax Law Changes on Company Financial Statements," State Tax Research Institute, June 2020.

foreign affairs and is constitutionally suspect. States should limit their income tax base to the domestic "water's-edge" and not tax foreign income with little or no connection with the United States.[11]

Branding foreign nations as "tax havens" has been widely rejected as a legitimate means for dealing with tax avoidance. No country, including the United States, has ever adopted the tax haven blacklist approach as a means for defining their income tax base. Tax haven blacklists are derived largely from a list created 20 years ago by the Organization for Economic Cooperation and Development (OECD) to encourage countries to adopt greater transparency and information sharing about tax issues, not to broaden the tax base of member countries. Presently, no countries remain on the OECD's list of uncooperative tax jurisdictions.

Moreover, significant progress has been made over the past decade by the OECD and G20 nations (including the United States) to implement fundamental international tax reform to address low-tax rate competition. The OECD/G20 project, commonly referred to as the base erosion and profit-shifting project, is one of the most ambitious international tax projects ever undertaken. Notably, the project does not include promoting a tax haven blacklist approach to reduce profit shifting and global low-tax rate competition.

Given the recent progress in revamping the international corporate tax system and the United States' participation in this project, tax haven blacklists warrant additional scrutiny for violating the Foreign Commerce Clause. The constitutional standard is clear: state tax measures may not impose a risk of multiple taxation at the international level and may not prevent the federal government from "speaking with one voice" on international policy matters. When a state arbitrarily penalizes taxpayers for doing business in specific countries, that state also arguably violates the foreign Commerce Clause by adopting measures contrary to the federal government's approach to taxing foreign source income and the United States' participation in the OECD/G20 project.

House Bill 1462 Contains Several Problematic Provisions Unrelated to Combined Reporting

In addition to imposing mandatory unitary combined reporting with a strict restriction on sharing net losses among group members and an extension of the tax base to include certain categories of foreign income, this bill includes several other problematic provisions unrelated to combined reporting that would make Pennsylvania's corporate income tax code hostile to business and among the worst in the nation. These provisions include:

- Disallowance of the deduction for foreign-derived intangible income (FDII), which is a tax provision enacted as part of the 2017 federal tax reform to encourage investment in the United States.
- Granting the Department of Revenue with broad, undefined powers to reallocate income and deductions among taxpayers.
- The repeal of industry specific apportionment rules, which are the most accurate reflection of these industries' income attributable to the State.

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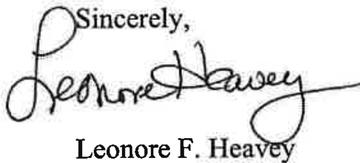
[11] https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/cost-state-tax-haven-policy-statement-final-4-16-15.pdf; *See also,* Frieden and Hogroian, "State Tax Haven Legislation: A Misguided Approach to a Global Issue" State Tax Research Institute, March 2016.

Conclusion

Studies show that MUCR is the most costly and uncertain way for a State to raise revenue because of its negative impact on job creation and revenue volatility. MUCR will not help Pennsylvania attract jobs or investment and should not be adopted. The "tax haven" blacklist interferes in foreign affairs, raises constitutional concerns that invite judicial challenge, and taxes foreign income with little or no connection with the United States.

For these reasons, COST respectfully urges members of the committee to vote "no" on House Bill 1462 or any other instrument introduced with its provisions or amended to include them.

Sincerely,



Leonore F. Heavey

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