



THE SECRETARY

COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF REVENUE
STRAWBERRY SQUARE
HARRISBURG, PA. 17128-1100

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November 30, 2004

The Honorable Edward G. Rendell
Governor of Pennsylvania
Room 225, Main Capitol
Harrisburg, PA 17120

Dear Governor Rendell:

As Chairman of the Pennsylvania Business Tax Reform Commission, I respectfully submit the Commission's final report to you, members of the General Assembly and to the public.

The Commission was created by an Executive Order issued by you on March 4, 2004. It is comprised of 12 distinguished business professionals appointed by you and by each of the four caucuses of the Pennsylvania legislature. Three of your appointees are members of the Pennsylvania Chamber of Business and Industry, the Pennsylvania Business Roundtable or Team Pennsylvania.

The Commission was tasked with evaluating Pennsylvania's business tax structure and recommending revenue-neutral changes to increase fairness and competitiveness. The recommendations in the Commission's final report are based upon testimony from numerous business groups and tax professionals, revenue estimates by the Department of Revenue and extensive discussions among the Commissioners. If adopted as a package, they would make Pennsylvania's business tax structure more competitive with other states, encourage job creation and broaden the business tax base.

I commend my fellow Commissioners for their hard work and commitment to public service, and for their willingness to work together to improve Pennsylvania's business climate.

Respectfully submitted,

Gregory C. Fajt, Chairman
Business Tax Reform Commission

cc: Members of the General Assembly

PENNSYLVANIA BUSINESS TAX REFORM COMMISSION REPORT

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FINAL REPORT

Overview

On March 4, 2004, the Governor of the Commonwealth of Pennsylvania, the Honorable Edward G. Rendell, issued an Executive Order establishing a Business Tax Reform Commission (Commission). The Order stated the Governor's desire to improve Pennsylvania's competitive position through a reduction in business tax rates. It directed the Commission to evaluate the Commonwealth's current business tax structure and recommend changes that would broaden the tax base, thus allowing for a corporate tax rate reduction while protecting the stability of the state budget. The result of these actions would be to ensure greater fairness in business taxation and create a more competitive business climate leading to greater economic growth. The Order required that the Commission recommendations be revenue neutral.

The Commission is comprised of twelve (12) members. The Governor appointed the Secretary of Revenue, Gregory C. Fajt, as Chairman. Three of the Commission's seven remaining gubernatorial appointments were based upon recommendations by the Pennsylvania Chamber of Business and Industry, the Pennsylvania Business Roundtable and Team Pennsylvania. The four caucuses of the Pennsylvania Legislature each selected one private citizen to serve on the Commission.

The Commissioners are Ron Bloom, Joseph C. Bright, R. Michael Cortez, Joseph Cottonaro, Denise L. Devine, Dean M. Glick, Joseph C. Guyaux, M. Christine Murphy, Leroy D. Nunery, II, Thomas W. Wolf, and Yarone S. Zober. Commissioner Zober resigned from the Commission and was replaced by Douglas J. Skowron. The Department of Revenue (Department) provided staff support for the Commission's work.

The Commission held 14 meetings to receive testimony from numerous tax professionals and interested organizations. In addition, several of the Commissioners attended a conference in Washington, D.C. on the state of the corporate net income tax across the nation. The Commissioners debated many alternatives, ultimately accepting some, rejecting some and recommending others for further study.

The Commission issued an Interim Report on June 18, 2004, which established a framework for comprehensive business tax reform. This Final Report builds upon that framework and includes recommendations that will broaden the business tax base, thereby allowing tax rates to be reduced, leveling the playing field and otherwise attaining the goals of the Governor's Executive Order. This Final Report is presented as a comprehensive plan designed to both comply with the constraints of, and achieve the goals established by, the Executive Order. The Commission endorses the tax recommendations contained in this plan as a package; it does not endorse any of the recommendations individually except the recommendations on improvements to the tax appeals process.

RECOMMENDATIONS

Reduction of the Corporate Net Income Tax Rate

Pennsylvania's Corporate Net Income (CNI) Tax rate is not competitive with other states. The Commonwealth's nominal tax rate of 9.99 percent, the third highest in the nation, discourages both new economic development and the retention of existing Pennsylvania businesses. The Commission believes the primary goal of business tax reform must be to reduce the CNI Tax rate from 9.99 percent to between 6 and 7 percent. To achieve this goal, while mindful of the Executive Order's requirement of revenue neutrality with respect to business taxes, the Commission recommends a series of changes to Pennsylvania's business tax structure. This Final Report also includes recommendations to encourage economic development.

The Commission's recommendations, if adopted as a package, would be revenue neutral with a CNI Tax rate of 7.22 percent. For competitive reasons and to help offset the impact of other recommendations in its Final Report, however, the Commission recommends that the CNI Tax rate be lowered to 6.99 percent. Using a static estimate of revenue impact, the lower rate together with the other recommended changes would cost \$49 million. Reducing the corporate income tax rate to 7.22 percent would move Pennsylvania's rate from third highest among the states to 25th highest and lower than all but one of its neighboring states. The 6.99 percent rate would move Pennsylvania to 26th highest among the states and lower than all neighboring states.

Mandatory Combined Reporting

The Commission considered the issues related to Pennsylvania's system of separate company reporting of the CNI Tax. Separate company reporting uses a narrow tax base and allows tax-planning opportunities such as the use of passive investment companies (PICs), sometimes called Delaware holding companies, to shift income outside the Commonwealth. To address these issues, the Commission recommends that the CNI Tax base be determined on a mandatory unitary combined basis. The Commission supports the adoption of mandatory unitary combined reporting only in conjunction with a reduction of the CNI Tax rate to between 6 and 7 percent. The Commission's Interim Report stated that "the Commission strongly prefers a rate at the low end of that range," and noted that some Commissioners could not support a proposal that included a CNI Tax rate of greater than 6 percent. Given the constraints of the Executive Order, this rate reduction could not be achieved without imposing additional business taxes at a level that is unacceptable to the Commission. Some Commissioners support other alternatives to achieve revenue neutrality that are reviewed in Tab 23.

One of the principal alternatives to mandatory unitary combined reporting was the adoption of legislation disallowing certain payments to out-of-state PICs. The Commission heard testimony that the revenue impact of such legislation can vary widely depending on the scope of the addback provisions. It did not attempt to resolve the issues of the appropriate breadth of expense disallowance, and did not reach a conclusion about the revenue impact of such legislation. Such legislation tends to create other distortions, including perhaps constitutional problems where the result of such disallowance taxes

income earned out of state. It also does not account for the losses of subsidiaries within the same corporate group. As a result, the Commission does not recommend expense disallowance but agreed upon combined reporting as a means of achieving the goals of the Executive Order.

Mandatory unitary combined reporting requires that a related group of businesses have a flow of value among them in order to combine their income for tax purposes. The combined net income of the group is apportioned by measuring the activity of the group in a taxing jurisdiction based upon the combined apportionment factors of the group. The Commission believes that mandatory unitary combined reporting better measures the net income of affiliated corporations generated within a taxing jurisdiction by broadening the tax base to make it less susceptible to manipulation.

With any change in a tax system, but in particular with a change to mandatory unitary combined reporting, there is a risk of litigation. To limit that risk, the Commission recommends that before mandatory combined reporting is adopted, great care be given to defining a “unitary business.” The Commission heard testimony about worldwide combination, water’s edge combination and other forms of combined reporting. The revenue estimates presented to the Commission, and on which this recommendation is based, used water’s edge combination. The Commission has not fully resolved the issues surrounding the design of a combined reporting statute. However, the Commission does not support mandatory worldwide combination. The Commission recommends the use of water’s edge accounting coupled with a legislative prohibition of the inappropriate tax use of foreign affiliates. The Commission further recommends that taxpayers be permitted an election to use worldwide accounting. Any election should be binding for a reasonable period of time.

The Commission does not intend that any of its recommendations, including combined reporting, change the current treatment of Keystone Opportunity Zones or Keystone Innovation Zones.

The Commission recognizes that mandatory unitary combined reporting may cause administrative complexities requiring additional resources for the Department of Revenue. The Commission recommends that the Department provide the General Assembly and the Governor with an administrative plan, including cost estimates, designed to achieve effective implementation of combined reporting.

CNI Tax Apportionment

The Commission recommends that the weighting of the sales factor of the CNI Tax apportionment formula should be adjusted from the present 60 percent to 100 percent. The Commission believes that this change will encourage all employers, including manufacturers, to locate or expand in Pennsylvania. This apportionment method acts as an economic stimulus by not penalizing employers through higher taxes for creating jobs and expanding their physical presence in Pennsylvania.

The Commission also recommends that the CNI Tax apportionment formula use market-based sourcing for the sale of services. Market-based sourcing would source

sales of services in the same manner as sales of tangible property, thereby leveling the playing field and encouraging growth in service-related industries.

Utilization of Net Operating Losses

The Commission believes that Pennsylvania's current \$2 million annual cap on the use of net operating losses (NOL) discourages economic development and conflicts with other state policy and funding initiatives that encourage technology-based start-ups such as biotechnology companies. If mandatory unitary combined reporting is adopted for the CNI Tax, the Commission recommends that the cap be lifted on the use of post-combination Pennsylvania NOLs. The Commission recommends that the NOL carry forward period should be the same as the federal income tax NOL carry forward period. In order to limit revenue losses, the Commission recommends that NOLs accrued prior to combined reporting remain subject to the \$2 million annual cap and should be computed and applied on a separate company basis.

Net Income Tax on Pass Through Businesses

The profits of pass through businesses are currently taxed to individual owners at the 3.07 percent personal income tax (PIT) rate, as opposed to the 9.99 percent CNI Tax rate. This 6.92 percent difference in the tax rates is the largest of any state. Although some pass through entities are subject to the Capital Stock and Franchise Tax (CSFT), this tax is being phased out. On the other hand, the owners of pass through entities are taxed currently on all business income, whether or not distributed. In addition, the owners of some pass through businesses may be subject to a local earned income tax on net profits.

The Commission recommends imposition of a net 1 percent entity level tax on the federally reported net income of pass through businesses apportioned in the same manner as the CNI Tax. The tax rate should be 4.07 percent, and NOL carryover deductions should be permitted to the extent allowed under Federal law. The assessment of this tax obligation at a rate of 4.07 percent at the entity level should be coupled with an income tax credit of 3.07 percent for the entity's owner on their personal tax obligation and a full credit of 4.07 percent for entities subject to the CNI Tax. The net effect of the 4.07 percent entity level tax and the 3.07 percent income tax credit for the entity owners would be a 1 percent tax on the net profits of pass-through businesses. This administrative mechanism would enhance enforcement since all tax for resident and non-resident individuals would be collected at the entity level.

If the CNI rate is reduced and an entity level tax is imposed on pass through businesses as recommended by the Commission, the rate gap between pass through businesses and ordinary business corporations will also be reduced to 2.92 percent. The proposed entity level tax will place Pennsylvania at third lowest among the states ranked by the total tax rate imposed at the personal and entity levels on such businesses.

Capital Stock and Franchise Tax

The Commission believes that the CSFT remains a major obstacle to Pennsylvania's competitiveness. The ideal action would be to repeal it altogether, but the Commission recognizes that that is impracticable from a revenue point of view. Therefore, the Commission recommends that the current statutory phase-out should remain on schedule or be accelerated.

Appeals Process

The Commission recommends reform of Pennsylvania's tax appeals process and certain related administrative procedures. The current tax appeals system is inefficient and confusing to businesses and is detrimental to Pennsylvania's business climate. Reform of the appeals system is deemed to be revenue neutral, although additional administrative costs are expected for the Department of Revenue and the State Treasurer. The Commission believes that its recommended reforms would enhance the administration of taxes for businesses operating within the Commonwealth. The Commission is providing a detailed list of recommendations to the Governor and General Assembly with this Report. The Commission believes that its proposals to reform the appeals process are so critical to improving the business climate in Pennsylvania that they should be considered separately from the tax proposals in this report.

Conclusion

The Commission believes that the recommendations contained in this Report would dramatically improve Pennsylvania's business climate by improving business tax equity across business structures and sectors. Cutting the CNI Tax rate by 30 percent would make Pennsylvania more competitive with other states. Imposing a pass-through entity tax would allow a more even-handed treatment of all business types. Increasing the weighting of the sales factor of the CNI Tax apportionment formula would provide a powerful incentive for economic growth, especially in the manufacturing sector. Implementing mandatory unitary combined reporting would allow Pennsylvania's business tax system to better reflect two decades of significant changes in the structure of the state's economy. Those changes have resulted in the formation of new business structures and business arrangements that affect the nature of business taxation in the Commonwealth. Overall, this package of recommendations would achieve the goals of the Executive Order.

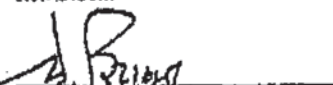
The Commission's recommendations, if adopted as a package, would be revenue neutral with a CNI Tax rate of 7.22 percent. For competitive reasons and to help offset the impact of other recommendations in its Final Report, however, the Commission recommends that the CNI Tax rate be lowered to 6.99 percent. Reducing the corporate income tax rate to 7.22 percent would move Pennsylvania's rate from third highest among the states to 25th highest and lower than all but one of its neighboring states. The 6.99 percent rate would move Pennsylvania to 26th highest and lower than all neighboring states. The recommended changes in this proposal would cost \$49 million.

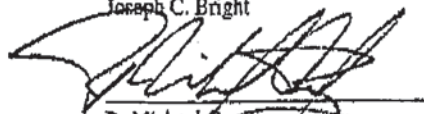
The Commission received extensive and highly professional support from the Department of Revenue. The Commission wishes to thank the Department, without whose assistance the work of the Commission would have been very difficult. The Commission would also like to thank Executive Director, Nicholas J. Crocetti, for his noteworthy assistance in coordinating its meetings and research needs and in assisting with both the Interim and Final Reports.

Respectfully submitted,


Gregory C. Fair
Chairman

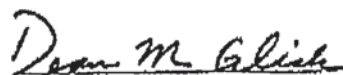

Ron Bloom

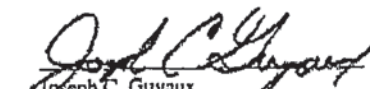

Joseph C. Bright

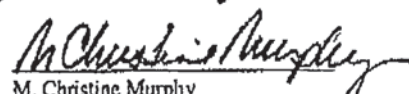

R. Michael Cortez


Joseph Cottonaro

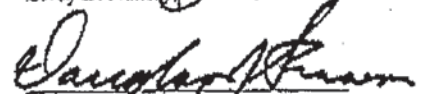

Denise L. Devine, CPA

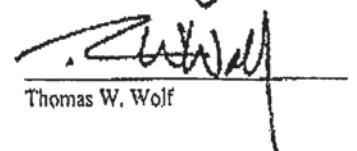

Dean M. Glick, CPA


Joseph C. Guyaux


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Thomas W. Wolf

INTERIM REPORT

Overview

On March 4, 2004, the Governor of the Commonwealth of Pennsylvania, the Honorable Edward G. Rendell, issued an Executive Order establishing a Business Tax Reform Commission (Commission). The Order states the Governor's desire to improve Pennsylvania's competitive position through a reduction in business tax rates. The Governor directed the Commission to evaluate the Commonwealth's current business tax structure and recommend changes that would broaden the tax base, thus allowing for a corporate tax rate reduction while protecting the stability of the state budget. The result of these actions would be to ensure greater fairness in business taxation and create a more competitive business climate leading to greater economic growth. The Order also required that the Commission recommendations be revenue neutral.

The Commission is comprised of twelve (12) members. The Governor appointed the Secretary of Revenue, Gregory C. Fajt, as the Chairman of the Commission. In addition, seven members of the Commission were appointed by the Governor. Three of the gubernatorial appointments were based upon recommendations by the Pennsylvania Chamber of Business and Industry, the Pennsylvania Business Roundtable and Team Pennsylvania. The four caucuses of the Pennsylvania Legislature each selected one private citizen to serve on the Commission.

The Commissioners are Ron Bloom, Joseph C. Bright, R. Michael Cortez, Joseph Cottonaro, Denise L. Devine, Dean M. Glick, Joseph C. Guyaux, M. Christine Murphy, Leroy D. Nunery, II, Thomas W. Wolf, and Yarone S. Zober. The Department of Revenue (Department) was directed to provide staff support for the Commission's work.

The Commission held a series of hearings to receive testimony from numerous tax professionals and interested organizations. In addition, several of the Commissioners attended a conference in Washington, D.C. on the state of the corporate net income tax across the nation. Armed with these insights, the Commissioners engaged in debate about many alternatives, ultimately accepting some, rejecting some and recommending others for further study.

Although the Commission will require additional time and information to fully complete its work, it believes that its preliminary recommendations establish a framework for comprehensive reform of Pennsylvania's business tax system. The following preliminary recommendations are a comprehensive, integrated package. The Commission endorses them as a package, and as a means to achieve its goal of dramatically lowering the Pennsylvania Corporate Net Income (CNI) tax rate. It does not endorse any of the recommendations individually, or without a substantial CNI tax rate reduction.

RECOMMENDATIONS

CNI Tax Rate

The Commission believes that the major obstacle to a competitive business structure, apart from the Capital Stock and Franchise Tax (CSFT) is the CNI tax rate. The Commonwealth's current 9.99 percent tax rate is so high that it discourages both new economic development and the expansion of existing Pennsylvania businesses. The Commission recommends that the primary goal of business tax reform should be to reduce the CNI tax rate to between 6 and 7 percent.

The additional recommendations that follow will further encourage economic growth. The Commission endorses these recommendations only if they are adopted as a unified proposal that lowers the CNI tax to the target rate of 6 to 7 percent. The Commission strongly prefers a rate at the low end of that range. Some Commissioners, however, have strong reservations about or could not support any proposal that includes a CNI tax rate higher than 6 percent.

CNI Tax Apportionment

The Commissioners believe that a goal of business tax reform should be to shift the apportionment formulae to market-based sourcing for the sale of services. Market-based sourcing would source sales of services in the same manner as sales of personal property, thereby leveling the playing field and encouraging growth in service-related industries.

Some Commissioners believe that further consideration should be given to increasing the weighting of the sales factor in the CNI tax apportionment formulae as a means of more fairly distributing the tax impact of combined reporting among the Commonwealth's corporations and as a possible economic stimulus.

The Commissioners do not recommend the adoption of either a throw-out or throw-back rule. This modification to an apportionment system is not designed to tax a state's fair share. Rather, it is designed to tax income that other states cannot or do not tax. The Commissioners do not believe that such an approach will advance the objective of evenhandedness or economic development in Pennsylvania.

Separate or Combined Reporting

The Commissioners have considered the problems attendant upon Pennsylvania's system of separate company reporting of the tax base. One aspect of separate company reporting is the ability to utilize tax planning devices such as passive investment companies (PICs), sometimes called Delaware holding companies. The Commissioners do not believe that legislation that would disallow for Pennsylvania taxpayers certain payments to out-of-state PICs is appropriate to address any abuses. Such legislation

generally creates other distortions, including perhaps constitutional problems where the result of such disallowance taxes income earned out-of-state.

Rather, the Commissioners believe that an acceptable solution would be combined reporting, provided that it is enacted together with the other reforms discussed herein. A mandatory combined unitary reporting system would require members of a unitary group to combine their income and expenses for tax purposes. The combined net income of the group would then be apportioned to the Commonwealth using the combined apportionment factors of the group to appropriately measure the activity of the group in Pennsylvania. Mandatory combined unitary reporting would provide a more accurate method of measuring the net income of affiliated corporations. It would substantially broaden the tax base and would be less subject to manipulation than the current separate company reporting method.

Combined reporting may be more difficult to administer and certain issues related to the definition of a unitary business may be litigated. Before combined reporting is adopted, the Commission believes that attention should be given to how a unitary business should be defined, whether the tax base should be water's edge, and if so, what problems need to be addressed with respect to foreign subsidiaries. The Commission recommends that the Department study the issues involved in implementing combined unitary reporting and report back to the Commission with its findings.

The Commission further recommends that the Department's revenue estimates for mandatory combined unitary reporting be subjected to independent review. The results of that review will be used by the Commission to develop final recommendations to the Governor and General Assembly.

Net Operating Losses

The Commission believes that Pennsylvania's existing \$2 million annual cap on the utilization of net operating loss (NOL) deductions discourages economic development and is at odds with other state policy and funding initiatives that encourage technology based and biotech company start-ups. It therefore recommends that the cap be lifted for future NOLs, which should be carried forward to the same extent that they are carried forward for federal income tax purposes. In order to minimize the revenue impact, the Commission recommends that NOLs accrued under the separate company system of reporting be permitted going forward on a separate company basis to the same extent as they are presently permitted. The Commission further recommends that consideration be given to extending the period for such separate company deductions.

Capital Stock and Franchise Tax

The Commissioners believe that the CSFT remains a major obstacle to Pennsylvania's competitiveness. The ideal action would be to repeal it altogether, but the Commissioners recognize that that is impracticable from a revenue point of view.

Therefore, the Commissioners believe that the current statutory phase-out should continue.

Revenue Impact

The revenue estimates provided to the Commission by the Department indicate that if the above recommendations are adopted, there will be a substantial revenue shortfall. The Commission recognizes that the Governor has asked that a restructuring of business taxes be revenue neutral, among other requirements. The Commissioners therefore recommend that consideration be given to certain changes that would increase revenue. If the tax rate is lowered as recommended, some tax credit programs may no longer be necessary. In addition, some economic development programs may not be necessary, or may not be necessary to the same extent. Other budgetary adjustments may also be appropriate.

In addition, consideration should be given to the imposition of a tax on pass through entities, discussed in the next section.

Tax on Pass Through Businesses

The profits of pass through businesses are currently taxed to individual owners at the 3.07 percent personal income tax (PIT) rate, as opposed to the 9.99 percent CNI tax rate. This 6.92 percentage point difference in the tax rates is the largest of any state. While pass through entities are subject to the CSFT, this tax is being phased out. On the other hand, the owners of pass through entities are taxed currently on all business income, whether or not distributed. In addition, the owners of some pass through businesses may be subject to a local earned income tax on net profits.

To the extent that the CNI rate is reduced as recommended by the Commission, the rate gap between pass through businesses and ordinary business corporations will also be reduced. The Commission believes that a further reduction of the rate gap is warranted, but it does not believe the gap should be eliminated.

If necessary, to achieve its recommended CNI rate reduction, the Commission recommends the implementation of an entity level tax on pass through businesses. The rate of any such tax, if imposed, should be kept as low as possible, and should not exceed 2 percent. If an entity level tax is imposed on pass through businesses, the Commission recommends that such businesses should be granted NOL deductions. The Commission recommends that the Department continue to study the pass through tax and prepare a final revenue estimate for the consideration by the Commission, and thereafter by the Governor and the General Assembly.

Appeals Process

The Commission recommends reform of Pennsylvania's tax appeals process. The current tax appeals system is inefficient and confusing to businesses, and is detrimental to

the business climate of the Commonwealth. A reform of the appeals system is deemed to be revenue neutral, and would enhance the administration of taxes for businesses operating within the Commonwealth. The Commission recommends further study so that a detailed recommendation can be presented to the Governor and General Assembly.

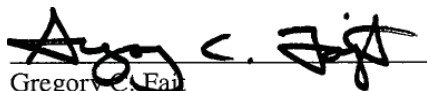
Conclusion

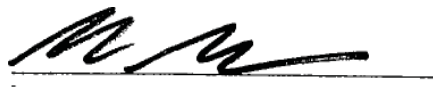
The preliminary recommendations discussed above may not be revenue neutral. The Commission therefore requests that the Governor extend its mandate until November 30, 2004. During that time the Commission will further study ways to finance a CNI rate reduction and other changes to the Commonwealth's business tax system, solicit testimony from the Department of Community and Economic Development concerning its programs and further consider the role that CNI tax apportionment can play in economic development. The Commission also recommends that the Department continue to refine its revenue estimates for the various options under consideration.

The Commission believes that lowering the CNI to 6 percent will have a significant positive impact on the state economy. It requests the Department to evaluate the potential dynamic effect of the proposals discussed in this interim report and present its findings to the Commission.

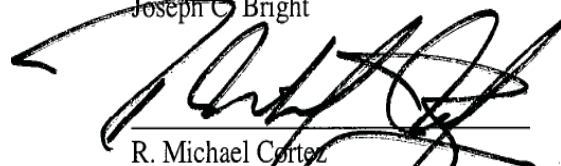
The Commission believes that it has made significant progress toward achieving the ambitious goals set forth in the Governor's Executive Order during the limited time available. Its members are committed to fully achieving those goals and look forward to continuing their work in the coming months.

Respectfully submitted,

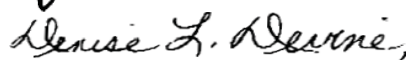

Gregory C. Egan
Chairman

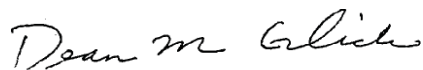

Ron Bloom

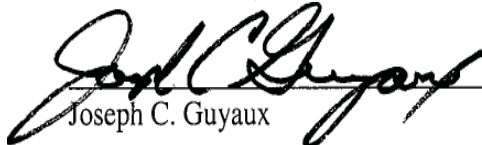

Joseph C. Bright

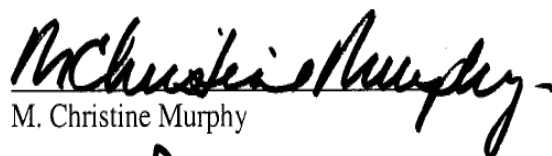

R. Michael Cortez

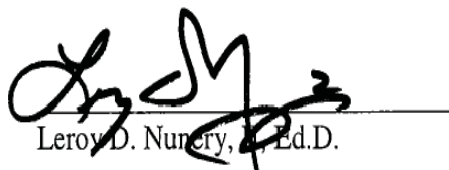

Joseph Cottonaro

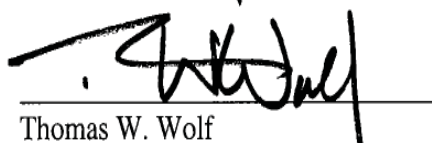

Denise L. Devine, CPA


Dean M. Glick, CPA


Joseph C. Guyaux


M. Christine Murphy


Leroy D. Nunery, Ed.D.


Thomas W. Wolf


Yafone S. Zober, Esquire

Pennsylvania Business Tax Reform Commission Members

Ron A. Bloom, Pittsburgh: Special Assistant to the President, United Steelworkers of America; gubernatorial appointment.

Joseph C. Bright, Philadelphia: Partner in the Tax Practice Group at Wolf Block Schorr and Solis-Cohen LLP; appointed by House Majority Leader Sam Smith.

R. Michael Cortez, Altoona: Vice President and General Counsel for Sheetz Inc.; gubernatorial appointment from the Pennsylvania Chamber of Business and Industry.

Joseph A. Cottonaro, Hershey: Senior Director of Taxes for Hershey Foods Corp.; appointed by Senate Majority Leader David J. Brightbill.

Denise L. Devine, Media: Founder and Chief Executive Officer of Nutripharm Inc., and its wholly owned subsidiary, Devine Foods Inc.; appointed by House Minority Leader H. William DeWeese.

Gregory C. Fajt, Secretary of Revenue, is a licensed attorney within the Commonwealth of Pennsylvania and a Certified Public Accountant (CPA). Chairman appointed by the Governor.

Dean M. Glick, Lancaster: Tax Manager, High Industries Inc.; gubernatorial appointment from Team Pennsylvania.

Joseph C. Guyaux, Pittsburgh: President, PNC Financial Services Group; gubernatorial appointment from the Pennsylvania Business Roundtable.

M. Christine Murphy, Philadelphia: Chairman and Chief Executive Officer of S. Zitner Company; gubernatorial appointment

Dr. Leroy D. Nunery II, Philadelphia: Vice President, Business Services, University of Pennsylvania; gubernatorial appointment.

Douglas Skowron, Pittsburgh: Director, Pittsburgh Gateways Corporation; appointed by Senate Minority Leader Robert J. Mellow

Thomas W. Wolf, Mount Wolf: Chairman and President, Wolf Organization Inc.; gubernatorial appointment.

Yarone S. Zober, Pittsburgh: Attorney with Reed Smith LLP; appointed by Senate Minority Leader Robert J. Mellow. Resigned as announced on September 1, 2004.

Ron A. Bloom

Since 1996, Ron Bloom has served as a Special Assistant to the President of the United Steelworkers of America (USWA) and currently heads the Union's Corporate Research, Industry Analysis and Pattern Bargaining Department. His responsibilities include coordinating the Union's collective bargaining program in the Union's core jurisdictions, with an emphasis on the particular issues facing the Union in its dealings with troubled companies. He is also involved in many of the Union's key public policy initiatives.

Prior to joining the Steelworkers, Mr. Bloom was one of the founding partners of the investment banking firm of Keilin and Bloom. The firm focused on financial transactions where employees played a role as stakeholders. Keilin and Bloom was involved in numerous such transactions on behalf of the Steelworkers, the United Auto Workers, the International Brotherhood of Teamsters, the Air Line Pilots Association and other unions.

Prior to founding Keilin and Bloom, Mr. Bloom was a Vice President at the investment banking firm of Lazard Freres & Co. While at Lazard, Mr. Bloom worked on a wide variety of corporate transactions including mergers, acquisitions, restructuring and divestitures. He specialized in analyzing, structuring and raising financing for union-led employee-ownership transactions.

Mr. Bloom served as a research and negotiating specialist for the Service Employees International Union (SEIU). While at SEIU he negotiated collective bargaining agreements in both the public and private sector, supervised contract administration, and directed a number of successful organizing campaigns.

Mr. Bloom has also served as the New England Regional Director of the Jewish Labor Committee, a multi-issue organization that acts as a liaison between the labor movement and the Jewish community. Before working for the Jewish Labor Committee, he was Executive Director of the Massachusetts Coalition for Full Employment.

Mr. Bloom, 48, was born in New York City. He received his undergraduate degree from Wesleyan University and graduated with distinction from the Harvard Graduate School of Business Administration.



Joseph C. Bright

Wolf Block Schorr and Solis-Cohen LLP

Mr. Bright is a Partner in the Tax Practice Group, where he concentrates in state and local taxation.

A former Chief Counsel of the Pennsylvania Department of Revenue (1980-81), Mr. Bright has since represented hundreds of taxpayers in state and local tax planning, administrative, legislative and litigation matters.

Mr. Bright is the author of *Taxation*, a two -volume treatise on Pennsylvania state and local taxation published by West Group as part of *Summary of Pennsylvania Jurisprudence 2d*. A book review of *Taxation* in *State Tax Notes* described the first edition of the treatise as the leading treatise on Pennsylvania state taxation and Mr. Bright as one of the leading state practitioners in the nation. He is the author of the *Pennsylvania State Tax Baedeker* (Master Tax Guide) and is a principal Pennsylvania correspondent for *State Tax Notes*, both published by Tax Analysts, Inc. He has written hundreds of articles on state and local tax topics. Mr. Bright is a Fellow of the American College of Tax Counsel and is listed in *Who's Who in America*.

Mr. Bright is an active member of the Tax Section of the Pennsylvania Bar Association, the State and Local Tax Committee of the Tax Section of the Philadelphia Bar Association, the Tax Section of the American Bar Association, the Tax Committee of the Pennsylvania Chamber of Business and Industry, and the State and Local Tax Committee of the Greater Philadelphia Chamber of Business and Industry.

In local civic affairs, Mr. Bright is a Board member of the Pennsylvania Economy League. He has served as Vice-Chairman of the Children's Hospital Foundation and Member of the Board of Managers, President of the Board of Trustees of St. Peter's School in Philadelphia, President of the Society Hill Civic Association, and Trustee of the Philadelphia General Hospital Research Fund.

Mr. Bright received his B.A., cum laude , from Harvard University in 1964 and his J.D., cum laude, from the University of Pennsylvania Law School in 1970, where he was the Managing Editor of the *University of Pennsylvania Law Review*. He also served as a lieutenant in the United States Army from 1965 to 1967, receiving a Bronze Star Medal for Meritorious Service.



R. Michael Cortez

Michael has served as Vice President and General Counsel for Sheetz, Inc. since 1996. Founded in 1952, Sheetz, Inc. is a \$2.3 billion family-owned and operated convenience store chain with more than 9,500 employees and nearly 300 stores in Pennsylvania (182), Ohio (15), Maryland (28), West Virginia (21), Virginia (49) and North Carolina (2). Sheetz ranks 109 on the Forbes list of largest private companies in the United States and has been named among Pennsylvania's top 10 employers two years in a row.

Michael advises Sheetz executive management and creates policies and procedures on all corporate legal issues, including employment law, environmental law, pricing and anti-trust issues, general liability, contracts, tax issues and general corporate matters. He is also responsible for the company's government affairs work, including testimony before numerous legislative bodies and meetings with governmental authorities. Michael has spoken before numerous trade organizations on issues such as sales below cost legislation, alternative dispute resolution and employment law. In addition, he is responsible for supervising in-house legal staff, as well as outside counsel, tracking litigation, and proactively educating and training employees and management on preventative measures and tactics. In his tenure at Sheetz, Michael has achieved a 95% reduction in corporate employment litigation expenses and attained the highest rating of any internal department with respect to service to stores.

Prior to his employment with Sheetz, Michael served as House Counsel and Assistant Secretary for Weis Markets, Inc. in Sunbury, Pennsylvania, for seven years. Michael also served as an Associate for the firms of Shramm & Raddue in Santa Barbara, California and Musick, Peeler & Garrett in Los Angeles, California.

Michael received his Juris Doctorate in 1984 from the University of California, Los Angeles, School of Law, where he was a Moot Court Honors Program member and a recipient of the American Jurisprudence Award in Family Law. Michael graduated Cum Laude with a B.A. in Political Science and Economics from Bucknell University in Lewisburg, Pennsylvania. Mike was a member of the Omicron Delta Epsilon International Honor Society in Economics, a member of the football team and an Academic All-American (District 2, University Division).

Currently, Michael is Co-Chair of the Pennsylvania Food Merchants Association (PFMA) Legislative Committee. Prior to his work with PFMA, Michael was instrumental in creating a legal committee within the National Association of Convenience Stores, one of the nation's most prestigious trade organizations, and served as the committee's first Chairman.

A graduate of Leadership Blair County, Michael has served as a Business Law Instructor for Mount Aloysius College and as an Advisory Board Member for the Blair County Chapter of the American Red Cross. Currently Michael serves on the local Salvation Army Advisory Board and on the Board of Directors for Sheetz Family Christmas, Inc., a not for profit charity.

Michael lives in Hollidaysburg, Pennsylvania with his wife, three daughters and son.



Joseph A. Cottonaro

Accreditation:

Admitted to Practice Law - 1974

Certified Public Accountant (CPA) - 1976

Education:

LL.M. Taxation, Temple University School of Law, Philadelphia, PA 1979

J.D., The Dickinson School of Law of The Pennsylvania State University 1974 , **BS**, Business and Administration, Drexel University, Philadelphia, PA 1971

Experience:

HERSHEY FOODS CORPORATION

A publicly traded Fortune 100 Company principally in the US, but with significant business operations in Canada, Mexico, Europe, South America and the Far East.

Director of Taxes

Mission to place a strong and sustainable strategic focus on responsibly managing worldwide effective tax rates to its lowest level consistent with applicable tax laws and accounting policies; serve as primary advisor to Senior Management and provide functional guidance to key personnel throughout the organization, and act as representative and spokesperson outside the Corporation on tax policy.

Continually charged with strengthening tax organization; ensuring its needed technical skills and capabilities, augmented by outside consultants; and selecting, developing and motivating a highly competent and technically adept staff that remains fully compliant with the company's ethical business code of conduct.

Responsible for establishing, communicating and coordinating Corporation's tax affairs wherever its business is conducted, including:

Planning – Attentive to responsively managing HFC's effective tax rate. Actively involved in the business planning process and the integration of tax strategies that fully comply with existing tax laws and local tax practice and customs. Anticipate implications of evolving tax legislation, regulations and practices.

Accounting - Preparing the tax provision aspects of its worldwide-consolidated financial statements compliance with FASB 109 as part of annual and strategic profit planning cycles.

Compliance - Administering the Corporation's compliance program in a timely, complete and accurate manner. This includes developing filing positions that adhere to the taxing laws as well as professional and ethical filing standards.

Examinations and Appeals - Coordinating federal, state and provincial U.S. and foreign tax examinations. Representing the Corporation before administrative appeals and administering audit and appeals activities for foreign entities.

Administrative - Supervising professional staff, preparing annual departmental operating and capital budgets, developing annual staff training and development plans as well as recruiting and conducting annual performance appraisals.

CERTAINTED CORPORATION

U.S. Publicly traded buildings supply manufacturer controlled by a foreign multinational corporation.

Manager, Tax Planning & Audits, Corporate Tax Department

Responsibilities included establishing tax structures for acquisitions and divestitures that comply with the tax laws and local practices; preparation and presentation of state tax protest of assessments; organizing IRS large case examinations and negotiating resolutions of issues.

STEVENS & LEE, PC

General practice in the areas of tax, corporate and securities law.

Tax Attorney, Business Group

Involved with federal and state tax planning, private placements, federal and state securities laws, loan re-negotiations and mergers and acquisitions.

ERNST & YOUNG, CPAs

Senior Tax Staff

Responsible for financial statement tax accrual review and preparation and review of multi-jurisdictional tax returns.

Professional Memberships:

Tax Executives Institute

Established Harrisburg Chapter

Served as Regional Vice President,

and Chapter Representative to National Board of Directors

Committee on State Taxation

American Institute of CPA

American Bar Association



Denise L. Devine, CPA, MBA

Ms. Devine is Founder and Chief Executive Officer of Nutripharm, Inc. and its wholly owned operating subsidiary Devine Foods, Inc. Ms. Devine and the Company have been cited by a number of publications as well as being honored by The Ben Franklin Technology Partnership for innovative product development. The company was also honored by the Greater Philadelphia Chamber of Commerce by being named the 2000 Emerging Business of the Year. Ms. Devine was named by the Governor in 1999 as a recipient of the “Best 50 Business Women in Pennsylvania” Award and by the Philadelphia Business Journal as a recipient of the 2002 “Women of Distinction” Award. She also received the 2000 St. Thomas of Villanova Gold Medal Villanova University Alumnae Award. Ms. Devine, co-founder of the Women’s Investment Network is also a nationally recognized professional leader. She is frequently invited to speak at national seminars and industry events. She served on the American Institute of CPAs Board of Directors dealing with critical ethics issues and the profession’s dialogue with the SEC and congress in the development of the Sarbanes-Oxley legislation. She was also appointed by the Governor of Pennsylvania to serve on The State Board of Accountancy, the ethics and licensing Board for the 20,000 CPA’s in Pennsylvania. She served several years as Chairman of that Board. Ms. Devine also serves on the Board of The Children’s Aid Society of Pennsylvania, The Villanova University Alumni Board and the Dean’s Advisory Board of Villanova University’s Business School. Ms. Devine, who is co-inventor on nineteen U.S. and international patents, will serve as an “Entrepreneur in Residence” at The Wharton School of The University of Pennsylvania in 2004.

Ms. Devine’s prior business experience includes several years with Campbell Soup Company involving tax planning, financing, structuring and negotiating various capital markets transactions, acquisitions, divestitures and joint ventures in the food business, and Arthur Andersen & Co. serving in the tax division and as a member of the firm’s national closely-held business team. Ms. Devine, a CPA, received an MBA from the Wharton School of the University of Pennsylvania, an M.S. in Taxation from Villanova Law School and a B.S. in Accounting from Villanova University, where she graduated first in her class.



Secretary Gregory C. Fajt

Gregory C. Fajt was nominated as Secretary of the Pennsylvania Department of Revenue in January 2003 by Governor Edward G. Rendell, and officially sworn in on March 14, 2003.

Fajt has been named to several boards and commissions, including Chair of the Pennsylvania Business Tax Reform Commission, the Taskforce for Working Families, and the Economic Development Cabinet.

Fajt (pronounced "fight") served as State Representative for the 42nd. District in Allegheny County from 1991 to 1996. During his tenure in the Pennsylvania Legislature, he focused on tax policy and economic development issues. He served on the Finance, Judiciary, Professional Licensure and Tourism Committees.

Fajt last served as a partner with Leech Tishman Fuscaldo and Lampl, LLC of Pittsburgh, Pa. His expertise was utilized in the areas of estate planning, and administration and corporate law. Fajt also served as counsel for tax, corporate, and ERISA for Joy Technologies Inc., a Pittsburgh-based Fortune 500 company.

Fajt earned his law degree from Duquesne University in 1984, where the major emphasis of his studies was taxation. He graduated cum laude from St. Vincent College in Latrobe, Pa., with a Bachelor of Science in Accounting in 1977. Fajt is a licensed attorney within the Commonwealth of Pennsylvania and a Certified Public Accountant (CPA).

The Secretary has a long history as a volunteer for many community and charitable organizations. Fajt was elected to the Big Brothers Big Sisters Community Council in 2003. He was listed in the publication Outstanding Young Men of America 1988-1990.

Fajt was born November 30, 1954 in Greensburg, Pa.



Dean Glick, CPA

Mr. Glick is a member of the American Institute of Certified Public Accountants, the Pennsylvania Institute of Certified Public Accountants, and Tax Executives Institute Inc. He is a past President and current member of the Board of Directors of Tax Executives Institute, Harrisburg Chapter. He has previously served on the PICPA's State Taxation Committee, and currently serves on the Pennsylvania Business Roundtable Taxation Subcommittee and the Lancaster Chamber Taxation Subcommittee. A graduate of Elizabethtown College, he is employed as Tax Manager of High Industries Inc. in Lancaster.



Joseph C. Guyaux

Joseph C. Guyaux is president of The PNC Financial Services Group. In that role he is responsible for leading PNC's Regional Community Bank; PNC Advisors, the company's wealth management business; and wholesale banking, which includes the company's leasing, capital markets, middle-market, asset-based lending and real estate finance businesses.

Guyaux joined PNC in 1972 and, after holding several management positions, was named senior vice president and manager of Metropolitan Commercial Banking in Pittsburgh in 1989. In 1991, he was elected president of PNC's Northeast PA market, with primary responsibility for the market's retail business. Guyaux was elected executive vice president and retail market manager for the Pittsburgh market in 1993 and elected senior vice president and manager, PNC Private Bank, in 1995. In 1997, he was appointed deputy manager of the Consumer Banking business and later that year he was named chief executive officer of the Regional Community Bank.

As chief executive officer of the Regional Community Bank, Guyaux instituted a successful customer-focused strategy that has resulted in increases in net income, customer and employee satisfaction, and extensive employee volunteerism in the six states the bank serves. He became responsible for PNC's middle market, corporate finance, capital markets, asset-based lending, real estate finance and leasing businesses in 2001 and 2002. When appointed president in 2002, Guyaux assumed responsibility for PNC Advisors.

Guyaux serves on the boards of directors of DQE, Duquesne University, Pittsburgh Theological Seminary, Civic Light Opera, Private Export Funding Corp. (PEFCO) and the Board of Trustees of Carnegie Museums of Pittsburgh.

A graduate of Brown University, Guyaux received his bachelor of science degree in 1972 and earned his master's in business administration from the University of Pittsburgh in 1984. He is also a graduate of the Stonier Graduate School of Banking.

M. Christine Murphy

M. CHRISTINE MURPHY is a Senior Executive with over thirty years of diverse experience in both private and public sectors, including partnership in a Big Four accounting firm, Revenue Commissioner and Deputy Director of Finance for the City of Philadelphia, and Executive Vice President and Chief Financial Officer for a publicly-held consulting firm. Currently, Chief Executive and owner of S. Zitner Co., a confectionary manufacturer in Philadelphia.

PROFESSIONAL EXPERIENCE

S. ZITNER CO.

Philadelphia, PA

(Manufacturer of fine confections distributed throughout the Mid-Atlantic region)

Chairman and Chief Executive Officer

ROY F. WESTON, INC.

West Chester, PA

(\$300 million, publicly-held environmental services firm with 2200 employees in 50 offices)

Executive Vice President and Chief Financial Officer

Director

CITY OF PHILADELPHIA

Philadelphia, PA

Revenue Commissioner - City and School District of Philadelphia

Deputy Director of Finance - City of Philadelphia

Responsible for interpretation and enforcement of tax laws and collecting and accounting for all tax revenue for the City and the School District of Philadelphia.

ARTHUR YOUNG & COMPANY (now Ernst & Young)

Philadelphia, PA and Minneapolis, MN

Partner – recognized firm expert in the financial services industry practice

PROFESSIONAL and COMMUNITY ACTIVITIES/AFFILIATIONS

Sovereign Bank, Board of Directors, Audit Committee

ImageMax, Board of Directors, Audit Committee

The Allegheny West Foundation, Board of Directors, Chair of Economic Development Committee

Greater Philadelphia Chamber of Commerce, Board of Directors

Overbrook School for the Blind, Board of Directors

The Visiting Nurse Association of Greater Philadelphia, Board of Directors

Hunting Park West – Germantown Business Association,
Board Vice-President

CoreStates Bank, N.A., Board of Directors

Independence Bancorp, Board of Directors

The Philadelphia Foundation, Board of Managers
Advisory Board

Pennsylvania Institute of Certified Public Accountants, Various statewide elected and appointed positions, including Treasurer, Council Member and Ethics Committee Member

Forum of Executive Women, Past President

EDUCATION AND CERTIFICATION

MBA, **Drexel University**, Philadelphia, PA

BS, Business Management, **Stonehill College**, North Easton, MA

Certified Public Accountant, Pennsylvania (inactive status)



Dr. Leroy D. Nunery II

Dr. Leroy David Nunery II is Vice President, Business Services for the University of Pennsylvania (appointed in March 1999). His Division is the major commercial enterprise arm of the University with total revenues of approximately \$200 million and 900 employees. It comprises Purchasing Services; the University of Pennsylvania Bookstore; Campus Dining; Campus Housing; Conference Services; three University-owned hotels; Transportation/Parking/Mail Services; Publication Services; Penn's Children's Center; Morris Arboretum; the Office of Community Housing; and several new business development initiatives. He is heavily involved in strategic planning and implementation of Penn's renowned West Philadelphia Initiatives, particularly the inclusion of local minority/women/disadvantaged entities in doing business with Penn; a robust employee assisted housing program; retail development; arts and culture programs; and workforce development.

Dr. Nunery's previous experience includes sixteen years in various roles in corporate banking and capital markets work and four years with the National Basketball Association as Vice President, Human Resources and Vice President, Business Development.

Dr. Nunery's extracurricular activities have been varied. Currently, he is a director on the following boards: the Financial Performance and Standards Committee of Blue Cross Blue Shield Association, Inc.; WXPB-FM; The Enterprise Center of West Philadelphia; The Enterprise Center Capital Corporation; The West Philadelphia Partnership; The University City District; The Philadelphia Convention and Visitors Bureau; the Philadelphia Sports Congress; the Please Touch Museum for Children in Philadelphia; and the Morris Arboretum. Other past outside activities have been: Past National President (1983 - 1987) of the National Black MBA Association, Inc.; Board of Directors, Pitney Bowes, Inc. (1991-1997); Board of Trustees, Lafayette College (1987- 1998); Board of Directors, Omega Psi Phi Fraternity Federal Credit Union (1997-1999); Board of Directors, Chicago Community Ventures, Inc. (1980-1983). He has advised several other organizations in strategic plan development, fund raising, and organizational development.

Throughout his career, he has been quoted and profiled in numerous leading publications and media for his work in business education and diversity. He has been a frequent public speaker and advisor on the issues of economic development, leadership development and strategic

planning. In May 2000, Lafayette College created the Leroy D. Nunery Award for Intellectual Citizenship, which is given annually to an upper-class student of color who demonstrates academic and social leadership.

Dr. Nunery is a graduate of Lafayette College (BA in 1977), Washington University (MBA in 1979), and University of Pennsylvania (Doctorate in Education in 2003). His doctoral thesis entitled "Reconceptualizing the College Town: Urban Universities and Local Retail Development" has been nominated for both the Alice L. Beeman Research Award for Outstanding Writing About Communications and the H.S. Warwick Research Award for Outstanding Writing About Alumni Relations in 2004.

He is a proud member of Omega Psi Phi Fraternity, Inc., Mu Omega Chapter (Philadelphia), and in June 2004, will be inducted into Sigma Pi Phi Fraternity, Inc., the oldest African-American fraternity in the United States. He is married to Gina Golson Nunery, an Assistant Vice President for TIAA-CREF. They have three children, Leroy David Nunery III (age 20), Gillian Golson (age 15), and Dorothy Jacqueline Nunery (age 11).



Douglas Skowron, J.D.
Director, Pittsburgh Gateways Corporation.

Mr. Skowron is responsible for managing and financing commercialization projects as well as program development and fundraising. Mr. Skowron also serves as legal counsel. Doug has generated increased foundation and public support for Pittsburgh Gateways, and is managing several business commercialization projects.

Doug also currently maintains a separate consulting practice focused on commercial real estate and recently completed the development of a 35,000 sq.ft. medical office building. Prior to this work, he managed a commercial real estate consulting practice with CB Richard Ellis Pittsburgh. He developed several commercial real estate projects while at CB and was instrumental in the development of a master plan for a mixed use technology park.

Prior to his work with CB, Mr. Skowron managed all small business and real estate lending programs for the Urban Redevelopment Authority of Pittsburgh. He financed over one hundred small business and real estate projects. Prior to his work with the URA, Mr. Skowron developed new economic development initiatives with the Governor's Office of Policy Development in Pennsylvania. He has also worked as a Legislative Assistant to an Illinois Congressman where he focused on public works and transportation issues. Throughout his private career, he has raised approximately \$40 million for various business and real estate projects. Throughout his public career, he has been involved in the planning or approval of approximately \$100 million for various programs and projects.

Doug is a licensed attorney and real estate broker in Pennsylvania. He holds a Masters in City & Regional Planning from Harvard University and a Juris Doctor from Duquesne University. He is also a member of the Sewickley Planning Commission.



Thomas W. Wolf

Date of Birth:

November 17, 1948

Education:

Ph.D. Massachusetts Institute of Technology (1981)

M. Phil. University of London (1978)

B.A. Dartmouth College (1972)

Employment:

Chairman & President, The Wolf Organization, Inc., York, Pennsylvania. The Wolf Organization distributes building materials through 30 branches located along the eastern seaboard.

Vice President, The Wolf Organization, Inc.

Store Manager, Wolf Supply Company

Sales Clerk, Wolf Supply Company

Instructor, M.I.T.

Graduate Teaching Assistant, M.I.T.

Peace Corps Volunteer, India

Civic Activities:

President, Better York, Inc. Chair, Lancaster York Heritage Region, Chair, Board of Trustees, York College of Pa. Past Chair, York County Chamber of Commerce, Past Chair, United Way of York County, Past Chair, WITF, Inc., Past President, The York Foundation

Other Activities:

Activities Director, Manis Lumber Company (Rome, Georgia) Director, RG Industries (York, Pennsylvania) Director, Bon Ton Stores, Inc. (York, Pennsylvania) Director, IREX Corporation (Lancaster, Pennsylvania) Director, Seigle's Home & Building Centers, Inc. (Elgin, Ill)

YARONE S. ZOBER, ESQ.

1121 Farragut Street
Pittsburgh, PA 15206

Home Phone: 412-661-9312
Cell Phone: 412-983-7663
E-Mail: zober1@hotmail.com

PROFESSIONAL EXPERIENCE

- Economic Development Coordinator to State Senator Jim Ferlo, September 2004-Present
- Attorney, Reed Smith, September 2003-September 2004
Areas of Practice: Bankruptcy, general litigation, real estate
- Chief of Staff to Pittsburgh City Council President Emeritus Jim Ferlo, 1998-2000

EDUCATION

- Juris Doctor, University of Pittsburgh School of Law, 2003

Honors: Magna Cum Laude graduate
Order of the Coif
University of Pittsburgh Law Review
Dean's Scholarship 2000-2003

Selected economic development
related coursework: Property, Enterprise Organization and Finance, Land
Transfer and Finance, Business Organizations, Natural
Resource Law, Agency and Partnership
- Master of Public Management, Carnegie Mellon University, Heinz School, 2000

Honors: Graduate of the Highest Distinction (3.97 GPA)
Focus: Financial Resources & Non-Profit Organizations

Selected economic development
related coursework: Economic Development I & II, State and Local Government
Law, Financial Analysis, Data Analysis, Strategic Planning
- Bachelor of Arts, Education, University of Pittsburgh, 1997

Honors: Magna Cum Laude (3.74 GPA)
University Scholar 1993-1997

BOARD AFFILIATIONS, COMMUNITY ACTIVITIES AND AWARDS

- Pittsburgh Magazine/PUMP "40 Under 40" Honoree, 2004
- Allegheny County Transition Team, Economic Development Committee, 2004
- Pennsylvania Business Tax Reform Commission, 2004
- Board Member, Highland Park Community Development Corporation, 2000-Present
- City of Pittsburgh Advisory Committee on Community Based Organizations, 1998-2000

Pennsylvania Business Tax Reform Commission
Meetings Held

At: Governor's Residence, State Dining Room
2035 North Front Street, Harrisburg, PA

Thursday, April 8, 2004
1:00 – 5:00 p.m.

At: Dixon University Center
2986 North Second Street, Harrisburg, PA

April 20, 2004
9:00 - 12:00 Morning Session - 1:00 - 3:00 Afternoon Session

April 29, 2004
9:00 - 12:00 Morning Session - 1:00 - 3:00 Afternoon Session

May 17, 2004
9:00 - 12:00 Morning Session - 1:00 - 3:00 Afternoon Session

May 27, 2004
9:00 - 1:30 Morning Session

June 9, 2004
9:00 - 12:00 Morning Session - 1:00 - 3:00 Afternoon Session

June 16, 2004
9:00 - 12:00 Morning Session - 1:00 - 3:00 Afternoon Session

At: Main Capital Rotunda, Harrisburg, PA

June 21, 2004
Press Event

At: Dixon University Center
2986 North Second Street, Harrisburg, PA

August 2, 2004
9:00 – 11:30 Morning Session – 12:30 – 3:00 Afternoon Session

September 1, 2004
9:00 – 12:00 Morning Session – 1:00 – 3:00 Afternoon Session

September 22, 2004

9:00 – 12:00 Morning Session – 1:00 – 3:00 Afternoon Session

At: Wyndham/Hershey Hotel
4650 Lindle Road, Harrisburg, PA

October 6, 2004

9:00 – 12:00 Morning Session – 1:00 – 3:00 Afternoon Session

At: Dixon University Center
2986 North Second Street, Harrisburg, PA

October 20, 2004

9:00 – 12:00 Morning Session – 1:00 – 3:00 Afternoon Session

November 4, 2004

9:00 – 12:00 Morning Session – 1:00 – 3:00 Afternoon Session

November 19, 2004

9:00 – 12:00 Morning Session – 1:00 – 3:00 Afternoon Session

At: Main Capital Rotunda, Harrisburg, PA

November 30, 2004

Press Event

Pennsylvania Business Tax Reform Commission
List of Testimony Presented

Thursday, April 8, 2004:

Presentation on Pennsylvania Business Taxes and Major Issues by Eileen H. McNulty, Executive Deputy Secretary of the Pennsylvania Department of Revenue

April 20, 2004:

Presentation by PA-21 co-chairs William George, President of the Pennsylvania AFL-CIO, and H. Craig Lewis, representing the Pennsylvania Business Roundtable.

Presentation by Brian Kennedy, Public Policy Director for the Pittsburgh Technology Council.

Presentation by Dr. Robert Tannenwald, Assistant Vice President and Economist, Federal Reserve Bank of Boston

April 29, 2004:

Presentation by Stanley Kull of Saul Ewing, representing the Tax Division of the Philadelphia Bar Association

Presentation by William R. Lazor, CPA, President, PICPA, Carl W. Back, Jr., CPA, and Raymond M. Chopper, CPA representing the Pennsylvania Institute of CPAs

Presentation by Steve Herzenberg of the Keystone Research Center

Presentation by James Panyard of the Pennsylvania Manufacturers Association

Presentation by C. Daniel Hassell, Deputy Secretary for Tax Policy of the Pennsylvania Department of Revenue

May 17, 2004:

Presentation by Grant Gulibon of the Commonwealth Foundation

Presentation by Kevin Shivers, Angelo Ventresca and Duane Keller of the National Federation of Industrial Businesses.

Presentation by David Thornburgh and Scott Bair of the Pennsylvania Economy League

Presentation by James D. Welty, Robert Freedenberg and Schott Sheeren of the Pennsylvania Chamber of Business and Industry

Presentation by William P. Carlucci of the Pennsylvania Bar Association

Presentation by Michael Mazerov of the Center on Budget and Policy Priorities

Presentation by Doug Lindholm of the Council on State Taxation (COST)

Presentation by Renee Blocker of the Multistate Tax Commission (MTC)

May 27, 2004:

Presentation by Michael McCarthy of the Pennsylvania Business Roundtable

Presentation by Raymond Murphy of United Pennsylvanians

Presentation by Donald Geyer, Esquire, Assistant Counsel for the Pennsylvania Department of Revenue

Presentation by Brenda Warburton, Research Director for the Pennsylvania Department of Revenue

June 9, 2004:

Presentation by Lawrence R. Cusack of KPMG's Strategic Relocation and Expansion Services

August 2, 2004:

Presentation by Secretary of Revenue, Gregory C. Fajt

Presentation by C. Daniel Hassell, Deputy Secretary for Tax Policy and Gerard Sallavanti, Executive Director of the Board of Appeals

Presentation by Diane Zdradzinski of the Board of Finance and Revenue, Lori Ulsh, Deputy Secretary of the Board of Finance and Revenue, and Jeffrey Gribb, Deputy Chief Counsel of the Treasury Department.

Presentation by Carol Weitzel and Michael Roman of the Office of the Pennsylvania Attorney General

Presentation by William Lazor, CPA of the Pennsylvania Institute of Certified Public Accountants (PICPA)

Presentation by George Bell and James Fritz of the Tax Section of the Pennsylvania Bar Association

September 1, 2004:

Presentation by Commissioner Joseph C. Bright, Esquire

Presentation by Amy Gill of the Pennsylvania Department of Revenue Research Department

September 22, 2004:

Presentation by Dennis Yablonsky, Secretary of the Department of Community and Economic Development

Presentation by Judith Maskrey of PPG Industries, Inc., Mr. David Green of Air Products and Chemicals, Inc., Mr. Anthony Chirico of York International Corp. and Thomas Bowen, Esquire of Stevens and Lee

Presentation by Nicholas J. Crocetti and Paul R. Vidas of CBIZ Accounting, Tax & Advisory, Inc.

October 6, 2004:

Presentation by Brenda Warburton, Research Director of the Pennsylvania Department of Revenue

Presentation by James Diffley, Group Managing Director of Global Insights

October 20, 2004:

Presentation by Brenda Warburton, Research Director of the Pennsylvania Department of Revenue

Presentation by William Ardinger, Esquire of Rath, Young & Pignatelli

Presentation by Commissioner Joseph C. Bright, Esquire

November 4, 2004:

Presentation by Stanley Arnold and William Ardinger, Esquire of Rath, Young & Pignatelli

Presentation by Jay Wortley, Senior Economist of the Michigan Senate Fiscal Agency

Presentation by Brenda Warburton, Research Director and C. Daniel Hassell, Deputy Secretary for the Pennsylvania Department of Revenue

Presentation by James Diffley, Group Managing Director of Global Insights

November 19, 2004:

No presentations.

Criteria for Pennsylvania's Business Tax Reform Commission

Recommendations

In order to evaluate the current tax structure, seven criteria are presented for use in evaluating the system and recommending reforms. The suggested criteria are as follows:

Equity

The tax system should fairly distribute tax liabilities across all sectors of the economy. A tax system should promote horizontal equity by imposing similar tax burdens on similarly situated taxpayers. It should also provide vertical equity where taxpayers with differing abilities to pay should pay different amounts consistent with the distributional objectives of the state.

Economy of Administration

Taxes should be inexpensive to administer for taxpayers and tax collectors.

Neutrality

The tax system should not unduly influence economic behavior decisions primarily due to tax reasons. Taxes should not unintentionally alter consumer, worker, or producer costs. To the extent possible, social and economic policy objectives should be met through explicit expenditure policies rather than through the use of tax expenditures. When tax expenditures are socially desirable, they should be justified in relation to the benefits and costs and periodically reviewed and allocated.

Competitiveness

Deviations from the neutrality of the tax base should be consistently directed toward improving the competitive position of Pennsylvania businesses and targeted to specific well defined goals which shall include the expansion of high quality employment within the Commonwealth.

Stable and Sufficient Revenue

The tax system should provide revenues that fund government services. It should provide adequate revenues to fund those services in both good and bad economic times.

Fiscal stability is a large part of a stable economic climate providing greater certainty for businesses and households. The tax system must be structured to keep up with economic growth.

Simplicity

Taxes should be readily understood by taxpayers and tax administrators. The state tax system should minimize compliance costs for taxpayers and administrative costs of state and local government.

It is to be noted that critical to this work shall be the availability of careful, thorough and reliable revenue estimates.

10. State Corporate Net Income Tax Issues – National Overview

This section is included for discussion purposes. It does not include Commission recommendations. Respective footnotes are listed at the end of each section.

The decline in the state corporate net income tax is a national trend. There are a number of cited reasons for the decline in the national state corporate net income tax base.

A. Legislative Changes in the Tax Rate, Tax Base and Compliance Rules.

1. The Congressional Research Service report on state corporate taxation, prepared for Congress dated April 2, 2004, provides in part:¹

“Several causes have been suggested for the recent decline in state corporate tax revenues. The most direct causes would be legislated changes in the tax rate, the tax base, and the compliance rules. The decline in revenue could be the result of state governments, in the aggregate, attempting to lower the tax burden on corporations. The December 2003 Fiscal Survey of States reported that states, in the aggregate, enacted net tax reductions every year from FY 1995 through FY 2001. Even though these tax cuts were not separated into types of tax by the Fiscal Survey, it seems likely that state corporate income taxes were included in the tax cuts. Recent research has reached a similar conclusion, noting that “...State tax bases have deteriorated further than the federal base because of a combination of explicit state actions [emphasis added] and tax avoidance/evasion by businesses.”

2. Aggressive Tax Planning

“A second explanation, alluded to above, is that corporations are more effectively avoiding, or even evading taxes through aggressive tax planning. The Multistate Tax Commission (MTC) concluded in a recent study that “... various corporations are increasingly taking advantage of structural weaknesses and loopholes in the state corporate tax systems.”² Again, the MTC study cannot definitively separate the revenue declines arising from policy changes and avoidance/evasion, but still concludes that tax avoidance and evasion are partly responsible for the decline in state corporate tax revenues.”

Note: The Council on State Taxation (COST) has asserted that the Multistate Tax Commission overstated the characterization of “sheltering” and cites the fact that the Multistate Tax Commission study cannot definitively separate the revenue decline arising from policy changes and avoidance/evasion. The Council on State Taxation response to the Multistate Tax Commission also cited International considerations which, over time, would include a shift by Corporate businesses to increased operations overseas. The Multistate Tax

Commission's rebuttal cited the business tax loss study by the American Economics Group. The American Economics Group's estimate of the total loss of state taxes, for the United States, was \$51 billion in 2001.

3. Cyclical Economic Changes

A third explanation is that cyclical economic changes have led to the decline in state corporate tax revenues. Note that cyclical economic effects are unrelated to the behavior of policymakers or corporations. The effect of economic cycles on revenue is difficult to identify because the legislated changes and the corporate behavior, described above, likely exacerbated (or attenuated) the cyclical economic changes. Recent research into the causes of state budget deficits, suggested that ".... the current [cumulative state] deficit is largely structural. The implication of this finding is that policy (structural) changes like tax cuts and discretionary spending increases generated state budget deficits in FY 2002 and FY 2003, not the machinations of the economic cycle."³

4. Federal Corporate Income Tax Changes

Changes to the Federal Corporate Income Tax Code, which have reduced the base of most state corporate income tax systems, could explain part of the decline in state corporate income tax revenue.

B. Other Factors Cited by Commentators that are Contributing to the Decline

1. The federal and state provisions allowing pass-through taxation for limited liability companies and the growth in S corporations at the federal and state level have contributed to the decline in national state corporate net income revenues;
2. International operations – certain companies, over time, have either increased international operations or shifted existing domestic operations overseas. See (COST) statement;
3. Use of economic incentives, e.g., credits in addition to rate reductions discussed above by competing states in attracting business, have eroded the base.

C. Academic and Governmental Studies Documenting Reasons for the Decline

There are a number of studies that have identified certain separate revenue effects on the corporate net income tax. These studies have examined the relationship of aggregate corporate book income to federal and/or state taxable income.⁴ These studies have referenced certain Federal General Accounting Office studies indicating that the common starting point for state taxable income is at issue, Line

28⁵. Also a recent General Accounting report indicates a number of corporations, at the federal level, had no federal taxable income over a six year period.⁶

D. Federal Corporate Enforcement Tax Issues

Pennsylvania's starting point for Pennsylvania net corporate income tax, which is Line 28 from Form 1120, is affected by the following enforcement issues: federal changes in legislation, federal compliance issues involving abusive listed transactions identified by the Internal Revenue Service,⁷ federal audit enforcement coverage of corporate taxpayers,⁸ federal foreign issues involving transfer pricing⁹ and enforcement of federal subpart F income and associated foreign provisions.

E. State Corporate Net Income Tax Reform Proposals

In response to this national trend, commentators have recommended: abolishing the state corporate net income tax and substituting an alternative business tax,¹⁰ enacting certain state corporate net income tax provisions, for example, addback provisions, throwback rules, throwout rules, etc., or the adoption of mandatory combined reporting for separate reporting states.¹¹

F. Vulnerability of Separate Company Reporting

Separate company reporting states are vulnerable to certain additional state tax strategies using related entities involving: entity isolation, inconsistent reporting, and structural nonuniformity.¹² Related entities include domestic passive investment companies¹³ and foreign intangible companies. The effect of certain related entities, e.g., a Delaware Holding Company structure, on a separate reporting state is not confined to domestic entities. To address this vulnerability a number of leading commentators have recommended combined reporting.¹⁴

As discussed above, the erosion of the state corporate net income tax base on the national level is a multifaceted issue.

FOOTNOTES

10. State Corporate Net Income Tax Issues – National Overview

1. Congressional Research Service Report for Congress, Income Taxes – Corporate Income – Dated March 23, 2004.
2. Multistate Tax Commission, “Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collection” – July 15, 2003. Note: See Associated Agreement by the Council on State Taxation, “Abusive Tax Shelters Should be Curtailed but the Multistate Tax Commission’s Exaggerated Numbers Aren’t Helpful to the Debate.”
3. Brian Knight, Andrea Kusko and Laura Rubin, “Problems and Prospects for State and Local Government,” paper presented at Urban Institute seminar, State Fiscal Crisis: Causes, Consequences and Solutions – April 5, 2003.
4. Trends in Book-Tax Income and Balance Sheet Differences – May 20, 2002.
5.
 - A. The Disappearing State Corporate Income Tax – Gary Cornia, Kelly Edminson, David L. Djoquist, and Sally Wallace – See Pages 8 & 9.
 - B. Nichols Johnson, “Federal Tax Changes Likely to Cost State Billions of Dollars in Coming Years,” Center on Budget and Policy Priorities, June 5, 2003.
 - C. State Corporate Tax Revenue Trends: Cases and Possible Solutions – William J. Fox and Le Ann Luna, June 5, 2002, See Page 6.
6. General Accounting Office Study – Tax Administration United States Controlled Corporations for Tax Years 1996-2000, General Accounting Office.
7. Listed Transactions. Congressional Research Service Report for Congress Anti Tax Shelter and Other Revenue Raising Tax Proposals Updated, February 27, 2004 (April 1, 2004).
8. Federal Audit Enforcement Initiatives – Ways and Means Hearing, March 31, 2004.
9. Transfer Pricing requires arm length pricing of goods and services pursuant to Section 482. Subpart F requires a deemed repatriation of amounts from certain entities that are controlled by U.S. persons.
10. Abolish the State Corporate Net Income Tax, “Stop Taxing Corporate Income,” State Tax Notes, July 1, 2002.
11. State Corporate Tax Reform

“Many economists and other researchers who analyze state corporate income taxes agree that the critical issue with the current state corporate income tax structure is the variability in the allocation and apportionment of corporate income from state to state. The current mosaic of state corporate income tax rules creates economic inefficiencies for the following reasons: (1) relatively high compliance costs, (2) increased opportunities for tax planning by businesses, and (3) potential gaps and overlaps in taxation. The new regulations as proposed in H.R. 3220 could exacerbate underlying inefficiencies because the threshold for business-the 21-day rule, higher than currently exists in most states-would increase opportunities for tax planning leading to more “nowhere income.” In addition, expanding the number of transactions that are covered by P.L. 86-272 also expands the opportunities for tax planning and thus tax avoidance and possibly evasion.” Congressional Research Service Report for Congress, Income Taxes – Corporate Income – Dated March 23, 2004.
12. Separate Company Reporting Issues – Identified by the Multistate Tax Commission

The Corporate Income Tax Sheltering Work Group draft report to State to Compliance Initiative Steering Committee, Dated April 14, 2004, listed the following corporate income tax shelter issues:

The top corporate income tax shelter issues identified include: (1) entity isolation, (2) manipulation or distortion of apportionment factors, (3) nowhere income resulting from nonuniformity among the states, (4) double deductions caused by state nonconformity to federal rules for special entities, and (5) state conformity to federal tax shelter devices.
13. In the last ten years, there has been an increase in partial or full inversions of companies[i] as well as the creation of 80/20[ii] companies in well known jurisdictions such as the Bahamas[iii], Bermuda[iv], and the Cayman Islands[v], as well as obscure countries such as Nauru[vi] and Niue[vii] for the purposes of multistate or federal tax planning. The IMF estimates that assets worth more than \$5 trillion are held offshore.
14. Some of the experts positions are outlined below:

“A state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers.” – Richard Pomp, Loiselle Professor of Law, University of Connecticut.

[the failure to use combined reporting is] “an open invitation to tax avoidance” – Charles McLure, Senior Fellow, Hoover Institution; Deputy Assistant Secretary of the Treasury during the Reagan Administration.

[combined reporting] “has been a success in every state that has adopted it.” – Michael McIntyre, Professor Law, Wayne State University.

11. **Pennsylvania Corporate Net Income Tax Issues - Overview**

The following section is compiled from testimony presented by business organizations, fiscal policy experts and the Pennsylvania Department of Revenue.

- A. "As stated in the testimony, there is very little "horizontal equity" in Pennsylvania's business tax system. Differences in effective tax rates between industries are significant. This is due to the variety of different taxes based on the type of business, major exemptions that provide preferential treatment to certain types of business, and the different financial make-up of different businesses."...

"The use of the "pass-through" model of entity selection will have a growing influence on how Pennsylvania and other states tax business. The effects of this trend and implications for tax policy should be part of planning for a future business tax system." See testimony presented by the Pennsylvania Economy League on May 17, 2004.

- B. Testimony presented indicated, "Pennsylvania has one of the highest statutory tax rates in the nation on its two major corporation taxes, the Corporate Net Income Tax (CNI) and the Capital Stock Franchise Tax (CSFT). This contributes powerfully to the perception of Pennsylvania as unfriendly to business."¹
- C. "The corporate net income tax rate of 9.99% is one of the highest in the country, and is higher than the stated rates in neighboring states. By itself, the rate is a deterrent to businesses that are considering moving to Pennsylvania. It also encourages corporations to consider methods of reducing their effective tax rate." See Appendix A for respective state corporate income tax rates.
- D. "The state business tax system is further flawed by the narrow base of the CNIT and the CSFT and resulting inequity in the distribution of business taxes across industries and types of businesses. While some businesses pay very high CNIT and CSFT rates, others subject to the taxes have relatively low or no tax liabilities. In addition, a large number of businesses are not required to pay either of the two taxes because of either their entity form or their industry. This results in nonuniformity in business tax burdens."²
- E. Stated testimony indicated, "In terms of actual tax burden, the tax base is as important as the tax rate. For example, Pennsylvania's comparatively high Corporate Net Income tax rate is offset somewhat by provisions that narrow the base." (See testimony presented by the Pennsylvania Economy League on May 17, 2004). Testimony presented also indicated that only 18 percent of taxpayers subject to the Pennsylvania

corporate net income tax are remitting Pennsylvania corporate net income tax.

Pennsylvania Department of Revenue presentation to the Commission illustrated the historical trends cited above, the majority of C corporations currently subject to the Pennsylvania corporate net income tax reported no liability. Approximately 36 percent of the C Corporations, in 2005, are expected to pay corporate net income tax.

- F. "For those businesses that are subject to both the CNI and CSFT, Pennsylvania's high rates can be a deterrent to new investment and job growth."
- G. "Pennsylvania is perceived as one of the most complex tax systems in the country," as noted by many diverse business groups.
- H. In its testimony presented before the Commission, the Pennsylvania Chamber of Business and Industry recommended a two-pronged strategy for tax policy. "Pennsylvania tax policy should be to encourage the location of large, multinational companies that are stable employers in a global economy to relocate in Pennsylvania. These employers will provide high paying jobs and will tend to feed the small business market.

Further, support continued growth of small to medium sized businesses and encourage new start-ups which are expected to provide most of the job growth in this sector. These policies are not mutually exclusive, but are supportive of each other."

RANGE OF STATE CORPORATE INCOME TAX RATES

(For tax year 2004 -- as of January 1, 2004)

State	Tax Rates		Tax Brackets	# of Brackets	Bank Tax Rates	Federal Tax Deductible *
ALABAMA	6.5	---	Flat Rate---	1	6.5	
ALASKA	1.0 - 9.4	10,000	90,000	10	1.0 - 9.4	
ARIZONA	6.968 (b)	---	Flat Rate---	1	6.968	
ARKANSAS	1.0 - 6.5	3,000	100,000	6	1.0 - 6.5	
CALIFORNIA	8.84 (c)	---	Flat Rate---	1	10.84 (c)	
COLORADO	4.63	---	Flat Rate---	1	4.63	
CONNECTICUT	7.5 (d)	---	Flat Rate---	1	7.5 (d)	
DELAWARE	8.7	---	Flat Rate---	1	8.7-1.7 (e)	
FLORIDA	5.5 (f)	---	Flat Rate---	1	5.5 (f)	
GEORGIA	6.0	---	Flat Rate---	1	6.0	
HAWAII	4.4 - 6.4 (g)	25,000	100,000	3	7.92 (g)	
IDAHO	7.6 (h)	---	Flat Rate---	1	7.6 (h)	
ILLINOIS	7.3 (i)	---	Flat Rate---	1	7.3 (i)	
INDIANA	8.5	---	Flat Rate---	1	8.5	
IOWA	6.0 - 12.0	25,000	250,000	4	5.0	* (k)
KANSAS	4.0 (l)	---	Flat Rate---	1	2.25 (l)	
KENTUCKY	4.0 - 8.25	25,000	250,000	5	--- (a)	
LOUISIANA	4.0 - 8.0	25,000	200,000	5	--- (a)	*
MAINE	3.5 - 8.93 (m)	25,000	250,000	4	1.0	
MARYLAND	7.0	---	Flat Rate---	1	7.0	
MASSACHUSETTS	9.5 (n)	---	Flat Rate---	1	10.5 (n)	
MINNESOTA	9.8 (o)	---	Flat Rate---	1	9.8 (o)	
MISSISSIPPI	3.0 - 5.0	5,000	10,000	3	3.0 - 5.0	
MISSOURI	6.25	---	Flat Rate---	1	7.0	* (k)
MONTANA	6.75 (p)	---	Flat Rate---	1	6.75 (p)	
NEBRASKA	5.58 - 7.81	50,000	---	2	--- (a)	
NEW HAMPSHIRE	8.5 (q)	---	Flat Rate---	1	8.5 (q)	
NEW JERSEY	9.0 (r)	---	Flat Rate---	1	9 (r)	
NEW MEXICO	4.8 - 7.6	500,000	1 million	3	4.8 - 7.6	
NEW YORK	7.5 (s)	---	Flat Rate---	1	7.5 (s)	
NORTH CAROLINA	6.9 (t)	---	Flat Rate---	1	6.9 (t)	
NORTH DAKOTA	3.0 - 10.5	3,000	50,000	6	7 (b)	*
OHIO	5.1 - 8.5 (u)	---	50,000	2	--- (u)	
OKLAHOMA	6.0	---	Flat Rate---	1	6.0	

OREGON	6.6 (b)	---Flat Rate---	1	6.6 (b)
PENNSYLVANIA	9.99	---Flat Rate---	1	--- (a)
RHODE ISLAND	9.0 (b)	---Flat Rate---	1	9.0 (v)
SOUTH CAROLINA	5.0	---Flat Rate---	1	4.5 (w)
SOUTH DAKOTA	---	---	1	6.0-0.25% (b)
TENNESSEE	6.5	---Flat Rate---	1	6.5
UTAH	5.0 (b)	---Flat Rate---	---	5.0 (b)
VERMONT	7.0 - 9.75 (b)	10,000 250,000	4	7.0 - 9.75 (b)
VIRGINIA	6.0	---Flat Rate---	1	6.0 (x)
WEST VIRGINIA	9.0	---Flat Rate---	1	9.0
WISCONSIN	7.9	---Flat Rate---	1	7.9
DIST. OF COLUMBIA	9.975 (y)	---Flat Rate---	---	9.975 (y)

Source: Compiled by FTA from various sources

Note: Michigan imposes a single business tax (sometimes described as a business activities tax or value added tax) of 1.9% on the sum of federal taxable income of the business, compensation paid to employees, dividends, interest, royalties paid and other items. Similarly, Texas imposes a franchise tax of 4.5% of earned surplus or 2.5 mills of net worth. Nevada, Washington, and Wyoming do not have state corporate income taxes.

(a) Rates listed include the corporate tax rate applied to financial institutions or excise taxes based on income. Some states have other taxes based upon the value of deposits or shares.

(b) Minimum tax is \$50 in Arizona, \$50 in North Dakota (banks), \$10 in Oregon, \$250 in Rhode Island, \$500 per location in South Dakota (banks), \$100 in Utah, \$250 in Vermont.

(c) Minimum tax is \$800. The tax rate on S-Corporations is 1.5% (3.5% for banks).

(d) Or 3.1 mills per dollar of capital stock and surplus (maximum tax \$1 million) or \$250.

(e) The marginal rate decreases over 4 brackets ranging from \$20 to \$650 million in taxable income. Building and loan associations are taxed at a flat 8.7%.

(f) Or 3.3% Alternative Minimum Tax. An exemption of \$5,000 is allowed.

(g) Capital gains are taxed at 4%. There is also an alternative tax of 0.5% of gross annual sales.

(h) Minimum tax is \$20. An additional tax of \$10 is imposed on each return.

(i) Includes a 2.5% personal property replacement tax.

(j) Fifty percent of the federal income tax is deductible.

(k) Plus a surtax of 3.35% (2.125% for banks) taxable income in excess of \$50,000 (\$25,000).

(l) Or a 27% tax on Federal Alternative Minimum Taxable Income.

(m) Rate includes a 14% surtax, as does the following: an additional tax of \$7.00 per \$1,000 on taxable tangible property (or net worth allocable to state, for intangible property corporations); minimum tax of \$456.

(n) Plus a 5.8% tax on any Alternative Minimum Taxable Income over the base tax.

(o) A 7% tax on taxpayers using water's edge combination. Minimum tax is \$50.

(p) Plus a 0.50 percent tax on the enterprise base (total compensation, interest and dividends paid). Business profits tax imposed on both corporations and unincorporated associations.

(q) The rate reported in the table is the corporation business franchise tax rate. The minimum tax is \$500. An Alternative Minimum Assessment based on Gross Receipts applies if greater than corporate franchise tax. Corporations not subject to the franchise tax are subject to a 7.25% income tax. Banking and financial corporations are subject to the franchise tax. Corporations with net income under \$100,000 are taxed at 6.5%. The tax on S corporations is being phased out through 2007. The tax rate on a New Jersey S corporation that has entire net income not subject to federal corporate income tax in excess of \$100,000 will remain at 1.33% for privilege periods ending on or before June 30, 2006. The rate will be 0.67% for privilege periods ending on or after July 1, 2006, but on or before June 30, 2007; and there will be no tax imposed for privilege periods ending on or after July 1, 2007. The tax on S corporation with entire net income not subject to federal corporate income tax of \$100,000 or less is eliminated for privilege periods ending on or after July 1, 2007.

(r) Or 1.78 mills per dollar of capital (up to \$350,000); or a 2.5% alternative minimum tax; or a minimum tax of \$1,500 to \$100 depending on payroll size; if any of these is greater than the tax computed on net income. Small corporations with income under \$290,000 are subject to lower rates of tax on net income. An additional tax of 0.9 mills per dollar of subsidiary capital is imposed on corporations. For banks, the alternative bases of tax are 3% of alternative net income; or up to 1/50th mill of taxable assets; or a minimum tax of \$250.

(s) Financial institutions are also subject to a tax equal to \$30 per one million in assets.

(t) Or 4.0 mills time the value of the taxpayer's issued and outstanding share of stock with a maximum payment of \$150,000. An additional litter tax is imposed equal to 0.11%

on the first \$50,000 of taxable income, 0.22% on income over \$50,000; or 0.14 mills on net worth.

(v) For banks, the alternative tax is \$2.50 per \$10,000 of capital stock (\$100 minimum).

(w) Savings and Loans are taxed at a 6% rate.

(x) State and national banks subject to the state's franchise tax on net capital is exempt from the income tax.

(y) Minimum tax is \$100. Includes surtax.

12. Existing Department of Community and Economic Development Initiatives

This section is partially compiled from statistics furnished to the Commission from the Department of Community and Economic Development.

The Commission's Final Report responds to the Governor's Executive Order that stated: "the Commission is established to evaluate the current business tax structure in this Commonwealth and recommend changes in the Commonwealth's business tax structure that will broaden those tax bases thereby allowing rates to be reduced, leveling the playing field and creating a fair business tax climate."¹ In this light, the Secretary of the Department of Community and Economic Development, Dennis Yablonsky, commented:

"the direction that you are heading in is terrific. It would really help to improve our competitiveness in the business climate in Pennsylvania. But I also want to underline that most of those things will level the playing field. They are not going to make us significantly better than our competitor states. They will level off the playing field for us. And that the tax credit programs that I am going to go through with you are critical components of continuing to do that work."²

Secretary Yablonsky provided the following information regarding the Commonwealth's tax credit programs:

- A. Job Creation Tax Credit Program - The Job Creation Tax Credit Program has created a total of 46,658 jobs in the 550 companies whose job creation has been monitored (in whole or in part) by the Department since July 1, 1996. Monitoring has yet to be completed on some companies with start dates since 4/1/00 and monitoring has yet to begin on companies with start dates of 7/1/03 or later. The average wage for projected jobs to be created by companies approved in FY03-04 is \$17.17 per hour or \$35,714 annually.

- B. Keystone Opportunity Zone – Per the Department of Community and Economic Development, the Keystone Opportunity Zone Program has created the following full time jobs and capital investment, from 1/1/99 through November 30, 2003:

Jobs Retained	Jobs Created	Total Jobs in Zone	Capital Investment
8,290	9,324	17,614	\$2,080,007,942

- C. Keystone Innovation Zone - Certain businesses located within a Keystone Innovation Zone (KIZ) may claim a tax credit against Pennsylvania corporate net income tax, personal income tax, or capital stock and franchise tax.

The credit is equal to 50 percent of the increase in the KIZ companies' gross revenues in the previous tax year based on activities in the KIZ over the KIZ companies' gross revenues in the second preceding tax year attributable to its activities in the KIZ.³

- D. Neighborhood Assistance Program - The Neighborhood Assistance Program (NAP) is designed to help improve distressed neighborhoods through the creation of effective partnerships between community based organizations and the business community. NAP provides for a wide range of innovative projects by offering a business firm the option of sponsoring its own community assistance project or contributing to an approved NAP project operated by a nonprofit neighborhood organization. NAP is an incentive program that provides a tax credit on the contribution made by a business firm to a nonprofit community organization based on 50 percent of the amount contributed (for Comprehensive Service Projects, the amount of tax credits awarded is based on 70 percent of the eligible contribution, and for Enterprise Zone Projects, the amount is 20 percent of the business firm's investment).
- E. Pennsylvania Research and Development Credit - The Research and Development Tax Credit Incentive of \$30,000,000 that is provided in 2004 will go directly to Pennsylvania businesses that are working to improve their products or seize new market opportunities. It is a key component of creating an innovation economy in the state. While the small business set aside has historically been underutilized, the recent expansion to \$6 million and the addition of the option to trade the credit will provide a direct incentive for Pennsylvania's small businesses to apply and receive a credit that they can trade for real cash to grow their businesses. It is the Department of Community and Economic Development's expectation, that in 2004 the full set aside will be used.⁴

The Commission evaluated the information submitted to it and the presentation submitted by Secretary Yablonsky in light of the proposed substantial reduction in the corporate net income tax rate, coupled with a possible accelerated repeal of the Capital Stock Franchise Tax. As testimony on behalf of the programs, Secretary Yablonsky presented the following comment:

“We believe that making the changes you’ve recommended and eliminating some or all of these tax credit programs, will not move us forward. And by moving us forward, I want to also underline the fact that we are not at the top of the heap in terms of economic performance in America.

We were 47th out of 50 states in job growth during the 1990s. We were 48th out of 50 states in population growth during the 1990s. And we led America in one statistic, a dubious one. We led America in the export of people age 25 to 30. We lost more young people than any other state in the union.

So we are moving from a baseline of very poor performance. And so, leveling the playing field is important, but eliminating some of these programs we think will be problematic.”⁵

FOOTNOTES

12. Existing Department of Community and Economic Development initiatives.

1. The Governor's charge of the Pennsylvania Business Tax Reform Commission, March 4, 2004
2. Testimony before the Pennsylvania Business Tax Reform Commission by Dennis Yablonsky, September 22, 2004.
3. General Economic Impact Considerations in Arriving at Recommendation

Certain businesses located within a Keystone Innovation Zone (KIZ) may claim a tax credit against Pennsylvania corporate net income tax, personal income tax, or capital stock and franchise tax.

The credit is equal to 50% of the increase in the KIZ company's gross revenues in the previous tax year based on activities in the KIZ over the KIZ company's gross revenues in the second preceding tax year attributable to its activities in the KIZ. Gross revenues may include grants received by the KIZ company from any source. A tax credit for a KIZ company may not exceed \$100,000 per year.

Unused KIZ tax credits may be carried forward for four tax years. Tax credits may not be carried back to a previous tax year, and taxpayers may not obtain a refund of unused credits.

A KIZ company may sell or assign all or a portion of a KIZ tax credit upon application to and approval by the Pennsylvania Department of Community and Economic Development.

4. Pennsylvania Revenue Tax Compendium
5. Testimony before the Pennsylvania Business Tax Reform Commission by Dennis Yablonsky, September 22, 2004

MAJOR RECOMMENDATION

13. Reduction of Pennsylvania Corporate Net Income Tax Rate

A. Current Pennsylvania Law – Tax Rate of 9.99%

A Corporate Net Income Tax (CNIT) rate reduction is a broad form of tax relief, as all companies that pay CNIT would benefit on a proportionate basis. Of the 142,140 C corporations expected to file CNIT returns in 2005, approximately 40,000 are expected to pay CNIT. If this option is adopted in conjunction with other alternatives (e.g., combined reporting, uncapping net losses, etc.), the estimated General Fund revenue loss would be offset by other revenue sources.

B. Reasons for Change

1. The Pennsylvania Corporate Net Income Tax statutory rate is not competitive in relation to other states corporate net income statutory rates.

State Corporate Net Income Tax Rates – Current Statutory Tax Rates

TABLE 1

<u>State</u>	<u>Highest Rate</u> <u>Corporate Net Income</u>	<u>Tax Rate</u>
Iowa	12.00	Graduated
North Dakota	10.50	Graduated
Pennsylvania	9.99	Flat
District of Columbia	9.975	Flat
Minnesota	9.80	Flat
Vermont	9.75	Graduated
Massachusetts	9.50	Flat
Alaska	9.40	Graduated
Rhode Island	9.00	Flat
West Virginia	9.00	Flat
New Jersey	9.00	Flat
Maine	8.93	Graduated
California	8.84	Flat
Delaware	8.70	Flat
Indiana	8.50	Flat
Ohio	8.50	Graduated
New Hampshire	8.50	Flat
Kentucky	8.25	Graduated
Louisiana	8.00	Graduated
Wisconsin	7.90	Flat
Nebraska	7.81	Graduated
New Mexico	7.60	Graduated
Idaho	7.60	Flat
Connecticut	7.50	Flat

New York	7.50	Flat
Illinois	7.30	Flat
Maryland	7.00	Flat
Arizona	6.968	Flat
North Carolina	6.90	Flat
Montana	6.75	Flat
Oregon	6.60	Flat
Tennessee	6.50	Flat
Alabama	6.50	Flat
Arkansas	6.50	Graduated
Hawaii	6.40	Graduated
Missouri	6.25	Flat
Oklahoma	6.00	Flat
Georgia	6.00	Flat
Virginia	6.00	Flat
Florida	5.50	Flat
South Carolina	5.00	Flat
Utah	5.00	Flat
Mississippi	5.00	Graduated
Colorado	4.63	Flat
Kansas	4.00	Flat

2. The statutory rate, as distinguished from the effective rate or the marginal rate, currently is at 9.99 percent, which is the third highest in the country.
3. Although the statutory rate is high, the effective tax rate is lower due to the narrow base of the tax. The effective rate is lower than the statutory rate because of the allowance of variance credits and deductions in arriving at Pennsylvania corporate taxable income.
4. Tax theorists customarily convert the statutory rates on taxable income to an effective rate based on economic income. The effective rate is the rate of tax paid on all income (which includes taxable and non-taxable income). Alternate definitions include: (1) the sum of current and deferred tax expenses under GAAP divided by the net income before taxes or (2) current tax expense divided by net income before taxes. Robert Tannewald has projected the effective state corporate profits tax rate by respective state. The effective corporate profits tax rate is defined as the state tax receipts divided by the state tax base. The tax effort is defined as the tax receipts divided by tax capacity. Tax effort is defined as the ratio of corporate profit and franchise tax collections to the state tax capacity. Tax capacity is an estimate of how much tax each state would have collected if they applied the average national tax rate to the estimated corporate profits. See the Multistate Tax Commission review, "Recent Trends in State Corporate Income Taxes" by Elliot Durbin, Director of Policy Research, Volume 2000, Number 1.

5. As stated in the testimony, it is estimated by one commentator that only 18 percent of the taxpayers subject to Pennsylvania corporate net income tax had Pennsylvania taxable corporate income.¹ The Pennsylvania Department of Revenue (PA DOR) estimated that only 36 percent of the corporations subject to the Pennsylvania corporate net income tax had Pennsylvania taxable income.
6. The current effective rate of state corporate net income taxes is slightly over 5 percent down from 9.6 percent in 1980 per Dan R. Bucks, Executive Director of the Multistate Tax Commission.²
7. Testimony presented by a number of commentators has indicated however, that the perception of the high statutory corporate net income tax rate coupled with the capital stock tax, puts Pennsylvania at a competitive disadvantage in attracting economic growth.³ Most tax policy experts agree that high marginal rates relative to the rest of the nation could put a state at a competitive disadvantage. A marginal tax rate is defined as the present value of current plus deferred income⁴ (both implicit and explicit) to be paid per dollar of additional taxable income (where taxable income is grossed up to include implicit taxes).
8. Some commentators testified, that the statutory rate itself may influence whether Pennsylvania is considered by a company selecting finalists for plant relocation or expansion.⁵
9. One North Carolina state tax policy group noted, however, a “stand-alone focus on “marginal rates” outside of the broader context of economic development and overall tax reform overstates the role of the corporate income tax in economic growth.”⁶

C. Discussion of the Recommendation

1. Testimony presented at the Commission meetings indicated the Pennsylvania Corporate Net Income Tax statutory rate should be reduced below the national median 7.5 percent statutory corporate net income tax rate. See testimony presented by Michael McCarthy, President of the Pennsylvania Business Roundtable.
2. a. Commission members stated their intent for a further rate reduction below 7.5 to 6.99 percent as a way to: attract new business to Pennsylvania and send existing businesses in Pennsylvania a clear message, that Pennsylvania is making a concerted effort to improve its business climate.
- b. Commission members discussed statutory rate reductions from 9.99 percent to 6 percent.

- c. Other Commission members were interested in reducing the statutory rate below a proposed rate of 6 percent.
- d. In accordance with the Charge of the Commission, a reduction to a rate of 6.99 percent from the existing 9.99 percent rate is suggested.

3. Other State Tax Commission Recommendations

The New Mexico Tax Commission recommended a rate reduction in conjunction with the Commission's recommendation to expand unitary taxation to all corporate businesses.

D. Evaluation of the Recommendation Under Established Criteria

- 1. A reduction in the statutory rate affects all taxpayers subject to the Pennsylvania corporate net income tax. The rate reduction provides business tax relief to all industries. The rate reduction was recommended as part of an integrated concept in conjunction with the uncapping of Pennsylvania net loss amounts for post combination years in arriving at Pennsylvania corporate taxable income.
- 2. The associated net loss in General Fund revenue as a result of the reduced rate is to be offset by an adoption of mandatory combined reporting and a 1% tax on pass through entities. See respective Tabs 17 and 18.
- 3. The recommendation for a 1% tax on pass through entities was only considered as an enabling provision to further reduce the Pennsylvania Corporate Net Income Tax rate to 6.99 percent.

E. Commission Members' Major Recommendation

Pennsylvania's Corporate Net Income (CNI) Tax rate is not competitive with other states. The Commonwealth's nominal tax rate of 9.99 percent, the third highest in the nation, discourages both new economic development and the retention of existing Pennsylvania businesses. The Commission believes the primary goal of business tax reform must be to reduce the CNI Tax rate from 9.99 percent to 6.99 percent. To achieve this goal, while mindful of the Executive Order's requirement of revenue neutrality with respect to business taxes, the Commission recommends a series of changes to Pennsylvania's business tax structure. This Final Report also includes recommendations to encourage economic development.

The Commission's recommendations, if adopted as a package, would be revenue neutral with a CNI Tax rate of 7.22 percent. For competitive reasons and to help offset the impact of other recommendations in its Final Report, however, the Commission recommends that the CNI Tax rate be lowered to 6.99 percent. Using a static estimate of revenue impact, the lower rate together with the other recommended changes would cost \$49 million. Reducing the corporate income tax rate to 7.22 percent would move Pennsylvania's rate from third highest among the states to 25th highest and lower than all but one of its neighboring states. The 6.99 percent rate would move Pennsylvania to 26th highest among the states and lower than all neighboring states.

F. Parameters Associated with the Recommendation

1. Assumptions

Each 1 percent drop in the Corporate Net Income Tax rate would reduce General Fund revenue by \$211 million.

2. Contingencies Impacting Fiscal Estimate

- a. The amount of \$211 million, cited above, was based on a static estimate prepared by the Pennsylvania Department of Revenue. See Tab 20H
- b. Additional contingencies impacting this fiscal estimate are as follows:
 - 1) Utilizing past apportionment data;
 - 2) Economic forecasts;
 - 3) Interaction of uncapping post-combination net operating loss deductions and providing for prior company separate Pennsylvania return losses subject to the existing \$2,000,000 limit;
 - 4) An increase in General Fund revenue associated with the recommendation to adopt combined reporting;
 - 5) Estimated aggregate additions and subtractions to arrive at Pennsylvania taxable income from respective Federal, line 28, amounts.

G. General Economic Impact Considerations in Arriving at Recommendation

1. Business Tax Burden

The Commissioners have reviewed a number of presentations by fiscal policy experts and various interest groups and believe that there will be a substantial benefit derived from the reduction of the statutory Pennsylvania corporate income tax rate and that this specific proposal would not have any burden placed on entities operating within the State of Pennsylvania.

2. Business Tax Climate

The intent of the corporate net income tax reduction is to enhance the tax climate and provide an economic stimulus, that is, to support existing Pennsylvania companies by enhancing their ability to retain profits within the companies and by demonstrating a favorable climate in order for the Commonwealth to attract new businesses and jobs. With the rate reduction, Pennsylvania's effective and marginal rates will still be lower than the statutory rate.

PA Business Tax Reform Commission Proposal

Comparison of Corporate Income Tax Rates

CNIT Rates - Tax Year 2004, as of January 1, 2004

PA rate at 6.99% per BTRC Proposal

State Rank By Maximum Rate	State	Corporate Income Tax Rates	
		Low	High
1	Iowa	6.00	12.00
2	North Dakota	3.00	10.50
3	Minnesota	9.80	9.80
4	Vermont	7.00	9.75
5	Massachusetts	9.50	9.50
6	Alaska	1.00	9.40
7	New Jersey	9.00	9.00
8	Rhode Island	9.00	9.00
9	West Virginia	9.00	9.00
10	Maine	3.50	8.93
11	California	8.84	8.84
12	Delaware	8.70	8.70
13	Indiana	8.50	8.50
14	New Hampshire	8.50	8.50
15	Ohio	5.10	8.50
16	Kentucky	4.00	8.25
17	Louisiana	4.00	8.00

18	Wisconsin	7.90	7.90
19	Nebraska	5.58	7.81
20	Idaho	7.60	7.60
21	New Mexico	4.80	7.60
22	Connecticut	7.50	7.50
23	New York	7.50	7.50
24	Illinois	7.30	7.30
25	Maryland	7.00	7.00
26	Pennsylvania	6.99	6.99
27	Arizona	6.97	6.97
28	North Carolina	6.90	6.90
29	Montana	6.75	6.75
30	Oregon	6.60	6.60
31	Alabama	6.50	6.50
32	Arkansas	1.00	6.50
33	Tennessee	6.50	6.50
34	Hawaii	4.40	6.40
35	Missouri	6.25	6.25
36	Georgia	6.00	6.00
37	Oklahoma	6.00	6.00
38	Virginia	6.00	6.00
39	Florida	5.50	5.50
40	Mississippi	3.00	5.00
41	South Carolina	5.00	5.00
42	Utah	5.00	5.00
43	Colorado	4.63	4.63
44	Kansas	4.00	4.00
45	Michigan	1.90	1.90

Notes:

Five states (Nevada, South Dakota, Texas, Washington, and Wyoming) do not have a CNIT.

This table compares statutory rates, but does not adjusted for different tax bases. For instance, Michigan has a low rate (1.9 percent) but a very broad base for its Single Business Tax.

State Corporate Net Income Tax Rates – Proposed Pennsylvania
Corporate Net Income Tax Rate of 6.99%
Comparison to Neighboring States.

TABLE 3

<u>State</u>	<u>Highest Rate</u>	<u>Tax Rate</u>
New Jersey	9.00	Flat
West Virginia	9.00	Flat
Delaware	8.70	Flat
Ohio	8.50	Graduated
New York	7.50	Flat
Maryland	7.00	Flat
Pennsylvania	6.99	Flat

H. Distributional Effect of the Proposal by Industry

For an extended discussion of the distributional effects of this proposal as part of the integrated recommendation, see Tab 21 D.

FOOTNOTES

13. Reduction of Pennsylvania Corporate Net Income Tax Rate

1. Testimony from PA-21 Project Team Presentation: April 20, 2004.

 Presentation by PA21 - Comments by William George. "Also the 9.99% is really -- I know people talk about it being the highest in the country, but the fact of the matter is that the CNIT for those who fit in the category to pay CNIT, we only see about 18 percent of those companies paying anything on the CNIT in the state of Pennsylvania."
 2. See "Ohio Vanishing Corporate Franchise Tax – Policy Matter Ohio by Zach Schiller.
 3. See BTC Report, W.C. Budget and Tax Center, February, 2004.
 4. Presentation by Michael McCarthy of the Pennsylvania Business Roundtable.
 5. Presentation by Dough Lindholm of the Council on State Taxation (COST) and Presentation by Lawrence A. Cusack of KPMG Strategic Relocation and Expansion Services.
 6. See North Carolina Budget and Tax Center, Volume 10, Number 1, February, 2004.
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MAJOR RECOMMENDATION

14. Modification of Existing Pennsylvania Net Operating Loss Provisions

A. Current Pennsylvania Law – Annual \$2,000,000 Limit on Use of Net Operating Loss Carryover

While the federal net operating loss deduction authorized by the Internal Revenue Code, Section 172, is not allowed, Pennsylvania provides for its own computation of a net loss deduction to be taken from Pennsylvania taxable income.¹ For tax years after 1998, the net loss deduction is the lesser of the amount of the loss that may be carried over, taxable income, or \$2,000,000. For tax years after 1997, Pennsylvania net losses may be carried forward for 20 years. Previously, net losses could be carried over for 10 years.² Net losses may not be carried back in Pennsylvania as a deduction to a prior tax year. Pennsylvania net loss carryover rules do not apply to capital losses.³ A taxpayer cannot carryover the consolidated capital losses to a separate Pennsylvania return.⁴ The surviving corporation in a merger can use the net loss carryover deduction of the surviving corporation if the loss would have survived for federal purposes.

B. Reasons for Change

The inability to fully utilize a Pennsylvania net loss or losses is a competitive disadvantage in attracting and maintaining business in the Commonwealth:

1. Pennsylvania is one of a few states that cap net losses.
2. Based on the current annual Pennsylvania \$2,000,000 cap on the use of a Pennsylvania net loss carryover, a taxpayer's net loss carryover amounts can expire. Currently, the maximum amount of net loss carryover amounts for 1998 and thereafter is \$40,000,000 (20 years at \$2,000,000) regardless of the amount of the actual loss. Losses carried forward from 1995 through 1997 were allowed to be carried forward for ten years. As a historical note, for tax years 1996 through 1998, there was a \$1,000,000 net operating loss cap.
3. Carryover apportioned Pennsylvania losses are only allowed against the annual cap on a historical basis.
4. The carryover amount of the net loss is determined for the loss after apportionment and applied in the carryforward year to final taxable income after apportionment.

5. Removing the corporate net income tax net loss cap would reduce horizontal equity with regard to the treatment of net operating losses between those subject to corporate net income taxes and noncorporate business taxpayers by providing corporate net income taxpayers an unlimited twenty year carryforward while noncorporate business taxpayers receive no benefit.
6. The Commission believes that the practice of limiting the use of net operating losses is bad policy as it creates an inaccurate and artificially high effective income tax rate and impacts Pennsylvania's competitive status.

C. Discussion of the Recommendation

1. Testimony Presented at the Commission Meetings

All states that impose a corporate net income tax, including Pennsylvania, allow a deduction for net losses incurred in prior years but not yet used to offset taxable income. However, by limiting the deduction to \$2,000,000 per year, Pennsylvania is among only a few states that cap the amount of the net losses that can offset the taxable income of future years.⁵ The amount of the net loss carryover not deductible is carried over for a period up to 20 years, after which the balance is permanently lost.

Besides Pennsylvania, among the states and the District of Columbia with a corporate net income tax, only New Hampshire and California cap the NOL carryover deduction. The carryover amount for a NOL incurred in 2002 is limited to \$250,000 in New Hampshire and generally 60 percent of the NOL in California. Presently, New Jersey has temporarily suspended the use of net operating losses in order to help resolve its fiscal crisis.

2. Comments by the Commission Members

- a. Commission members recommend that any change to combined reporting should allow for the full use of postcombination net operating losses.
- b. Commission members also indicated that precombination net operating loss deduction carryover amounts should also be available for taxpayers subject to the existing \$2,000,000 annual cap.

- c. Commission members recommended the uncapping of post-combination net operating losses in the context of the Commission's recommendation to adopt mandatory combined reporting and the reduction in the Pennsylvania corporate net income tax rate from 9.99 percent to 6.99 percent.
 - d. The determination of postcombination net operating loss deductions do not provide for net operating loss carrybacks.
- 3. Other State Tax Commission Recommendations - none applicable relating to this recommendation.

D. Evaluation of the Recommendation Under Established Criteria

1. As discussed above, the uncapping of the Pennsylvania post combination net loss deductions is recommended by the Commission in conjunction with the adoption of mandatory combined reporting.
2.
 - a. The reconciliation from the federal consolidated returns with the utilization of federal net operating losses to Pennsylvania net losses will impact corporate business recordkeeping. Taxpayers will have to separately track and distinguish Pennsylvania unitary losses in the determination and utilization of postcombination net loss amounts.
 - b. The federal consolidated return regulations provide for separate federal rules which incorporate the use of a “separate return limitation for losses, referred to as SRLY, incurred by the separate member before joining the federal consolidated return.” These rules are referred to as SRLY rules.⁶

Losses of the parent corporation, in a consolidated return, however, are allowed without a SRLY against the losses of all members of the group. This is referred to, for federal income tax purposes, as the “lonely parent rule.”

- c. Federal consolidated taxable income is generally computed by offsetting the income with losses of members of the federal consolidated group.
 - d. There are additional federal consolidated return regulations dealing with the allocation of consolidated federal net operating loss amounts when a separate member leaves a federal consolidated return group.
3. Federal consolidated net operating losses are based on a direct or indirect 80 percent ownership of affiliates. Consequently, federal consolidated losses will vary in amount from unitary losses for taxpayers, as a result of the following:
 - a. Differences in members of a Pennsylvania unitary group versus a consolidated group;
 - b. The nonapplication of the federal “lonely parent rule” in determining Pennsylvania precombined losses;
 - c. Different carryover limitation utilization for Section 382 relating to pre-combination net losses;

- d. Application of Federal Separate Return Limitation Year (SRLY) provisions on precombined losses.
- 4. In contrast to a Federal consolidated return, a unitary group control definition is based on less than 80 percent, typically more than 50 percent actual or constructive ownership. Assuming the unitary group's constructive ownership rules do not conform to federal rules, additional differences can arise. A possible consideration in defining control of the unitary group is to define ownership (direct and indirect) by conforming the definition with Section 382 of the Federal Internal Revenue Code.
- 5. The utilization of Pennsylvania postcombination net losses could involve possible distortions or abuses which may arise in a transition period up to the adoption of combined reporting in Pennsylvania.
- 6. The Multistate Tax Commission has recently summarized salient combined reporting issues which include the utilization of net operating losses by a unitary group. See Combined Reporting Issues List for MTC Income and Franchise Tax Uniformity Subcommittee.⁷ The issues identified by the MTC are as follows:

“Special Rules, Limitations and Carryovers

- a. How are net operating loss carryovers determined?
 - 1) Is there a unitary group carryover, or a post-apportioned carryover specific to each member?
 - 2) If the group method is used, what happens to the carryover if some of the members leave the group? Is the loss allocated based on the separate accounting contribution of the member creating the loss, or is there some other allocation of loss?
 - 3) What happens if a member joins the group with a net operating loss? Is the net operating loss limited to that member or can it be shared with other new members?”
- 7. a. Currently, Pennsylvania has adopted certain Federal income tax rules involving the limitation on the use of net losses after a change in ownership. As discussed above, the Pennsylvania Department of Revenue's position is that the surviving corporation in a merger can use the loss carryover deduction of the surviving corporation if the loss would have survived for Federal income tax purposes.

- b. The Pennsylvania regulation for determining net loss deductions specifically incorporated the Federal reference to Internal Revenue Code Sections 381, 382 and 269. Section 381 is a carryover of tax attributes provision. Section 382 is a loss limitation provision. Section 269 is a loss disallowance provision. Pennsylvania law specifically incorporates, by reference, the federal provisions dealing with the succession of tax attributes in Section 401(4)(g).
- c. The Pennsylvania regulation Sec. 153.15 Net Loss Deduction provides in part. "*Change in ownership*."⁸ Under Section 401(3)(g) of the TRC, in the case of a change in the ownership of a corporation effected in a manner described in Sections 381 or 382 of the IRC (26 U.S.C.A. §§381 or 382), certain limitations provided the IRC with respect to the use of net operating losses after a change in ownership shall apply for the purposes of computing the portion of the net loss available for carryover as a deduction against income subject to the corporate net income tax, whether the change is effected by purchase, liquidation, acquisition of stock or reorganization. The applicable limitations include limitations imposed by the IRC solely on account of a change in ownership, including but not limited to, Sections 269, 318 (insofar as it defines the scope of Section 382 of the IRC (26 U.S.C.A. §382)), 381 and 382 of the IRC (26 U.S.C.A. §§269, 318, 381 and 382). The carryover of net losses is not limited by the Federal consolidated return regulations."
- d. Code Sec. 382 limitation - Under Federal Internal Revenue Code Sec. 382, if an ownership change occurs with respect to a loss corporation, the amount of the prechange loss that can be offset against future income is limited.⁹ This limitation with respect to net losses also applies for the purpose of computing the portion of a net loss carryover for Pennsylvania corporate net income tax purposes.
- e. Under the Minnesota model, the loss limitation rules are similarly applied. "The determination of whether an ownership change has occurred is made under the federal limitation provision. If an ownership change occurs, a Sec. 382 limitation applies to all Minnesota losses that occurred prior to a change in ownership and are carried over to a postchange year. The IRC Sec. 382 limitation restricts the amount of NOLs from prechange years that can be applied to the income in a postchange year. Specifically, in a post-change year, the amount of Minnesota net income used to determine the NOL deduction, with regard to prechange losses, is limited to the IRC Sec. 382 limitation determined for that year. The IRC Sec. 382 limitation amount generally equals the value of

the stock of the loss corporation immediately before the ownership change multiplied by a prescribed percentage rate described in IRC Sec. 382 as the long-term tax exempt rate. This limitation on net income is then multiplied by the post-change year's apportionment percentage to determine the limited amount of apportioned taxable net income that is eligible for a NOL deduction for those losses being carried forward from prechange years. If there is an unused IRC Sec. 382 limitation amount for Minnesota corporate franchise (income) tax purposes in a postchange year, the following year's limitation will be increased by the excess amounts determined for Minnesota tax purposes in a manner similar to IRC Sec. 382(b)(2).”

f. Section 269(b) provides for the disallowance of loss if the acquisitions were made to evade or avoid income . Internal Revenue Code Sec. 269(a) specifies two instances in which deductions, credit, carryovers or other allowances may be disallowed:

- 1) when a person acquires control of a corporation, and
- 2) when a corporation acquires assets of another corporation, which was not controlled immediately prior to the transactions by the acquiring corporation of its shareholders.

In each instance, the principle purpose of the acquisition must be the avoidance of income tax. In addition, Code Section 269(b) specifically addresses the disallowance of deductions, credits, carryovers and other items when a liquidating corporation has been acquired by qualified stock purchase.

As discussed above, IRC Section 269 is referenced in Pennsylvania Reg. Sec. 153.15.

8. Capital Losses

For Pennsylvania corporate net income tax purposes, the capital loss of a corporation on a separate company basis may have been lost on a federal consolidated return because it was used to offset capital gains sustained by affiliates. For federal income tax purposes a corporation may carry back a capital loss to each of the three tax years preceding the loss year. Any excess may be carried forward for five years. See IRC Section 1212(a)(1).

As constituted, Pennsylvania net loss rules do not apply to capital losses. The rules apply only to business and nonbusiness losses

arising from the operation of a trade or business. Adoption of combined reporting will encompass the utilization of capital losses against capital gain of other unitary members. This should be considered in the static revenue estimate. PA DOR should also examine other ramifications on the use of capital losses. Minnesota's position on capital losses is included for reference.

E. Commission Members' Major Recommendation

1. The Commission believes that Pennsylvania's current \$2 million annual cap on the use of net operating losses (NOL) discourages economic development and conflicts with other state policy and funding initiatives that encourage technology-based start-ups such as biotechnology companies. If mandatory unitary combined reporting is adopted for the CNI Tax, the Commission recommends that the cap be lifted on the use of post-combination Pennsylvania NOLs. The Commission recommends that the NOL carry forward period should be the same as the federal income tax NOL carry forward period. In order to limit revenue losses, the Commission recommends that NOLs accrued prior to combined reporting remain subject to the \$2 million annual cap and should be computed and applied on a separate company basis.
2. Pennsylvania separate company precombination net loss deduction carryover amounts will carryover to postcombination periods subject to the existing \$2,000,000 annual net loss cap per loss entity. The Pennsylvania precombination loss deduction carryover amounts will be utilized only by that separate member who is part of the unitary group in offsetting the separate member future contribution to Pennsylvania taxable income of the unitary group. Utilization of precombination losses will be determined on a separate company reporting basis. The Commission recommends that the Pennsylvania Department of Revenue draft proposed procedural rules relating to the allocation of Pennsylvania net losses when a member leaves a unitary group.

F. Parameters Associated with the Recommendation

The Pennsylvania Department of Revenue has limited historical data to determine the General Fund impact of uncapping estimated Pennsylvania postcombination net operating loss amounts. Estimates of the effect of uncapped NOLs on a combined group's income tax have been prepared using a three-year period of Minnesota combined income tax returns.

A static revenue estimate was prepared based on a number of contingencies impacting the fiscal estimate. The data suggests that the treatment of precombination NOLs on postcombination tax returns can have a marked effect on the revenue estimate. It is assumed for computation purposes, In the first years after combination is introduced, taxpayers have generally higher net income to report, and can therefore use more of the precombination losses postponed from previous years computed on a separate company basis. In addition, the use of uncapped losses from combined returns further reduces taxable income. The result is a "bubble" of NOL revenue losses lasting until the precombination NOLs expire. The Department has assumed that precombination loss carryovers are limited to a maximum of 20 years for Pennsylvania losses incurred in tax years after 1997, to avoid a higher tax rate in the first few years after combination.

The contingencies impacting the fiscal estimate are as follows:

1. The associated Federal income tax considerations outlined above;
2. The definition of the unitary group as it relates to control; and/or other subjective factors, if adopted;
3. The provision of certain Pennsylvania anti-abuse provisions to prevent an inappropriate use by taxpayers of other taxpayer's net operating losses in a transition period up to the filing of returns on a combined basis. Taxpayers may assert that a company or companies with separate company net losses are part of a unitary group when in substance they are not part of a unitary group;
4. The estimated utilization rate of existing Pennsylvania pre-combination net loss deduction carryover amounts included in computing Pennsylvania postcombined reporting income or loss;
5. Further revenue analysis on the projected static estimate of post-combination net loss amounts on the General Fund. The variables associated with this analysis will be predicated on an assumed set of

rules or assumptions in defining a unitary group. See discussion on Major Recommendations – Mandatory Combined Reporting.

6. Assumptions

Pennsylvania law specifically incorporates, by reference, the federal provisions dealing with succession of tax attributes. (Sec. 401(4)(g), Act of March 4, 1971, P.L. 6; ¶100-651; Req. Sec. 153.15, ¶14-551.)

The Department has estimated the revenue effects of combined reporting under several different scenarios for net loss deductions. The baseline scenario assumes that each member of a combined group would be permitted to use up to \$2,000,000 of pre-combination net loss carry-ins for up to 20 years for net operating losses incurred in tax years after 1997, and that post-combination losses would be uncapped. Any pre 1998 NOL carryovers will be utilized under existing statutory rules.

Other options considered but not recommended, include the following:

- a. Disallow precombination losses carried into combined returns;
- b. No cap on precombination losses carried into combined returns;
- c. Cap the postcombination deduction at \$20 million.

For all scenarios, net loss carry-ins could only be used by the taxpayer associated with the net loss on a separate-company basis, that is, the net loss carry-ins could not be shared with other members of the same combined group.

7. Contingencies Impacting Static Revenue Estimate

Although the Department is able to estimate the revenue effects of changing the net loss rules for net losses carried in by corporations currently subject to CNIT, taxpayer data is limited regarding the revenue effects of changing the Pennsylvania net loss rules going forward (e.g., uncapping net losses incurred by the combined group for use against future income). Therefore, the potential revenue effects of such options carry significant uncertainty.

G. General Economic Impact Considerations in Arriving at Recommendation

1. Business Tax Burden

Those companies that operate within the Commonwealth should receive a substantial benefit due to liberalization of the rules. The purpose of the recommended modification of the net operating loss rules is to enhance the business climate within the Commonwealth.

2. Business Tax Climate

The modification of the rules of net operating losses should improve the business climate and may attract quality companies to select Pennsylvania for new ventures. This factor is crucial, especially in light of the reality that most new entities suffer losses in their early stages. The utilization of these losses will reduce the tax burden on these companies as they grow and therefore make Pennsylvania an attractive location for these new entities.

H. Distributional Effect of the Proposal by Industry:

For distributional effect by industry of the uncapping of post combination net operating losses see Tab 20F.

For an extended discussion of the distributional effects of this proposal as part of the integrated recommendation, see Tab 21D

FOOTNOTES

14. Modification of Existing Pennsylvania Net Operating Loss Provisions

1. The federal net operating loss deduction authorized by IRC Sec. 172 is not allowed in Pennsylvania. However, a net loss deduction is available. For tax years after 1998, the net loss deduction is the lesser of:
 - \$2 Million
 - The amount of the net loss or losses that may be carried over to the taxable year; or
 - Taxable income
2. For tax years after 1997, Pennsylvania net losses may be carried forward for 20 years. Previously, net losses could be carried over for 10 years. (Sec. 401(3)(c)(1), Act of March 4, 1972, P.L. 6 [72 P.S. §7401(3)(c)(1)]. Net losses may not be carried back in Pennsylvania as a deduction to a prior tax year.
3. Pennsylvania net loss carryover rules do not apply to capital losses. They apply only to business and nonbusiness losses arising from the operation of a trade or business.
4. For a corporation ineligible to allocate or apportion its income, a “net loss” is defined as the negative amount for a taxable year arrived at under [72 P.S. §7401(3)(1)]. For a corporation eligible to allocate or apportion its income, the “net loss” is the negative amount for a taxable year arrived at under [72 P.S. §7401(3)(2)]. Negative amounts must be allocated and apportioned in the same manner as positive amounts. (Reg. Sec. 153.15).
5. Testimony Presented at Commission Meetings: Brian Kennedy, Public Policy Director for the Pittsburgh Technology Council – April 20, 2004
 - a. “Pennsylvania is one of only two states that, in fact, has a cap on net operating losses, and this is a significant deterrent, especially for R and D in the pharmaceutical industry or in the information technology industry, like we have in Pittsburgh.

From our perspective -- and we represent a number of manufacturers that basically are cyclical industries that are beyond their start-up phase, the net operating loss provisions are harmful to them as well, especially, as you know, Pennsylvania's manufacturers, quite a few of them, have lost.”

“If the cover doesn't look good, you don't open it. I think that's one of the problems you deal with in Pennsylvania. The question is, will you not make the first cut? I think that's one of the issues. In terms, generally, it is the cost of doing business. I think a lot of decisions are made - sometimes decisions are, frankly, are not made at the top level. I'm sure you all know people in mid-level positions who are given responsibilities to make recommendations; and, frankly, they are being judged on how they provide lowering of costs, or what have you.”
6. The SRLY rules limit a member's SRLY losses based on the member's contribution to consolidated taxable income. The member's contribution to consolidated taxable income is measured cumulatively over the entire period during which the corporation is a member of the group. Therefore, even though a member does not contribute to consolidated taxable income, the member's SRLY losses may still be absorbed in a consolidated return year, but only to the extent of the member's cumulative net contribution to consolidated taxable income in prior consolidated return years of the group. Conversely, in a tax year in which the member contributes income to consolidated taxable income, the member's SRLY losses may be absorbed in a consolidated return year only to the extent the member's contribution exceeds its cumulative consolidated net operating loss (if any) sustained in prior consolidated return years of the group.

The member's contribution to consolidated taxable income is determined by taking into account only the member's items of income, gain, deduction, and loss, instead of by comparing consolidated taxable income with and without the member's items. In making this determination, a member's built-in deductions are taken into account in the year recognized only if they are allowed after application of the SRLY limitation. See Internal Revenue Regulation Section 1.1502-21 and Commerce Clearinghouse Explanation 2004 Fed. ¶33,168,0508.
7. Options for dealing with current NOL carryover amounts within a combined reporting system include:
 - a. Disallow all NOL carryover amounts generated under the old separate entity reporting regime.
 - b. Require corporations to recalculate their NOL carryovers to the amounts that would be available if they were created under a combined reporting regime.
 - c. Allow NOLs created under a separate entity reporting regime to be used only by the member of a combined group to which the NOL is attributable.
 - d. Allow the combined group to pool all of the separate entity NOLs generated as separate entities and make them available for use by the entire group under combined reporting.
8. Definition of Ownership Change. In general, an ownership change involves an increase of more than 50 percentage points in stock ownership by five-percent shareholders during the testing period (usually the three-year period ending on that date on which a loss corporation must make a determination whether it has had an ownership change).

9. Computation of Section 382 Limitation. The Code Sec. 382 limitation for a tax year of a loss corporation after an ownership change is generally equal to the fair market value of the corporation's stock immediately before the ownership change multiplied by the long-term tax-exempt rate. This limitation for a tax year may be increased by certain items, such as unused limitation for a prior tax year and certain built-in gains recognized during the tax year (see Code Sec. 382(b)(2) and Code Sec. 382(h)).

MAJOR RECOMMENDATIONS OF THE COMMISSION

15. Single Sales Factor Apportionment

A. Current Pennsylvania Law – 60 percent Factor

1. For purposes of calculating their CNI Tax, multistate corporations doing business in Pennsylvania estimate how much of their business income is related to economic activities in Pennsylvania. This is done using an apportionment formula based on a weighted average of a company's sales, tangible property and payroll in Pennsylvania. The current formula weighs these factors 60 percent, 20 percent and 20 percent, respectively.
2. The apportionment formula is designed to measure the economic activities in Pennsylvania that produce business income in the state. The payroll and property factors measure the use of labor and property located in the state. For products, the sales factor measures the taxpayer's market within the state, and for services it measures their cost.
3. The single sales factor apportions a corporation's total business income by using sales alone instead of Pennsylvania's current combination of sales, property and payroll. In effect, the single-sales factor formula reflects the policy decision that only the in-state sales of the taxpayer should determine the economic activities producing business income in Pennsylvania. Generally, multistate corporations with little in-state property or payroll investment relative to in-state sales will see their income taxes increase and multistate corporations with substantial state investments will see their taxes decrease. Under this approach, a corporation may create jobs and thus increase its Pennsylvania property and payroll without raising its Pennsylvania CNI apportionment factor and CNI tax.

B. Reasons for Change

The primary rationale for the change is to provide an incentive for increasing in-state employment and capital investment, while reducing the tax liability for corporations that have significant property and payroll in the state. The single sales factor apportions a corporation's total business income by using sales alone. In effect, the single-sales factor formula reflects the policy decision that only the in-state sales of the taxpayer should determine the economic activities producing taxable business income in Pennsylvania. Generally, multistate corporations with little in-state property or payroll investment relative to in-state sales will see their

income taxes increase and multi-state corporations with substantial in-state investments will see their taxes decrease. Under this approach, corporate expansions in Pennsylvania are encouraged because a corporation may increase its Pennsylvania property and payroll without raising its Pennsylvania CNI apportionment factor and CNI tax.

C. Discussion of the Recommendation

1. Testimony Presented at the Commission Meetings

The primary rationale for higher weights on the sales factor is to provide an incentive for increasing in-state employment and capital investment, while shifting a larger share of corporate taxes to out-of-state taxpayers. Apportioning income based solely on sales and static estimations, produces a modest net reduction in total corporate tax revenues.

Three corporate representatives presented testimony advocating the additional weighting of the sales factor.¹ The respective representative's testimony is included in the report.

2. Comments by the Commission Members

Some commissioners have advocated the adoption of a 100 percent single sales factor. Other Commission members support increasing the weighting of the sales factor in conjunction with the adoption of mandatory combined reporting.

3. Other State Tax Commission Recommendations – None Presented

D. Evaluation of the Recommendation Under Established Criteria

1. Out-of-state corporations with a significant amount of product sales in the Pennsylvania market place but with little or no property or payroll in the Commonwealth would have more of their income apportioned to Pennsylvania and therefore pay higher CNI taxes in Pennsylvania. As a result, more of the tax burden would be shifted to out-of-state companies that do not hire Pennsylvanians, but use them as customers.
2. Corporations with a higher percentage of property and payroll in the Commonwealth would have less taxable income apportioned to Pennsylvania and therefore pay lower CNI taxes in Pennsylvania. Lowering the effective tax rates of Pennsylvania corporate employers and capital investors would lower the tax cost of operating in Pennsylvania. This change is expected to have a positive impact on Pennsylvania's business tax competitiveness.

E. Commission Members' Major Recommendation

To lessen the impact of mandatory unitary combined reporting, the Commission recommends that the weighting of the sales factor of the CNI tax apportionment formula should be adjusted from the present 60 percent to 100 percent. The Commission believes that this change will encourage all employers, including manufacturers, to locate or expand in Pennsylvania. This apportionment method acts as an economic stimulus by not penalizing employers through higher taxes for creating jobs and expanding their physical presence in Pennsylvania.

The Commission also recommends that the CNI apportionment formula use market-based sourcing for the sale of services. Market-based sourcing would source sales of services in the same manner as sales of tangible property, thereby leveling the playing field and encouraging growth in service-related industries.

F. Parameters Associated with the Recommendation

1. Assumptions

The net effect is expected to be an increase in business development.

2. Contingencies Impacting Fiscal Estimate

The Pennsylvania Department of Revenue prepared a report that detailed the fiscal impact in adopting an additional weighting of the sales factor to 75 percent, or 90 percent or 100 percent sales factor.²

G. General Economic Impact Considerations in Arriving at Recommendation

1. Business Tax Burden

Corporations with a higher Pennsylvania share of payroll and property would generally see their CNI taxes reduced relative to corporations with a lower Pennsylvania share of payroll and property. Firms holding property and employing personnel in Pennsylvania are more likely to utilize state and local services than those conducting only sales operations. Thus, the change to a 100 percent sales factor runs counter to the benefit principle. However, the increased property and payroll taxes should help support the additional benefit.

Competitors with similar product sales in Pennsylvania proportionally would incur more of the CNI tax burden. On the other hand, competitors with similar levels of employment and property holdings

would incur proportionally less CNI tax burdens if their product sales in Pennsylvania were different.

2. Business Tax Climate

Corporations could increase their Pennsylvania payroll and property investments in Pennsylvania without incurring an increase in their CNI Tax. Removing the current increase in CNI taxes from increasing production activities in Pennsylvania would improve Pennsylvania's competitive position and support economic policies designed to retain and expand in-state jobs and investment.

Increasing the weighting of the sales factor encourages corporations to export their products out of the state. Increasing exports has long been a goal of economic development strategies in Pennsylvania and other states. The greater the proportion of export sales to total sales, the lower the apportionment of tax burden to Pennsylvania. However, some studies argue that a single-sales factor may actually create an incentive for a corporation to locate outside the state and avoid nexus.

Eliminating two of three factors currently used in the apportionment formula will simplify the CNI tax. Eliminating the need to account for and determine the location of the property and payroll factors would achieve both efficiency and administrative objectives. While this could be said for eliminating any of the three factors from the formula, complexity and uncertainty is common for multistate companies which, under the current formula, must seek to reconcile state unemployment or personal income tax withholding records (in-state payroll) to total payroll, and to account for states' varying measures of property value and location.

H. Distributional Effect of the Proposal by Industry

The Pennsylvania Department of Revenue prepared an analysis by industry of the effect of adopting an additional weighting of the sales factor. The analysis was prepared on a separate company reporting. According to the Department's analysis, "based on separate company reporting, generally, the single-sales factor proposal has the overall effect of reducing CNIT revenue by \$64 million for tax year 2000. About 10,000 corporations will pay more CNIT, while about 5,500 affected corporations pay less CNIT. The switch to a single- sales factor formula has no effect on the 90,000 corporations doing business only in Pennsylvania. Because the single-sales factor results in a net revenue decrease, Pennsylvania-only companies would pay a greater share of total CNIT revenues. Manufacturers, companies with a capital stock value greater than \$10 million, and companies with significant physical presence

in Pennsylvania tend to have the biggest tax benefit from the single-sales factor.”

The Pennsylvania Department of Revenue also prepared an analysis, in conjunction with combined reporting, with the effect of a 100% single-sales factor, see Tab 20E.

For an extended discussion of the distributional effect of this proposal, as part of the integrated recommendation, see Tab 21D.

The Department recommends that any proposal to increase the weight of the sales factor should be made in conjunction with statutory changes to strengthen the definition of the sales factor. Under current law, there are significant problems associated with the definition, including the sourcing of intangibles and services. Pennsylvania law has a clear market state sourcing rule for sales of tangible personal property.

This rule creates a compliance burden for taxpayers and an administrative burden for the Department. In addition, it has enabled taxpayers to make claims about the proper interpretation of this rule. If a single-sales factor for apportionment purposes were to be adopted, this rule may result in taxpayers paying no tax to Pennsylvania although Pennsylvania is a market state and these taxpayers have Pennsylvania property and payroll.

FOOTNOTES

15. Single Sales Factor Apportionment

1. Testimony of Mr. David Green of Air Products and Chemicals, Inc.; Mr. Anthony Chirico of York International Corp.; and Mr. Thomas Bowen, Esquire of Stevens and Lee on the Single Sales Factor to the Pennsylvania Business Tax Reform Commission on September 22, 2004
 2. Testimony of Amy Gill of the Pennsylvania Department of Revenue Research Department on the Single Sales Factor presented to the Pennsylvania Business Tax Reform Commission on September 1, 2004, including "Overview of the Single Sales Factor" and "The revenue effects of a single sales factor apportionment formula."
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MAJOR RECOMMENDATIONS OF THE COMMISSION

16. Market Base Service Apportionment

A. Current Pennsylvania Law- Pass-Through Taxation

This section is compiled from the Pennsylvania 21st Century Tax Project (PA-21). The Pennsylvania Department of Revenue analyzed the fiscal impact and determined that changing to market based sourcing would be revenue neutral.

“For purposes of calculating their CNI tax, corporations doing business in Pennsylvania and at least one other state generally are required to estimate how much of their business income is associated with their Pennsylvania operations. This is done using an apportionment formula that weighs, in part, the proportion of sales assigned to Pennsylvania. Like most states, Pennsylvania assigns sales of particular services to the state in which the largest share of the costs were incurred to produce the service. This contrasts with the sales factor for the sale of tangible personal property that assigns sales to each state where the output is delivered.”¹

A copy of the Pennsylvania 21st Century Tax Project (PA-21) report is included in the testimony presented on April 20, 2004.

B. Reasons for Change

“Assign sales of services based on destination (customer location) in computing the Pennsylvania CNI apportionment formula. This will result in the same assignment rule for sales of both services and tangible personal property.”

C. Discussion of Alternatives to the Recommendation

1. Testimony was presented by the PA 21 Project team²
2. Some Commission members commented that this proposal could attract financial service firms that are currently involved in interstate commerce.
3. Other State Commission Recommendations - Not Applicable.

D. Evaluation of the Recommendation Under Established Criteria

Under the current approach, when an income-producing activity is performed in more than one state, all of the sales are attributed to the state in which a greater proportion of the income-producing activity is performed, based on the costs of producing the services (i.e., the state where most of the costs in producing the service were incurred is attributed to 100 percent of the sales). It is essentially an "all or nothing" proposition with only one state being assigned all of the sales.

In contrast, the destination-sales approach or customer location approach assigns the service sales to the state where the customer is actually physically located or to the marketplace to which the services are "delivered."

E. The Commission's Major Recommendations

The Commission recommends market based sourcing for sales of services in conjunction with its other recommendations.

F. Parameters Associated with the Recommendation

The Department is unable to present a detailed analysis of the effect of the proposal due to the fact that many cases with service-sourcing issues are resolved at the tax appeal level, outside of the normal process for reviewing returns. Based on a review of significant cases with this issue, the Department has determined that the proposal is revenue neutral.

Product providers and sales providers would be treated more equitably. A destination rule attributes sales of a multistate corporation to market states. In contrast, the greater cost of performance rule assigns sales to the state of its principal operations while assigning none to the market state for the corporation's services. While the greater cost of performance rule was defended at the time it was drafted as "the best that could be designed to cover the greatest number of situations that might arise," it has been the object of increasing criticism. Treating service providers consistently with goods producers would adopt a uniform treatment of sales for both goods and services and advance horizontal equity and tax neutrality.

G. General Economic Impact Considerations in Arriving at the Recommendation:

The general economic impact considerations in arriving at this recommendation are included in the PA 21 analysis of its recommendation. As stated above, the Pennsylvania Department of Revenue has determined that the proposal is revenue neutral. The increased tax from some companies is offset by decreased tax from other

companies. The PA-21 project estimates this as a loss of \$42 million dollars.

- ”1. Out-of-state corporations that perform most of their services for Pennsylvania clients out of state would have more of their income apportioned to Pennsylvania. Exportability is achieved by shifting more tax burden to firms selling services into the state.
2. Corporations that perform most of their services for multistate clients in Pennsylvania would have less taxable income apportioned to Pennsylvania. Lowering the effective tax rates of Pennsylvania corporations exporting services to other states would lower the tax cost of operating services in Pennsylvania. This change is expected to have a positive impact on Pennsylvania's business tax competitiveness.

This can be said about single-sales factor, but not market sourcing. The sales factor is supposed to represent the destination of sales, not where the cost of performance occurs. The benefit principle is violated only if the payroll and property factors are eliminated.

3. Competitors performing their services outside of Pennsylvania with similar volumes of services in Pennsylvania would incur more proportionally similar CNI tax burdens as corporations performing their services in Pennsylvania. Whether adopting a destination approach increases or decreases horizontal equity, depends on one's view of what is the correct measure or "norm" for determining if corporations are in the same economic situation. To the extent that the location of the customer is the measure of similarity, the destination approach increases horizontal equity. To the extent that the location of the service provider is the measure of similarity, then moving to a destination approach reduces horizontal equity.
4. Corporations could increase their service operations in Pennsylvania without incurring an increase in their CNI sales factor. Lessening the current tax increase in CNI taxes from increasing service activities in Pennsylvania would improve Pennsylvania's competitive position and support economic policies designed to retain and expand in-state jobs and investment. However, at this time we have no evidence of how many new jobs, if any, would be created in Pennsylvania as a result of this tax change.
5. Generally, it would provide a clearer rule, potentially reducing administrative costs for both service corporations and the Department of Revenue. The cost of performance rule has been criticized because it can be difficult to determine the costs-of-performance measure to be used and the state of activity. On the other hand, the history of the

market state rule by manufacturers "for the most part ... provides a workable, definite standard ...avoiding state tax controversies." However, because services, unlike products, are intangible, a destination rule will not necessarily eliminate ambiguity in assigning sales, particularly where a service benefits multiple locations (states) of the customer."

FOOTNOTES

16. Market Base Service Apportionment

1. Testimony presented by the PA-21 Project Team on April 20, 2004.
2. Testimony presented by the PA-21 Project Team on April 20, 2004.

MAJOR RECOMMENDATION

17. Mandatory Combined Reporting

A. Current Pennsylvania Law – Separate Company Reporting

Pennsylvania requires corporations to file tax reports on a separate company basis. Corporations that are part of an affiliated group for Federal purposes are required to file "separate company" Pennsylvania returns even though their income may have been reported to the Federal Government in a consolidated return of affiliated corporations. Thus, the taxable income and capital stock value of the corporation is computed on a stand-alone separate company basis even though the corporation participates in a consolidated filing for Federal income tax purposes.

Pennsylvania's use of separate company reporting is in the minority. The two main types of reporting methods used in other states are: (1) combined returns for corporate groups conducting a unitary business; and (2) consolidated returns for affiliated corporations meeting common ownership requirements. States may either require combined reporting or may permit it upon application of the taxpayer. Pennsylvania law specifically prohibits corporations from filing a consolidated report of combined net income.

Consolidated reporting is a method of filing a single return for a group of corporations with common ownership. For federal income tax purposes an "affiliated group" is a group of corporations with a common parent that owns at least 80 percent of the voting stock and 80 percent of the value of all the stock of at least one member corporation. Many states use this Federal rule for determining corporations that are authorized to file consolidated returns.

The filing of a consolidated return is elective in most states that permit such returns. In other states, the state may require the filing of a consolidated return. However, in most states only corporations that are taxable in the state are permitted or required to join in the filing of a consolidated return.

B. Reasons for Change

The Commission considered the issues related to Pennsylvania's system of separate company reporting of the CNI Tax. Separate company reporting uses a narrow tax base and allows tax-planning opportunities such as the use of passive investment companies (PIC's), sometimes called Delaware holding companies, to shift income outside the Commonwealth.¹ To address these issues, the Commission recommends that the CNI Tax base be determined on a mandatory unitary combined basis. The Commission supports the adoption of mandatory unitary combined reporting only in conjunction with a reduction

of the CNI tax rate to within the range of 6 to 7 percent. The Interim Report issued by the Commission stated that “the Commission strongly prefers a rate at the low end of that range,” and noted that some Commissioners could not support a proposal that included a CNI rate of greater than 6%. Given the constraints of the Executive Order, this rate reduction could not be achieved without imposing additional business taxes at a level that is unacceptable to the Commission. Some Commissioners support other alternatives to achieve revenue neutrality that are reviewed in Tab 23.

The final recommendation of the Commission is to reduce the CNI tax rate to 6.99 percent.

One of the principal alternatives to mandatory unitary combined reporting was the adoption of legislation disallowing certain payments to out-of-state PICs. The Commission heard testimony that the revenue impact of such legislation can vary widely depending on the scope of the addback provisions. It did not attempt to resolve the issues of the appropriate breadth of expense disallowance, and did not reach a conclusion about the revenue estimate on such legislation. Such legislation tends to create other distortions, including perhaps constitutional problems where the result of such disallowance taxes income earned out of state. It also does not account for the losses of subsidiaries within the same corporate group. As a result, the Commission does not recommend the disallowance of such expenses but agreed upon combined reporting as a means of achieving the goals of the Executive Order.

Mandatory unitary combined reporting requires that a related group of businesses have a flow of value among them in order to combine their income for tax purposes. The combined net income of the group is apportioned by measuring the activity of the group in a taxing jurisdiction based upon the combined apportionment factors of the group. The Commission believes that mandatory unitary combined reporting better measures the net income of affiliated corporations generated within a taxing jurisdiction by broadening the tax base to make it less susceptible to manipulation.

The goal of combined reporting is to accurately calculate the total net income of a related group by eliminating the distorting effects of transactions within the group. From the state perspective, this reduces corporate income tax avoidance based on shifting income to commonly owned corporate low tax or no tax states that are beyond the income tax reach of Pennsylvania. As a result, certain tax strategies are nullified by combined reporting.¹ It can also benefit businesses by recognizing the losses of money-losing members of the group.

Combined reporting is required of affiliated corporations conducting a unitary business. In combined reporting, the unitary group is treated as a single entity. The business income and apportionment factors of each member of the group

are combined, intercompany transactions are eliminated, and the resulting income is apportioned using the combined apportionment factors as modified by the elimination of intercompany transactions. Even members of the group that are not taxable by the state are included in the combined report if they are part of the same unitary business. In short, the tax liability is computed as if the group was a single entity.

Combined reporting provides benefits for taxpayers by allowing the utilization of losses by one unitary member against the income of another unitary member.

Combined reporting is distinguished from consolidated reporting defined above. The Commission's recommendation does not include consolidated reporting.

There are 17 other states nationally that use mandatory combined reporting. These states are:

1. Alaska
2. Arizona
3. California
4. Colorado
5. Hawaii
6. Idaho
7. Illinois
8. Kansas
9. Maine
10. Minnesota
11. Montana
12. Nebraska
13. New Hampshire
14. North Dakota
15. Oregon
16. Utah
17. Vermont²

C. Discussion of the Recommendation

1. Testimony Presented at the Commission Meetings

The presenters who entered testimony related to combined reporting were:

- a. Neutral as to its adoption but expressed reservations as to its implementation;
- b. Either recommended combined reporting or, recommended it in conjunction with other proposals to reduce business taxes; and

- c. Expressed reservations which precluded their recommendation.

The reservations expressed by the presenters primarily relate to the following issues:

- a. The presenters cited California as an example where there is still litigation in defining a unitary group even though combined reporting was enacted in California a number of years ago;
- b. The determination of a unitary group for Pennsylvania;
- c. Issues involving the adequacy of future Pennsylvania regulatory guidance in determining the unitary group definition; and
- d. Potential litigation involving Pennsylvania's interpretation of combined reporting as to water's-edge versus worldwide combined reporting. See testimony presented on April 29, 2004 by the Pennsylvania Institute of Certified Public Accountants.

The opportunity to use Pennsylvania postcombination net operating losses was cited in the testimony of the Council on State Taxation as a factor in arriving at Council on State Taxation's neutral position on this issue. See testimony presented on May 17, 2004 by Doug Lindholm.

Other reservations expressed by certain presenters involved the perceived impact on Pennsylvania's competitiveness with surrounding states. Some business representatives stated that combined reporting is perceived negatively due to its complexity and potential for litigation. See testimony presented by the Pennsylvania Chamber of Business and Industry on May 17, 2004.

Although not cited by the presenters, other states have considered combined reporting. To date, the legislation: was not adopted, was deferred for further consideration, or is pending for discussion. Recent examples include Maryland, Virginia, North Carolina and Ohio. With Vermont's enactment of combined reporting, other Eastern states that previously rejected combined reporting may reconsider its adoption (e.g., Arkansas was currently holding meetings with the joint committee on Economic and Tax Policy). Estimates of expected revenue raised from combined reporting for Ohio and New York are \$200 million and \$300 million, respectively.

The testimony of certain presenters and Commission members indicated that the adoption of combined reporting, without other provisions providing for increased utilization of net losses and/or a reduction in Pennsylvania's CNI tax rate would result in an increase in business taxes.

2. Comments by the Commission Members

Certain Commission members had concerns as to the impact of tax planning in the context of combined reporting.

The following comments are from Commission members on the November 19, 2004 Business Tax Reform Commission meeting concerning the recommendation to adopt mandatory combined reporting.

Commissioner Cortez noted: “We want to limit abuses. My concern is when you look at mandatory combined reporting, it limits a lot of things, some of which you and I wouldn’t call abuses at all. Some of them are tax planning devices and in a separate company, they are perfectly okay. Others are abuses.”

Commissioner Cottonaro also noted, “I think there are two notions that go on with combined reporting. One is for those that support it, it’s viewed as a fair way to get at the prorata share for a particular jurisdiction of its taxable income. Then another aspect of it, which I think is secondary to that notion, is it makes it from a regulator’s side easier and from a company side perhaps more difficult. But you do then eliminate abuses, what may be commonly viewed as abuse.”

Commissioner Murphy commented that the need for adoption of mandatory combined reporting was in part necessitated by the significant changes to the Commonwealth’s economy. Commissioner Murphy recommended inserting language out of the Executive Order as follows: “significant changes in the structure of the Commonwealth’s economy have occurred resulting in the formation of new business structures and business arrangements that affect the nature of business taxation.”

Commissioner Cottonaro concurred and noted, “What we’re focused on is getting a fair method of a base for which we can apply our tax... The adoption of mandatory unitary combined reporting recognizes the changes in the structure of the Commonwealth’s economy and the fairest way to allocate these arrangements to the Commonwealth.”

Commissioner Nunery also concurred by recommending language in the Executive Order as follows: “contained in this report would dramatically improve Pennsylvania’s business climate by ensuring business tax fairness across business structures and sectors.”

Certain Commission members also had reservations about the assumptions involving the associated estimated increase in General Fund revenue

relating to the adoption of combined reporting. The increased revenue impact on existing passive investment companies was also discussed.

Global Insight was subsequently engaged to verify the assumptions and methodology utilized by the Pennsylvania Department of Revenue. See Tab 21C.

Commission members clearly indicated the adoption of combined reporting is an integrated recommendation. The recommendation is offered in conjunction with a reduction in the CNI statutory rate to 6.99 percent and the full utilization (uncapping) of postcombination net losses. Pre-combination losses would still be subject to the existing \$2,000,000 cap; the adoption of a single sales factor apportionment; service delivery point as an appropriate allocation determination; and the 1 percent tax on pass through entities.

3. Other State Tax Commission Recommendations on Combined Reporting

a. State of New Mexico Tax Commission

The New Mexico Blue Ribbon Tax Reform Commission issued a final report in October, 2003.

The Commission report provided in part,

“Often touted as the fairest approach to corporate taxation at the state level, reporting as a combined unitary business eliminates much of the game playing. It does require the tax agency to take an active role in determining which elements of a corporate family are “unitary.” As a matter of equity, the commission noted that a business operating solely in New Mexico does not have the same opportunities to shift income to lower tax jurisdictions as a competitor that is a member of a multistate corporate family. Because fairness is the issue and because there really is no rationale for a step-rate corporate income tax, the Commission also recommended an offsetting reduction in the corporate income tax rate structure. The rate decreases were phased in to match changes in the personal income tax rates. The Commission recommended that these changes not begin prior to the 2005 tax year in order to give the Taxation and Revenue Department and the company’s time to prepare for the new filing method.”

The New Mexico Business Tax Reform Commission evaluated certain options for business tax reform and relief, before arriving at its recommendation. See the Blue Ribbon Tax Reform Commission document dated September 11-12, 2003.

The options for business tax reform and relief listed two options relating to combined reporting. The first option is to require all corporations to file using the unitary filing method and provide for a change in the definition of a unitary corporation. The pros and cons of extending combined reporting to all taxpayers was outlined in the report.³ In addition, the Commission provided for a delayed starting date in adopting combined reporting.

The Commission provided in part:

“This option must be phased in or given a delayed starting date to accommodate businesses that have relied upon single entity reporting in crafting their business plans and to allow the Tax Return Commission to issue crucial regulations and instructions. The method of the phase-in and a time period in which combined filing would be required of all corporations must be considered.”

The Commission’s second option provided for a change in the definition of a unitary corporation to an objective standard. The Commission recommended changing the definition of a unitary corporation to an objective standard, such as that of Colorado.

The Commission’s report referenced Colorado’s six tests of unity, which are quoted below.⁴

Section 39-22-303(11)(a) CRS provides that an affiliated group of C corporations that satisfy three of six tests of unity for the current tax year and the two preceding tax years may join in the filing of a combined report. The following are Colorado’s tests of unity:

1. 50 percent or more of the gross operating receipts of one affiliated C corporation is from sales or leases to another affiliated C corporation; or if 50 percent or more of the cost of goods sold and leased by one affiliated C corporation is paid to another affiliated C corporation;
2. 50 percent or more of the value of five or more of the listed services used by one C corporation during the tax years is furnished by an affiliated C corporation at less than an arm’s length charge;
3. 20 percent or more of the long-term debt (debt lasting more than one year) is owed to or guaranteed by an affiliated C corporation;
4. one affiliated C corporation substantially uses the patents, trademark, service marks, logo-types, trade secrets, copyrights or other proprietary materials owned by the other;
5. 50 percent or more of the board of directors of one affiliated C

corporation are members of the board of directors or are corporate officers of another affiliated C corporation; and

6. 25 percent or more of the 20 highest-ranking officers of one affiliated C corporation are members of the board of directors or are corporate officers of an affiliated C corporation.

The Commission then discussed the pros and cons of adopting an objective standard such as Colorado. The Commission then noted:

1. This option complements Option 1.
2. Phase-in issues might be considered.⁵

1. State of North Carolina Governor's Commission

Governor's Commission to Modernize State Finances Final Report, December, 2002.

The Commission recommended the following:

“Simplify taxation by moving to combined reporting by related entities, as required at the federal level. In the past two years, the General Assembly has acted to limit the ability of related corporations to reduce their North Carolina tax liability. The move to a combined reporting system, required in many other states, may clarify the rules for both taxpayers and tax administrators. Combined reporting is required at the federal level and may help simplify the administrative burden for business taxpayers. The Commission recommends that this move be done carefully, as the effects on state revenues are not easily determined. Department of Revenue staff would have to be trained to handle this shift.”

c. State of Ohio Committee to Study State Taxes

1. Report of the Committee to Study State and Local Taxes, March 1, 2003
2. Corporate Franchise Tax Options

The Committee has identified the following options:

“Adopt a Combined/Unitary Income Tax base. The broadest tax base includes the use of a unitary theory of income taxation. Unitary taxation is a constitutionally sanctioned tax system that treats corporate groups as a single business enterprise for income tax purposes. The result is a more fair tax picture for a business enterprise. This approach reduces many of the tax planning opportunities that affect the current Ohio tax. Many states that have had significant economic development during the past decade

utilize unitary taxation, including California, Colorado and Illinois. In all, 16 states currently utilize unitary taxation...”

The “combined group tax” approach means that affiliated companies combine their incomes. As such, intercompany profits and losses are eliminated as part of the combination of income. While income is allocated and apportioned with respect to the combined group, each corporation with nexus with the states files its own separate return.

As an alternative, the state could offer corporations the option to file a “consolidated return” with the same affiliates as participate in the filing of the U.S. consolidated income tax return. Under this approach, the group would allocate and apportion income as if one corporation had earned all the income, and the group will pay tax as a single unit. (The consolidated return group is not limited to those having “unitary” activities and profits.) Like the “combined tax returns” presentation, the impact of inter-company transactions is effectively neutralized as part of the consolidation of income process.”⁶

4. Multistate Tax Commission Uniformity Project

a. Regulation for Determining the Existence of a Unitary Group

The Multistate Tax Commission (MTC) Executive Committee approved a regulation setting forth the principles for determining the existence of a unitary business during a teleconference meeting on January 15, 2004. The regulation sets forth the conceptual basis for determining what a unitary business is and the principles by which it can be determined whether business entities are unitary. MTC promulgated the measure because many states are required to publicly declare how they determine the existence of a unitary business.

b. Council on State Taxation (COST) Comments in Response to Issuance of the Multistate Tax Commission Regulations.

Diann Smith, general counsel with the Council on State Taxation noted that COST believes the MTC regulation follows the law existing in various cases.

“Because the regulation does not attempt to create any presumptions, we see it more as a guidepost to taxpayers and tax departments as to the type of facts that are relevant rather than a bright-line standard for unitary,” she says.

But Smith noted that COST would like to see a differentiation, particularly in the same line of business issue, between domestic and foreign operations.

COST would also like for the states and/or the MTC to discuss standards that would create “instant unity.” This is a situation in which one business acquires another business. The question is, are the two businesses unitary at the exact point when they are acquired, or are they at some point down the line?

Now that the MTC has finished its work on the regulation, it is up to states to go forward.

“The states must decide whether they want to revise their regulations to comport with this,” Katz notes. “It is our hope that because it is part of our uniform apportionment and allocation regulations that the states don’t have to go to their legislatures; that the tax departments can just propose a modification of their regulation and adopt it.”⁷

D. Evaluation of the Recommendation Under Established Criteria -

1. As discussed above, the definition of a unitary group for Pennsylvania's combined reporting and potential litigation in defining a unitary group was cited by a number of presenters to the Pennsylvania Business Tax Reform Commission as the primary reasons for their guarded reservations in adopting combined reporting. In adopting combined reporting; however, Pennsylvania has options subject to the established precedent of the United States Supreme Court. These options are detailed in a white paper presented to the Commission titled, "Options in Combined Reporting."

The Executive Summary for the report is as follows:

"As discussed in prior testimony provided to the Pennsylvania Business Tax Reform Commission, the separate accounting system for reporting Pennsylvania corporate net income tax, as constituted, results in disparate treatment among corporate taxpayers.

A number of commentators have also argued that a separate accounting system is inadequate to accurately measure the income of a corporation and as a result have recommended the adoption of combined reporting.

Recently, Vermont, a separate reporting state, enacted combined reporting for tax years beginning on or after January 1, 2006.

The Legislative statement of intent in adopting combined reporting provides as follows:

"In recognition of the fact that corporate business is increasingly conducted on a national and international basis, it is the intent of the general assembly to adopt a unitary combined system of income tax reporting for corporations, and as an integral part of this proposal, to lower the corporate income tax rates. Vermont's separate accounting system is inadequate to measure accurately the income of a corporation with non-Vermont affiliates and creates tax disadvantages for Vermont corporations which compete with multistate and multinational corporations doing business in Vermont. It is the intent of the general assembly, in adopting a unitary combined reporting system, to put all corporations doing business in Vermont on an equal income tax footing, and with the revenue from the expanded and more accurate tax base, to lower Vermont's corporate income tax rates."⁸

The predominant criticism relating to the adoption of mandatory combined reporting is the potential for litigation as to what constitutes a unitary

group. Business organizations point to California and cite California's ongoing litigation. California's approach to combined reporting is referred to by commentators as a "broad approach" to combined reporting. However, it is not the only approach. Other states have adopted an intermediate middle ground approach by incorporating more objective than subjective factors or by requiring operational integration.

The Legislative options in adopting mandatory combined reporting are summarized in the report. This list of legislative options is not intended to be all-inclusive:

1. Adopt a broad approach to combined reporting that incorporates the Multistate Tax Commission's regulations and procedures. The Multi-State Tax Commission has recently released an updated regulation on unitary taxation on January 27, 2004. The regulation sets forth principles for determining the existence of a unitary group. Pertinent sections of the regulations are cited in the report.
2. Adopt a mandatory combined reporting statute that closely follows another state mandatory combined reporting approach where taxpayers could rely on all outstanding published rules and adjudicated case law of that state;
3. Design a mandatory combined reporting statute that:
 1. Does not overreach in its intended purpose in reforming the Pennsylvania corporate net income tax, but sufficiently broadens the existing corporate net income tax base by;
 2. Accurately measuring and defining a unitary group's Pennsylvania taxable income or loss by utilizing post combination net operating losses and issuing;
 3. Clear published rulings and regulations that;
 4. Provide more objective criteria rather than subjective criteria in defining a unitary group and where;
 5. Subjective criteria are confined to known combined reporting abuse areas by;
 6. Either adopting certain state's established mandatory and combined reporting requirements which include both clear apportionment rules and which do not involve pending constitutional challenges; and

7. Which provide for a water's edge election that addresses known combined reporting abuses which include: the asserted misuse of 80/20 companies, addresses tax havens, and prevents the use of special purpose entities that are devoid of business purpose but which are used to reduce state taxable income;
8. Which adopt, where possible, either portions of the Multistate Tax Commission's regulations or other states:
 - a. Presumptions of a unitary business, and/or
 - b. Clear indication of a unitary business; and/or
 - c. Published rulings or guidance and adjudicated case law; or
9. Which would facilitate Pennsylvania taxpayers' transition to a mandatory combined reporting system but also avoid a wave of new litigation in Pennsylvania.

Flexibility in Determining a Unitary Group in Applying Mandatory Combined Reporting.

The adoption of mandatory combined reporting encompasses a number of specific choices. The permissible constitutional variations in adopting a combined reporting system can provide for efficiencies in tax administration, reduction in compliance costs for taxpayers, and still provide for sufficient base broadening of the Pennsylvania corporate net income tax. An adoption of more objective tests rather than subjective tests could address business concerns by providing clear guidance in structuring business transactions during the transition period and provide future guidance in organizing a taxpayer's business operation and prevent unintended litigation.

Subjective tests could be confined to clear anti-abuse areas. The adoption of Federal rules in determining unity of ownership could also simplify state tax administration by avoiding duplicate rules. The possible adoption of financial standards in determining unity of ownership is not currently utilized. Since there is no state precedent, solicitation of comments from the professional community of the viability of utilizing this test is imperative.

There are a number of legislative options including the adoption of the broad approach to combined reporting. Such approach incorporates the Multistate Tax Commission's regulations and procedures in adopting mandatory combined reporting. Thus, facilitating the transition from separate reporting to mandatory combined reporting.”⁹

E. Revenue Estimate for Adoption of Mandatory Combined Reporting

The Pennsylvania Department of Revenue obtained information from Minnesota in identifying a unitary group. Below is a brief summary of Minnesota's combined reporting rules:

The 1999-2000 Minnesota omnibus tax bill contained corporate franchise (income) tax changes.

Part of the changes included a definition of the unitary principle.

The unitary business principle is defined as follows, "the definition of a "unitary business" is made consistent with the United States Court definitions and a presumption is created that a unitary business exists whenever business operations are of mutual benefit dependent upon or contributory to one another."

In *Amoco Corp. vs. Commissioners of Revenue*, the Minnesota Supreme Court April 3, 2003 held that prior to the amended statutory language cited above the intent of the Minnesota Legislature was to apply the common law definition of a unitary group. In making its decision, the Minnesota Supreme Court declined to apply the unity factors included in *Container Corp. of America*. *Container* defined the federal constitutional parameters that are logically consistent with the underlying principles of the unitary business concept.

After the statute change in 1999, Minnesota is now following the *Container* tests. Minnesota's approach would be considered a broad approach in defining a unitary group.

On an ancillary combined reporting issue, the State of Minnesota does not allow for the aggregation of capital gains and losses. In Revenue Notice 91-19, the Revenue Department determined that it is the position of the Commissioner of Revenue that a corporation filing on a basis of a combined report may deduct capital losses only against capital gains realized by that corporation. The aggregation of capital gains and losses among members of an affiliated group or corporation so that a capital loss of one corporation offsets the capital gain of another is not permitted.

F. The Commission Member's Major Recommendation -

The Commission considered the issues related to Pennsylvania's system of separate company reporting of the CNI Tax. Separate company reporting uses a narrow tax base and allows tax-planning opportunities such as the use of passive investment companies (PIC's), sometimes called Delaware holding companies, to shift income outside the Commonwealth. To address these issues, the Commission recommends that the CNI Tax base be determined on a mandatory unitary combined basis. The Commission supports the adoption of mandatory unitary combined reporting only in conjunction with a reduction of the CNI Tax rate to between 6 and 7 percent. The Commission's Interim Report stated that "the Commission strongly prefers a rate at the low end of that range," and noted that some Commissioners could not support a proposal that included a CNI Tax rate of greater than 6 percent. Given the constraints of the Executive Order, this rate reduction could not be achieved without imposing additional business taxes at a level that is unacceptable to the Commission. Some commissioners support other alternatives to achieve revenue neutrality that are reviewed in Tab 23.

With any change in a tax system, but in particular with a change to mandatory unitary combined reporting, there is a risk of litigation. To limit that risk, the Commission recommends that before mandatory combined reporting is adopted, great care be given to defining a "unitary business." The Commission heard testimony about worldwide combination, water's edge combination and other forms of combined reporting. The revenue estimates presented to the Commission, and on which this recommendation is based, used water's edge combination. The Commission has not fully resolved the issues surrounding the design of a combined reporting statute. However, the Commission does not support mandatory worldwide combination. The Commission recommends the use of water's edge accounting coupled with a legislative prohibition of the inappropriate tax use of foreign affiliates. The Commission further recommends that taxpayers be permitted an election to use worldwide accounting. Any election should be binding for a reasonable period of time.

The Commission does not intend that any of its recommendations on combined reporting change the current treatment of Keystone Opportunity Zones or Keystone Innovation Zones.

The Commission recognizes that mandatory unitary combined reporting may cause administrative complexities requiring additional resources for the Department of Revenue. The Commission recommends that the Department provide the General Assembly and the Governor with an

administrative plan, including cost estimates, designed to achieve effective implementation of combined reporting.

G. Parameters Associated with the Recommendation

1. Assumptions

Because Pennsylvania is a strict separate entity reporting state, the Department lacks sufficient internal data necessary to directly measure the effect of combined reporting. The Department has utilized combined return data from Minnesota to derive an estimate as outlined below.

138,000 Pennsylvania C corporations from the Department's database were matched to the federal BMF data by employer identification number (EIN) and federal form 1120 line 28 income, which is the starting point in computing Pennsylvania taxable income. Out of the 138,000 C corporations, there were 63,500 whose federally reported EINs and incomes matched exactly the EINs and income figures reported on the Pennsylvania tax return. Because Pennsylvania is a strict separate entity reporting state, this exact match of EINs and incomes indicates that there were approximately 63,500 corporations filing in Pennsylvania that were not part of a federal consolidated group. In other words, they are separate entities having no affiliates at both the federal and state levels, and their tax liabilities would not be affected by changing to a combined reporting requirement.

For the companies that didn't match by either EIN or income, it is unclear whether they are members of a combined group. Therefore, these 74,500 corporations represent the population of corporations that are most likely to be members of a unitary business engaged in by more than one member of a combined group.

Match Against Minnesota Tax Records

1. Pennsylvania Department of Revenue sent the 74,500 EINs that did not match the BMF by EIN and income to the Minnesota Department of Revenue
2. Minnesota matched these EINs against their tax records and identified 4,643 combined unitary groups with a member corporation filing in Pennsylvania.
3. Minnesota provided the Department of Revenue with combined income and apportionment data for these groups.

Calculation of Net Effect for Sample Companies

1. Pennsylvania Department of Revenue calculated net CNIT impacts for all combined groups included in the sample using Minnesota, Pennsylvania and federal data.

It was not feasible to simulate a combined report for each Pennsylvania CNI taxpayer. Consequently, sampling techniques were created in order to estimate the impact on the entire population.” See Tab 20 C and “Fiscal Impact of Combined Reporting on the Pennsylvania Corporate Net Income Tax” prepared by the Pennsylvania Department of Revenue and presented on May 27, 2004.

The Pennsylvania Department of Revenue later expanded its analysis by reviewing tax return data for two additional years, 1999 and 2001. See Tab 20B. Global Insight subsequently reviewed that analysis and concurred with the methodology used by the Department for all three years 1999 through 2001.

2. Contingencies Impacting Revenue Estimate

- a. The definition of the unitary group is critical to the establishment of fiscal estimates for both the utilization of post combination net losses and the fiscal impact of projected revenue from combined reporting. The Pennsylvania Department of Revenue has no data available to discern information that would be comparable to a subjective analysis in determining a unitary group.
- b. The Department would need as additional data to apply objective criteria to the sample results and do further analysis. It is anticipated that there may be additional scenarios that may involve objective criteria that the Department may have to evaluate. It is recommended that the Pennsylvania Department of Revenue solicit comments from practitioners, the Bar Associations, and other tax groups that may be affected before finalizing objective criteria or proposing subjective criteria in defining a unitary group.
- c. The adoption of a combined reporting statute must include Passive Investment Companies or Related Foreign Passive Investment Companies in the definition of a unitary group. Without an inclusion of the above type entities in the unitary group definition, combined reporting will not raise sufficient revenue to reduce the CNI rate as recommended by the Commission.

3. Recommendations to Consider in Defining a Unitary Group to Avoid Unnecessary Litigation

As discussed above, there are options in defining a unitary group. Utilizing objective tests with limited or no subjective tests in designing a combined reporting statute may: (a) minimize litigation, (b) reduce the costs to administer, and (c) reduce the cost of compliance by business. The associated General Fund ramifications of adopting an “intermediate” or “objective” tests approach in defining a unitary group would have to be examined by the Commission and the Pennsylvania Department of Revenue in considering these alternatives.

H. General Economic Impact Considerations in Arriving at Recommendation

1. Business Tax Burden

It is believed that mandatory combined reporting will provide initial administrative burdens for entities and tax preparers for a compliance standard and for the Department of Revenue in developing its resources.

2. Business Tax Climate

In conjunction with the adoption of mandatory combined reporting, the Commission is recommending a number of associated recommendations to improve the business climate which include:

1. Reduction of the Pennsylvania CNI rate from 9.99 percent to 6.99 percent;
2. Modification of Existing Pennsylvania Net Operating Loss Provisions;
3. Adoption of Single Sales Factor Apportionment;
4. Adoption of Market Base Service Apportionment; and
5. Recommendations Concerning the Pennsylvania Appeals Process

I. Distributional Effect of the Proposal by Industry

For the distributional effect by industry concerning combined reporting using a 60 percent sales factor and an existing \$2 Million dollar cap, see Tab 20B.

For an extended discussion of the business tax climate distributional effects of this proposal as part of the integrated recommendation, see Tab 21D.

FOOTNOTES

Mandatory Combined Reporting

1. (Michael Mazerov, Senior Fellow, Center on Budget & Policy Priorities, Washington, DC (mazerov@cdpp.org))

A Robust Corporate Net Income Tax in Pennsylvania:

Three key policy choices

- Combined reporting
- Adopting the “throwback rule”
- Rejecting a “single sales factor” apportionment formula

2. Mandatory Combined Reporting (State Tax Notes, May 31, 2004, Karen Setze)

The Vermont General Assembly on May 21 approved mandatory unitary combined reporting for the state corporate income tax beginning January 1, 2006. According to the text of H 784, Vermont's separate accounting system "is inadequate to measure accurately the income of a corporation with non-Vermont affiliates and creates a tax disadvantage for Vermont corporations which compete with multistate and multinational corporations doing business in Vermont. It is the intent of the general assembly, in adopting a unitary combined reporting system, to put all corporations doing business in Vermont on an equal income tax footing."

3. Other State Tax Commission Recommendations – State of New Mexico Tax Commission Report – October, 2003

OPTION 1. Require All Corporations to File Using the Unitary Filing Method.

Combined filing is based on the unitary business principle, which holds that flows of value between commonly controlled and operated corporations make accurate estimation of individual profits of the separate affiliated corporations impossible.

PROS

- This option might achieve a more accurate measure of profits, losses and apportionment factors by combining profits and losses of interdependent corporations on a single return, and subjecting the combined group to a single apportionment formula.
- Tax administrators believe that combined filing discourages tax avoidance through favorable transfer pricing and measures that minimize tax obligations.
- Many administrators also believe that most taxpayers would be unaffected by this option because:
 - small businesses do not have to combine "families of firms";
 - many small businesses operate only in New Mexico; and
 - large taxpayers already must file combined returns in other states and it is not difficult to modify their returns for filing in New Mexico.

CONS

- This option does not necessarily encourage economic growth. The New Mexico business climate might become perceived as less friendly, particularly if the tax administrators are viewed as aggressive.
- Corporations will lose some freedom to manage their tax obligations. Many corporations will face increased tax obligations.
- Some argue that a movement toward mandatory combined filing will not reduce litigation and uncertainty but merely change the subject matter of the arguments.
- The tax collector will certainly face greater problems of administration (and so many taxpayers), especially in the transition to mandatory filing methods.

4. Change the Definition of a Unitary Corporation to an Objective Standard, Such as That of Colorado.

PROS

- Employing an objective standard such as that of Colorado could preempt such problems.
- Employing an objective standard might simplify the tax code.

CONS

- The transition to an objective standard might create additional administration issues.
- The six categories listed in the Colorado standard might overlook other factors that should be considered as characteristic of unitary corporations. Such factors might include centralized purchasing, advertising, accounting, management and other dependencies.

- The objective standard creates additional factors to define unitary corporation and might complicate the tax code.

ISSUES

- This option complements Option 1.
- Phase-in issues might be considered.

5. ISSUES

This option must be phased in or given a delayed starting date to accommodate businesses that have relied upon single entity reporting in crafting their business plans and to allow the TRD to issue crucial regulations and instructions. The method of the phase-in and a time period in which combined filing would be required of all corporations must be considered.

6. State of Ohio Committee to Study State Taxes Report Dated March 1, 2003
 7. Diann Smith, general counsel with the Council on State Taxation notes – See COST Website
 8. Diann Smith, general counsel with the Council on State Taxation notes – See COST Website
 9. Options in Adopting Combined Reporting – CBIZ Accounting, Tax & Advisory Testimony before the Pennsylvania Business Tax Reform Commission – September 22, 2004
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MAJOR RECOMMENDATION

18. Adoption of Additional Entity Level Tax on Pass-through Entities

A. Current Pennsylvania Law

Pennsylvania law provides special tax treatment for certain "pass-through entities." This special tax treatment includes: (1) a complete exemption from tax; (2) an exemption from certain taxes; and (3) special rules for calculating tax liability. Common pass-through entities include Pennsylvania S corporations, partnerships, business trusts, and limited liability companies.

Pennsylvania S corporations are "small corporations" that qualify to have their income taxed at the shareholder level, thus at the lower personal income tax rate.

Limited Liability Companies (LLCs) can have two different treatments for income tax purposes. If the entity has multiple owners, then Pennsylvania follows Federal rules and generally treats the LLC as a partnership.

Pennsylvania has historically treated partnerships as pass-through entities. Under Pennsylvania law, a partnership is considered to be an aggregate of the owners and not a separate legal entity. Tax liability for the activities and assets of the partnership is imposed at the partner/owner level. Accordingly, partnerships generally are not subject to the corporate net income tax unless the partner is a corporation. If the limited liability company has a single owner, then the entity is treated as a division of the owner. For individuals, this pass-through treatment is that of a sole proprietorship.

The Tax Reform Code provides that any entity that is classified as a corporation for Federal income tax purposes is subject to both the corporate net income and capital stock franchise taxes. Accordingly, if a partnership or LLC elects to be classified as a corporation for Federal income tax purposes, it is subject to the corporate net income and capital stock franchise taxes as a corporation.

B. Reasons for Change

The adoption of an entity level tax on the net income of pass-through entities is an enabling provision to reduce the statutory Pennsylvania Corporate Net Income Tax rate to 6.99 percent. An enabling provision is defined as a provision resulting in a net increase in General Fund revenue to offset the loss in revenue as a result of the Commissions' recommendation.

C. Discussion of Alternatives to the Recommendation

1. Testimony Presented at Commission Meetings

The PA-21 recommendation included an adoption of a new 0.5 percent entity-level income tax that would be paid by S corporations and limited liability companies (LLCs). This tax would be in addition to the personal income tax paid by investors on pass-through income. The 0.5 percent rate would be combined with the personal income tax paid by investors to arrive at total income tax for purposes of comparison to the net worth tax of the entity in determining whether or not the net worth tax applies to pass-through entities. This tax would reduce the difference in tax rates between C corporations and businesses operating as pass-through entities.¹

Testimony was also presented on behalf of pass-through entities and small businesses.

Presenters for National Foundation of Independent Businesses (NFIB) entered testimony on the effect of certain proposals on its members.² The presenter entered the following statistics into the testimony:

“In Pennsylvania, as in the nation as a whole, small firms lead the way in employment and job creation. Nearly 98 percent of all businesses in Pennsylvania employ fewer than 100 workers and small businesses create almost 80 percent of the new jobs in the state. By virtue of their size, small businesses are particularly sensitive to changes in tax policy...”

“The vast majority of Subchapter-S companies are small businesses. Ninety percent of NFIB members who are organized as subchapter S companies earned less than \$10 million in gross revenues -- 84-percent earned less than \$3 million. Further, NFIB's research found that 40 percent of its Sub-S members previously were organized as proprietors or partnerships. Thirty-three percent of companies previously filed as c-corporations. Twenty-seven percent of companies filed originally as subchapter S corporations. This data contradicts assertions by some that subchapter S companies mostly are comprised of larger corporations that changed their status to avoid paying the higher corporate tax rate...

Therefore NFIB has serious concerns with any proposals that would raise the tax rate paid by pass-through entities, including Subchapter S corporations or that may limit the types of small business that are eligible for pass-through taxation.”

2. Comments by Commission Members

Commission members noted that this enabling provision was only recommended in the context of providing a net increase in General Fund revenue to offset a further reduction in the Pennsylvania Corporate Net Income Tax rate from 9.99 percent to 6.99 percent.

3. Other State Tax Commission Recommendations – Not Applicable

D. Evaluation of the Recommendation Under Established Criteria

1. Pass thru business owners are subject to Pennsylvania personal income tax.
2. The Pennsylvania Personal Income Tax does not have a provision (such as net operating loss deductions) that enables taxpayers to smooth out their tax payments over time when their business incomes vary over time.
3. As discussed above, testimony was submitted on the equalization of rates between pass-through entities and rate reduction.³ Commission members considered this proposal for full equalization of the rates, but did not recommend it.

Presenters indicated that any equalization of rates was premised on a broadening of the Pennsylvania corporate net income tax base.

4. Testimony was also submitted as to the imposition of a license fee on all entities including pass-through entities. This proposal was also considered but not adopted by the Commission.⁴ Commission members cited the ability to pay as the overriding consideration in not including this proposal as a recommendation.
5. As discussed above, the PA-21 proposal did consider a pass-through entity level tax of .5 percent.
6. As discussed above, Commission members cited the difference between the highest statutory rate for a pass-through owner for personal income tax of 3.07 percent which is in contrast with the existing statutory 9.99 percent rate for the corporate net income tax.

It was noted by Commission members that pass-through owners have no provision for the carryover of losses under the Pennsylvania personal income tax structure.⁵ It was also noted that pass-through owners may also be subject to additional local taxes e.g. partners are taxed on earnings

from self-employment in local communities. Commission members cited these factors in rejecting an equalization of rates between businesses.

A comparison of the two statutory rates the 9.99 percent and the 3.07 percent should also involve an analysis and comparison of both effective rates and marginal rates of the two different tax structures.

As discussed, the Pennsylvania Corporate Net Income Tax has a provision for the utilization of losses but on a limited basis. With the proposed uncapping of post combination net losses, the gap between the two different tax structures is narrowed in favor of corporate taxpayers subject to the Pennsylvania Corporate Net Income Tax.⁵

As discussed in the testimony submitted, the Pennsylvania Corporate Net Income Tax has a high statutory tax rate but a limited tax base. After consideration of existing provision of the Pennsylvania Corporate Net Income Tax including the subtraction for dividends received, the effective and marginal Pennsylvania Corporate Net Income Tax rates are lower than the statutory rate of 9.99 percent.

Under this proposed tax, there is no carry back of losses for the pass through entity, but it provides a carry forward period of 20 years for the pass through entity to utilize any loss carryover amount against the entities' 1 percent pass through entity tax liability. This carry forward period would correspond with the current Pennsylvania Corporate Net Income tax rules on net loss carryovers.

E. Commission Members' Major Recommendation

The Commission recommends imposition of a net 1 percent entity level tax on the federally reported net income of pass through businesses apportioned in the same manner as the CNI Tax. The tax rate should be 4.07 percent, and NOL carryforward deductions should be permitted to the extent allowed under Federal law. The assessment of this tax obligation at a rate of 4.07 percent at the entity level should be coupled with an income tax credit of 3.07 percent for the entity's owner on their personal tax obligation and a full credit of 4.07 percent for entities subject to the CNI tax . The net effect of the 4.07 percent entity level tax and the 3.07 percent income tax credit for the entity owners would be a 1 percent tax on the share of net profits of pass-through businesses distributable to individual owners. This administrative mechanism would enhance enforcement since tax for resident and non-resident individuals would be collected at the entity level.

The proposed entity-level tax is imposed on S corporations, LLCs, LLPs, and LPs, (but not general partnerships), and is estimated to increase

personal income tax collections by \$30 million related to income distributed to individual owners of pass-through businesses that is underreported. The Commission's intent was not to tax general partnerships since general partners do not receive liability protection in the event of lawsuits.

It is assumed that all entities subject to this tax would be allowed to compute and use net operating losses.

F. Parameters Associated with the Recommendation

1. Assumptions

A collateral effect of this provision is an increase in compliance associated with the collection of tax of individual owners of the pass through entities.

2. Components of the Proposed Tax

The components of the proposed tax are as follows:

A. The entity level tax is a net 1 percent tax, paid by the pass through entity. Pass through entities subject to the tax are defined to include the following; S corporations, limited liability partnerships, limited partnerships, and limited liability companies. Sole proprietors and general partners are not subject to the tax.

Payment of the tax on the pass-through entity's net income would be required at 4.07 percent. Individual owners would receive a 3.07 percent credit to apply against their personal income tax liability. In order to avoid double taxation of income at the corporate level, a credit or deduction would be crafted to offset the 4.07 percent tax applied to income passed through to corporate owners of pass-through entities.

B. Treatment of Entity

1. Payment of tax occurs at the entity level.
2. It is the intent of the Commission that the net 1 percent tax is computed on a Federal income tax basis. It is the intent of the Commission that CNI apportionment rules including the use of the proposed single sales factor be used.
3. It is the intent of the Commission that NOL carryforward deductions should be permitted to the extent allowed under

Federal law in computing the net 1 percent tax at the entity level.

4. The intent is to at 4.07 percent for corporate partners at the entity level and provide a full credit for the amount withheld.

G. General Economic Impact Considerations in Arriving at Recommendation

1. Business Tax Burden

This tax burden will be born by the generally smaller entities within the Commonwealth. The policy question of equalization between corporation taxpayers and taxpayers that have selected pass through entities status is one the driving forces behind this recommendation. Certain pass through entity owners may incur significant increases in personal income tax liabilities. Pass through owners are not subject to the Pennsylvania corporate net income tax. As a result, the pass through owners receive no benefit under the reform measures proposed. The result, for the pass through owners, is a net increase in tax. The net increase in tax is predicated on a pass through owner's net tax after consideration of a limited net loss carryforward provision at the pass through entity level.

See Appendix A for the comparison of tax rates on pass through entities.

H. Distributional Effect of the Proposal

For an extended discussion of the economic impact of this proposal as part of the integrated recommendation, see Tab 21D.

APPENDIX A

PA Business Tax Reform Commission Proposal

Comparison of Taxes on Pass-Through Entities

PIT Rates - Tax Year 2004, as of January 1, 2004

Income tax on pass-through entity rates as of November 4, 2003

PA Income Tax on S corps, LLCs, LPs, and LLPs at 1% per

BTRC proposal

State	Personal Income Tax Rate		Income Based Tax Rate		State Rank By
	Low	High	S Corps	Partnerships	Total Tax Rate
MONTANA	2.00	11.00			1
CALIFORNIA	1.00	9.30	1.50		2
MASSACHUSETTS	5.30	5.30	4.50		3
VERMONT	3.60	9.50			4
OREGON	5.00	9.00			5
IOWA	0.36	8.98			6
NEW HAMPSHIRE	On Dividends and Interest Only		8.50	8.50	7
MAINE	2.00	8.50			8
HAWAII	1.40	8.25			9
NORTH CAROLINA	6.00	8.25			10
LOUISIANA	2.00	6.00	8% top rate		11
MINNESOTA	5.35	7.85			12
IDAHO	1.60	7.80			13
NEW JERSEY	1.40	6.37	1.33		14
NEW YORK	4.00	7.70	Varies		15
OHIO	0.74	7.50			16
ARKANSAS	1.00	7.00			17
SOUTH CAROLINA	2.50	7.00			18
UTAH	2.30	7.00			19
NEBRASKA	2.56	6.84			20
NEW MEXICO	1.70	6.80			21
OKLAHOMA	0.50	6.75			22
WISCONSIN	4.60	6.75			23
WEST VIRGINIA	3.00	6.50			24
TENNESSEE	On Dividends and Interest Only		6.50	6.50	25
KANSAS	3.50	6.45			26
GEORGIA	1.00	6.00			27
KENTUCKY	2.00	6.00			28
MISSOURI	1.50	6.00			29
DELAWARE	2.20	5.95			30
VIRGINIA	2.00	5.75			31
NORTH DAKOTA	2.10	5.54			32
ARIZONA	2.87	5.04			33
ALABAMA	2.00	5.00			34
CONNECTICUT	3.00	5.00			35
MISSISSIPPI	3.00	5.00			36

MARYLAND	2.00	4.75			37
COLORADO	4.63	4.63			38
ILLINOIS	3.00	3.00	1.50	1.50	39
PENNSYLVANIA	3.07	3.07	1.0% Proposed	1.0% Proposed	40
MICHIGAN	4.00	4.00			41
INDIANA	3.40	3.40			42

Notes:

Seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) do not impose a PIT.

Rhode Island is not shown and ranked because liability is based on 25% of federal tax liability.

States are ranked by the highest marginal PIT plus the rate imposed on the income tax of a pass-through entity.

Income taxes imposed on pass-through entities:

MA imposes a maximum 4.5% tax on income of S corporations with receipts over \$9 million.

VT imposes a \$250 fee on S corporations and partnerships.

NH also imposes a 0.75% Business Enterprises Tax on all business entities.

LA allows S corporations to exclude net income in proportion to LA residents' ownership of the corporation's share of capital stock.

NJ also imposes per member fees on partnerships to a maximum of \$250,000 per partnership.

rate so there is no differential imposed, only the fixed dollar minimum tax.

NY also imposes per member fees on LLCs to a maximum of \$25,000 per LLC.

CT imposes a \$250 annual tax on S corporations and partnerships.

PA - BTRC proposal would impose entity level tax on limited liability companies, limited partnerships, limited liability partnerships and S corporations entities

FOOTNOTES

18. Adoption of a Business Benefits Tax

1. “Design Issues in a Credit Method Value-Added Tax for the United States”
Tax Division Report of the American Institute of Certified Public Accountants., May 1990
2. “Design Issues in a Credit Method Value-Added Tax for the United States”
Tax Division Report of the American Institute of Certified Public Accountants., May 1990
3. Presentation to the Pennsylvania Business Tax Reform Commission by Joseph C. Bright on October 20, 2004.
4. Presentation to the Pennsylvania Business Tax Reform Commission by Joseph C. Bright on October 20, 2004.
5. Presentation to the Pennsylvania Business Tax Reform Commission by Joseph C. Bright on October 20, 2004.

Appendix A – Prepared by the Pennsylvania Department of Revenue

MAJOR ADMINISTRATIVE RECOMMENDATION

19. Pennsylvania Appeal Process

A. Current Pennsylvania Appeals Process

The Department of Revenue has primary responsibility for the administration of Pennsylvania tax laws. The head of the Department is the Secretary of Revenue appointed by the Governor. The Department of Revenue collects taxes, enforces tax laws, and conducts the administrative review of tax reports. These reports include settlement, assessment, appraisal, and determination.

The Department is charged with making sure taxpayers conform to tax laws and pay required taxes. The Department's primary tool is administrative review of filed tax returns. In Pennsylvania this review is called settlement, assessment, appraisal or determination. All of these terms refer to the process of reviewing a tax return for accuracy and compliance and sending a bill for additional tax if the Department concludes that a taxpayer did not properly pay a tax obligation. Thus, Pennsylvania uses four different terms for essentially the same process, but not for the same tax.

All of the above processes are primarily- desk audits but also may involve field audits. In Pennsylvania, assessment and determination are discretionary, but settlement is mandatory. Appraisal is a term that applies only to inheritance tax and appraisal is mandatory. Should a taxpayer disagree with the final action issued by the Department, the taxpayer may file a petition for resettlement, a petition for reassessment, a petition for redetermination, or any other protest relating to the assessment of tax or any other matter to the tax imposed by the Tax Reform Code. The taxpayer then has a right to appeal the Department's decision to the Board of Appeals and ultimately to the Board of Finance and Revenue.

The Board of Appeals is an administrative body created by resolution of the Executive Board in April 1978. The Board has been designated by the Secretary of Revenue with the responsibility of reviewing the Department's initial actions against taxpayer's (i.e. assessments, determinations, settlements) as well as the Department's actions on requests for refunds of certain taxes and interest thereon through the exercise of due process. In settled taxes the Auditor General is represented in proceedings before the Board.

"The Board of Appeals provides an efficient, inexpensive and definitive remedy for the resolution of tax disputes. The Board provides each

taxpayer an opportunity to be heard, whether by written correspondence or personal appearance. Upon conclusion of the appeal, the taxpayer or authorized representative is provided with written notice of the decision concerning the propriety of the action of the Department. When required by law, the Department of the Auditor General will concur with these decisions.

The Board is the first and definitive review in the appellate process for the majority of Commonwealth taxpayers, regardless of tax type. Eighty percent of all cases brought forward to the Board of Appeals are resolved at this level. Thus, only twenty percent resort to appealing at a higher level. Additionally, the law providing for the payment of interest by the Commonwealth on tax overpayments has required the Board to develop more efficient methods of operation in order to minimize the payment of interest. This takes on added significance due to the enactment of legislation granting the Board of Appeals original jurisdiction over all refunds beginning January 1, 1995.”¹

Taxpayers not satisfied with the result of their petition to the Board of Appeals have the right to appeal the finding to the Board of Finance and Revenue. The Board of Finance and Revenue, created by statute, has six members representing the six fiscal offices of the Commonwealth: State, Justice, Revenue, Treasury, Auditor General and General Counsel.

The Board of Finance and Revenue holds hearings on a monthly basis. The general practice is that taxpayers or their representatives appear before the Board and present their case. As a result of the hearing, the Board attempts to resolve the action presented in the petition or it may resettle the account upon “such basis as it shall deem according to law and equity.” (FC Sec. 1103) The effective result of this is to have some form of resolution of the tax dispute whether it be complete relief, partial relief or the sustaining of the Department of Revenue’s position.

A taxpayer who remains unsatisfied with the result of the Board of Finance and Revenue action may appeal this result within 30 days to the Commonwealth Court.

B. Reason for Change

Pennsylvania’s tax appeals process has long been described as arcane and inefficient. Several commentators have expressed concerns that the appeals process makes Pennsylvania uncompetitive with other states.

C. Discussion of the Recommendation

1. Testimony Presented at Commission Meetings

- a. In a recent article, Douglas L. Lindholm and Stephen P.B. Kranz cited CFO Magazine's 2004 State Tax Survey which touched upon many issues and noted the following:

“Regarding state tax administrative appeals and procedures, and identified the “worst” states in each category:

- What is your overall impression of the tax environment in this state? Is it fair and predictable? (Least Fair: New Jersey, California, Massachusetts, New York and Pennsylvania. Connecticut, Louisiana and Illinois were close behind).
- How do this state's revenue department policies and systems influence companies' decisions to locate or expand there? (Least Desirable Locations: New Jersey, California, Massachusetts, New York and Pennsylvania, followed by Michigan, Louisiana and Illinois).
- How would you rate the independence of this state's administrative appeals process – tax board, administrative law judge, or tax court – from its audit department? (Least Independent: Pennsylvania, Massachusetts, California, Louisiana, Alabama and Illinois).²

- b. “*Standardize Appeals Periods* – An issue that frustrates many business taxpayers and practitioners is the fact that different taxes require separate appeals. The rules for each in many cases have subtle differences. The due dates for filing petitions are confusing for corporate taxes and sales and use tax.

For example, under the Board of Appeals, corporate taxpayers have 90 days from the settlement mailing date to file an appeal, while sales and use taxpayers have 30 days from the assessment - mailing date to file an Intention to Petition.

Under the rules governing Board of Finance and Revenue appeals, corporate taxpayers have 90 days from a Board of Appeals decision mailing date. Sales and Use taxpayers have 60 days from a Board of Appeals decision mailing date on a petition for reassessment. On a Sales and Use petition for refund the taxpayer has 90 days from the Board of Appeals decision mailing date.

For appeals to the Commonwealth Court, corporate taxpayers have 30 days from the Board of Finance and Revenue decision mailing date. Sales and use taxpayers have 30 days from the Board of Finance and Revenue decision mailing date.

An example of one area that causes taxpayers problems and limits their ability to obtain refunds is the time limit to request refunds.

After January 1, 1998, taxpayers have three years from the date of payment to petition for refund. This has been generally interpreted as three years from the due date of the tax report without extension.

However, in the case of a tax settlement or assessment, the tax must be paid and a refund filed within six months of the notice mailing date. This provision may severely reduce the three-year statute for an unwary taxpayer. For example, a taxpayer shows a \$10,000 liability on its filed return, which is settled by the Department at \$100,000. Taxpayer pays the tax but seven months after the settlement date determines that its proper liability is only \$8,000. Under current law, the taxpayer can only recover \$2,000 and not \$92,000 since the increase in tax at settlement was not protested within six months from the settlement date. Thus, the three-year statute effectively becomes a six-month statute.

Furthermore, the requirement that only the United States Postal Service qualifies for timely filing on the due date of a return or petition is unreasonable. If the mailing date is considered timely filed, then mailing services such as UPS and Federal Express, that retain a mailing trail, should qualify.

One possible solution would be to adopt federal standards (Internal Revenue Code) for appeal periods. Taxpayers and practitioners generally understand federal statute of limitations concepts, but erroneously try to apply them to states. With 50 states and the District of Columbia, this leads to a multiplicity of statutory periods, unnecessary confusion and contempt within the taxpayer and practitioner communities, which was captured by the CFO magazine survey of earlier this year.

Concerning the corporate tax settlement process, corporate taxes are self-assessed in Pennsylvania. The Department of Revenue reviews every corporate tax report and "settles" the tax by either accepting it as filed or making adjustments. The entire settlement process is subject to audit and approval by the Auditor General.

Historically there were valid reasons for involving the Auditor General in this process, but those reasons are no longer valid. This process is particularly ripe for improvement. Perhaps the Auditor General could be called upon to audit those tax settlements in excess of a dollar threshold.³

- c. “At the outset, it should be said that there is not unanimity of opinion about the efficiency and efficacy of Pennsylvania's current tax appeals system. Some members of the PBA Tax Section would tell you that the current system is broken and that wholesale changes are required. Others would tell you that while the system is not perfect, and could stand some changes, it does not function all that badly. On the whole, I would say that more hold the latter view than the first, but I think everyone does agree that at least some changes are in order.

One fact many people overlook when discussing Pennsylvania's tax appeals process is the sheer volume of appeals flowing through the system. The Department's Board of Appeals receives 25,000-30,000 appeals of one type or another on an annual basis. The Board of Finance and Revenue, which generally serves as the second level of appeal, receives approximately 20 percent of that amount, or 5,000 appeals annually. Slightly less than 20 percent of the cases taken to the Board of Finance and Revenue, or 800 cases, are appealed annually to the Commonwealth Court.

The cases entering the system via the Board of Appeals range from very small dollars to huge dollars and from simple questions of documentation to legal issues on the cutting edge of tax law jurisprudence. Whatever criticism may be appropriate, the fact is that the present system is dealing with this large volume of appeals, more or less effectively.

Unfortunately, the present Pennsylvania tax appeals system has developed a reputation for being confusing, complex, inefficient, and time consuming. While this is the view of some, it is not necessarily an accurate portrayal of the system for all taxpayers or practitioners. For the small business or individual taxpayer with relatively straightforward issues, the current system has the advantage of being relatively inexpensive and, for those prepared carefully to follow procedural instructions, it is accessible to a significant extent without necessity of professional representation. It also works fairly well for the knowledgeable tax practitioner, whether an attorney or an accountant.

For those who have more complicated cases and are not familiar with the system, however, it can seem a quagmire. Not only must they learn the published rules but they also must find a way to understand the informal inter-workings of the appeals system that have developed over the decades. This is probably true to some extent in every state of the Union, although Pennsylvania's administrative appeals system seems to be chastised most by out-

of-state tax practitioners or corporations without a significant presence in Pennsylvania. For instance, the present system might be challenging for an out-of-state tax manager who occasionally attempts to handle the company's own tax appeals in Pennsylvania or who might use a particular out-of-state tax practitioner or firm to handle all of the company's state tax controversies nationwide. For the majority, however, we believe it works fairly well, and it has several good points, such as no requirement "to pay to play" before filing a tax appeal.

On the other hand, our appeals system certainly can be improved and modernized. This could be done either through refining certain aspects of the current system or by a major overhaul of the entire process.”⁴

- d. The Tax Division of the Philadelphia Bar Association’s testimony cited the following concerns:

“As noted above, in many cases, Pennsylvania tax laws can be extremely difficult to read. This could be addressed by clear and concise regulations, but due to the difficulty of issuing formal regulations and the lack of resources, the Department of Revenue ("DOR") rarely issues such regulations. In many cases, DOR may have unwritten policies, but these are only known by a fairly small group of practitioners, are not readily accessible to the public and are subject to change from time to time with little or no notice. The DOR has been trying to issue informal written guidance, but this guidance is often not subject to sufficient outside review before finalization.”⁵

- e. The testimony further provided in part, “The tax appeal process needs to be improved. There is no uniform period of time to appeal a tax assessment (it varies by tax). The Department of Revenue is not required to send out a notice of assessment by certified mail, and a taxpayer who has failed to receive a notice may be foreclosed from appealing a tax. Once a tax is appealed, it may take a year to run through the two administrative levels of appeal (the Board of Appeals and Board of Finance and Revenue). The quality of tax decisions is not always as high as they should be. Although this may exceed the mandate of the Business Tax Reform Commission, the formation of a separate Tax Court should be considered. Alternatively, perhaps the Commonwealth Court could designate certain judges, who have experience in tax matters, to handle all tax cases.”...⁶

- 2. Comments by Commission Members

Commissioner Bright provided the Commission with substantial insight into the appeal process in Pennsylvania.

“Let me recommend for further review, if you care to, two documents. One is a white paper done on behalf of the COST, that is, the Counsel on Taxation, entitled Case for a State Tax Court by Elizabeth Buroker Coffin. I think that’s been distributed. And a Model State Administrative Tax Court Act, actually the draft of that was produced by a committee of the American Bar Association.

You may or may not agree with a lot of the particulars in here, but I think they’re both very thoughtful documents and certainly the general principles that they state I think are worthy of serious attention.

Some of the key points that I picked out in working on this list and I think should be our focus are the impartiality, independence and skill of the decision makers, accountability of the decision making process, which covers a broad scope. Open access, understandable, coherent, access and efficiency of operation. It seems to me those are key overriding considerations that should be our goals.

In going through this list, some of these things would require statutory changes, some of them would not, and some of the possible changes would require constitutional changes. I suggest that the commission just ignore that for the moment and figure out what it is that the Commission recommends, what do we want, and then let the technical people decide whether that calls for a statutory change, with the exception, possible exception, of constitutional changes.”⁷

Based upon Commissioner Bright’s comments, the Commission debated the various recommendations.

3. Other State Tax Commission Recommendations

Establishment of a Dedicated Court to Only Address Commonwealth Tax Issues – Other State Tax Commissions or studies have recommended the establishment of a state tax court. (See the California Commission on Tax Policy in the New Economy Recommendation).⁸

D. Evaluation of Recommendations Under Established Criteria

The recommendations by the Commission contain pure administrative operational issues, reorganization matters and recommendations that may require legislation.

E. Commission Members Major Recommendation

The Commission recommends reform of Pennsylvania's tax appeals process and certain related administrative procedures. The current tax appeals system is inefficient and confusing to businesses and is detrimental to Pennsylvania's business climate. Reform of the appeals system is deemed to be revenue neutral, although additional administrative costs are expected for the Department of Revenue and the State Treasurer. The Commission believes that its recommended reforms would enhance the administration of taxes for businesses operating within the Commonwealth. The Commission is providing a detailed list of recommendations to the Governor and General Assembly with this Report. The Commission believes that its proposals to reform the appeals process are so critical to improving the business climate in Pennsylvania that they should be considered separately from the tax proposals in this report.

Pennsylvania Business Tax Reform Commission
Recommendations Regarding the Tax Appeal Process

General Issues

1. Standardize assessment terminology to use assessment throughout. Eliminate the terms settle and determine.
2. Require all assessments to be prominently labeled and sent via certified mail. The term assessment should be consistently and prominently used on uniform billing statements to be issued by the Department of Revenue. Either the Department or taxpayers may use mailing services qualified under Internal Revenue Code Sec. 7502 in lieu of certified mail. The Department estimates that this recommendation will increase mailing costs by \$2.2 million dollars and impose additional operational and staffing costs on the Department of Revenue. It is recommended that the necessary funds be appropriated to implement this recommendation.
3. Eliminate the settlement of corporate taxes and replace with the selective audit and assessment process used in other taxes. Retain personnel used in the settlement process and reassign them. In the Department of Revenue reassign taxing officers to the desk audit of selected returns. In the Auditor General's Office reassign taxing officers to the post-audit review of selected corporation tax desk and field audits.

4. Standardize all administrative appeal periods to 90 days. The Court appeal period would remain at 30 days.
5. Follow the federal regime for time limits for refunds in conjunction with expanding the Commonwealth's enforcement authority including the use of a streamlined bank attachment process. This recommendation is intended to work in conjunction with the additional recommendations above.
6. Eliminate any requirement in an administrative appeal for a bond, except in the case of collected and unremitted taxes, in a jeopardy situation or where the Department determines that there is substantial indication of flight or lack of the ability to pay. Other forms of security may be appropriate, such as a letter of credit.
7. Reform the bulk sales law.

This topic should be reviewed by the Department with the objective of enhancing the environment in which entities operate in the Commonwealth. The goal should be to make the process practical, prompt and efficient. The Department should solicit the views and cooperate with bar associations, accountants and other affected groups.

8. Require the Department of Revenue to provide the taxpayer with an explanation of the basis for any assessment.
9. Give the Secretary of Revenue compromise authority over tax, interest and penalty. It is recommended that the Secretary delegate the authority to compromise penalties to the Board of Appeals. It is further recommended that the Secretary exercise his authority to compromise tax only when an appeal has been filed with the Board of Finance and Revenue. Any compromise of tax by the Secretary of Revenue should be subject to the approval of the Attorney General.

Board of Appeals

The Board of Appeals hears approximately 25,000 to 30,000 cases per year. The Board should continue its mission to preserve a first level, informal, non-adversarial, no-fee hearing.

Board of Finance and Revenue

The adjudication of tax appeals above the Board of Appeals level should be independent of all officials involved in tax administration, audit and litigation.

Specifically:

1. Give decision-making authority on tax appeals to independent hearing officers who are appointed for a 5-year term and paid by the State Treasurer. Special tax training and experience will be required of these officers. The officers should be located in a facility apart from personnel involved in the administration or appeal of taxes. The recommendations of the American Bar Association Draft Model State Administrative Tax Tribunal Act, including the small claims process, should be considered in this process.
2. Retain the existing Board structure for determination of state depositories and other non-tax-appeal functions.
3. Hearings will be adversarial and a record will be established. The Department of Revenue and the taxpayer will present their arguments and evidence. It is recommended the Rules of Administrative Practice and Procedure be used to conduct these hearings.
4. Permit accounting professionals to represent taxpayers to the extent permitted by the Pennsylvania Supreme Court and other applicable law.
5. Require Internet publication of all Board decisions, but not compromises. Appropriate amendments should be made to the confidentiality statutes to authorize unredacted publication of decisions. Publication will provide useful precedent to the Board of Finance and Revenue, taxpayers and practitioners.

Appeals to Commonwealth Court

1. Limit court appeals to whether findings are based on substantial evidence, abuse of discretion, errors of law and questions of constitutionality. Base the appeal on the record established at the Board of Finance and Revenue.

F. Effect on the Business Tax Climate

It is anticipated that these recommendations will have a substantial positive impact on the Pennsylvania business climate.

FOOTNOTES

19. Major Administrative Recommendation

1. Testimony before the Pennsylvania Business Tax Reform Commission by –Gerard Sallavanti on August 2, 2004.
2. “Best and Worst of State Tax Administration: COST Scorecard on Appeals, Procedural Requirements;” Douglas L. Lindholm and Stephen P.B. Kranz in Tax Management Multistate Tax Report, March, 2004.
3. Testimony before the Pennsylvania Business Tax Reform Commission by William Lazor on August 2, 2004.
4. Testimony before the Pennsylvania Business Tax Reform Commission by James Fritz on August 2, 2004
5. Testimony before the Pennsylvania Business Tax Reform Commission by Stanley Kull on April 29, 2004.
6. Testimony before the Pennsylvania Business Tax Reform Commission by Stanley Kull on April 29, 2004.
7. Testimony before the Pennsylvania Business Tax Reform Commission by Joseph Bright on September 2, 2004.
8. Establishment of a Dedicated Court to Only Address Commonwealth Tax Issues

California Commission on Tax Policy in the New Economy, Chairman William J. Rosendahl, June 2, 2003, Sacramento, California.

<u>Guiding Principle</u>	<u>Pro</u>	<u>Con</u>
Fairness	The highest forum to which most taxpayers can pursue their tax appeals without payment of tax, interest, and penalty is the State Board of Equalization. Board members serve for limited terms and are not trained specialists in tax law. With certain limited exceptions, an administrative resolution of disputes does not take into account the "hazards of litigation." This factor, when objectively applied by independent tax resolution specialists, encourages the settlement of tax disputes. Instead, for many taxes, California maintains an all-or-nothing policy thereby forcing taxpayers to concede the entire amount in dispute or pursue litigation.	California already has a tax court that is open to the public and that is directly accountable to the voters. It's called the Board of Equalization (BOE), though perhaps the Board's name should be changed to the California State Tax Commission. Both the BOE and the Franchise Tax Board have settlement programs, affording taxpayers the opportunity for administrative resolution with a staff of trained accountants, auditors and attorneys. In addition, taxpayers may take their case to a public hearing before the elected Members of the Board of Equalization. Each of the 5 members is advised by an independent staff of trained accountants, auditors, and attorneys, but unlike Tax Court judges, they are accountable to the voters.
Simplicity	There is no practical judicial alternative to dispute resolution. In the federal system, taxpayers who are unable to settle with the Internal Revenue Service are afforded the opportunity to present their case to the United States Tax Court without paying any tax, interest, or penalty. In contrast, the resolution of most tax disputes in California in Superior Court requires the payment of tax, interest, and penalty in full before the Court can have jurisdiction. As a practical matter, this requirement deprives most California taxpayers of any judicial resolution. Additionally, the judges of the United States Tax Court are trained and experienced in tax law. In contrast, virtually all Superior Court judges have no particular tax expertise.	With a few exceptions, specialization of the judicial system has been avoided in California on the basis of cost and the theory that it will reduce the flexibility of the judiciary to meet changing needs. The issue of pre-resolution payment of tax liabilities can be addressed without replacing the Board of Equalization with a Tax Court (then-Speaker Hertzberg introduced a bill to allow posting of a bond as an alternative to payment). The Tax Court proposal would take only tax cases away from Superior Court judges, even though there is no requirement that Superior Court judges have any particular legal specialization. The current system gives taxpayer an opportunity for a three-part resolution: (i) before the agency staff in the settlement programs; (ii) before the elected Board of Equalization; and (iii) in Superior Court, if the taxpayer chooses to pay the liability in full before suing for a refund.
Efficiency	The publication of decisions by the United States Tax Court provides a growing body of judicial precedent that can serve as guidance to all taxpayers. In contrast, California has a very limited number of published decisions on tax disputes.	The Board of Equalization publishes decisions on tax disputes. There is no need to create an unaccountable new agency primarily for this purpose.

20. Static Revenue Estimate of Integrated Recommendations on the General Fund

A. Overview

The Pennsylvania Department of Revenue used three years of Minnesota data from 1999, 2000 and 2001.

The estimate assumptions were as follows:

1. Estimates assume limiting \$2 Million net operating loss (NOL) carry-ins to 10 years of carry-forward to avoid a higher tax rate in the first few years.
2. Combined group net operating losses assumed to be carried forward for 20 years.
3. Net operating losses assumed to be shared within a group
4. Estimate based on Minnesota net operating loss rules (no deductions for dividends received and foreign source income)
5. Fully phased in uncapped group net operating loss carry-forwards reduces tax liability by 10.7 percent.
6. Estimate does not include bank and insurance company affiliates.

The net operating loss estimates were based on the following assumptions:

1. First 3 years of data show net operating loss cost reducing revenue gains from proposal;
2. Separate company net operating loss “bank” carry-in to 2005 is expected to exceed \$100 billion
3. Oldest net operating loss carry-in available in 2005 will be from 1995
4. 1998 losses will be the first that can be carried forward for 20 years

In addition, the Pennsylvania Department of Revenue prepared static revenue estimates for a number of scenarios which are included in the testimony.

The Pennsylvania Department of Revenue modified its estimate by assuming 20 years of carryforward and based on the utilization of precombination losses on a separate company basis.

The final static revenue estimates are summarized below in Sections G and H. The two static revenue estimates differ by the proposed reduction in the Pennsylvania corporate net income tax rate.

B. Combined Reporting by Industry – 1999-2001

Combined Reporting by Industry: 1999 to 2001			
<u>Industry</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Agriculture, Forestry, and Fishing	6.0	(11.5)	0.4
Mining and Construction	3.1	3.0	3.8
Manufacturing	191.0	157.3	177.9
Transp., Commun., and Utilities	33.6	52.9	47.5
Trade	126.8	130.6	150.5
Finance, Insurance and Real Estate	13.9	29.1	(20.8)
Services	24.9	28.6	30.0
Miscellaneous	34.6	28.6	12.8
Other	<u>63.5</u>	<u>56.5</u>	<u>45.6</u>
Total	497.4	475.1	447.6
Data reflects \$2M NOL carry-in cap and 60% sales factor. No impact from group NOLs.			

C. Combined Reporting Comparison to Previous Estimate – Tax Year 2000

**Combined Reporting: Comparison to
Previous Estimate – Tax Year 2000**

<u>Industry</u>	<u>May</u>	<u>Oct.</u>
Agriculture, Forestry, and Fishing	8.7	(11.5)
Mining and Construction	12.7	3.0
Manufacturing	122.0	157.3
Transp., Commun., and Utilities	59.5	52.9
Trade	146.7	130.6
Finance, Insurance and Real Estate	86.2	29.1
Services	80.8	28.6
Miscellaneous	14.3	28.6
Other	<u>00.0</u>	<u>56.5</u>
Total	530.9	475.1

D. Combined Reporting by Industry: Baseline Scenario: 1999-2001

Combined Reporting by Industry: Baseline Scenario: 1999 to 2001			
<u>Industry</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Agriculture, Forestry, and Fishing	6.0	(11.5)	0.4
Mining and Construction	3.1	2.3	3.6
Manufacturing	191.0	146.4	163.3
Transp., Commun., and Utilities	33.6	48.3	46.9
Trade	126.8	115.5	143.5
Finance, Insurance and Real Estate	13.9	23.9	(22.3)
Services	24.9	16.3	26.8
Miscellaneous	34.6	24.2	11.8
Other	<u>63.5</u>	<u>45.6</u>	<u>41.8</u>
Total	497.4	411.0	415.8
Estimate reflects \$2M cap carry-in NOLs; 60% sales factor; uncapped group NOL carry-forwards.			

E. Sales Factor Effects by Industry – Tax Year 2000

Sales Factor Effects by Industry Tax Year 2000			
<u>Industry</u>	<u>60% Sales</u>	<u>75% Sales</u>	<u>100% Sales</u>
Agriculture, Forestry, and Fishing	(11.5)	(11.2)	(10.6)
Mining and Construction	2.3	2.2	1.9
Manufacturing	146.4	112.5	55.9
Transp., Commun., and Utilities	48.3	46.3	43.0
Trade	115.5	112.6	107.7
Finance, Insurance and Real Estate	23.9	25.3	27.6
Services	16.3	14.9	12.6
Miscellaneous	24.2	26.7	30.9
Other	<u>45.6</u>	<u>45.6</u>	<u>45.6</u>
Total	411.0	374.8	314.5

F. Group NOL Effects by Industry – Tax Year 2000

Group NOL Effects by Industry: Tax Year 2000			
<u>Industry</u>	<u>Disallowed</u>	<u>\$20 Mil Cap</u>	<u>Uncapped</u>
Agriculture, Forestry, and Fishing	(11.5)	(11.5)	(11.5)
Mining and Construction	3.0	2.6	2.3
Manufacturing	157.3	135.9	146.4
Transp., Commun., and Utilities	52.9	50.7	48.3
Trade	130.6	122.6	115.5
Finance, Insurance and Real Estate	29.1	24.5	23.9
Services	28.6	22.8	16.3
Miscellaneous	28.6	25.3	24.2
Other	<u>56.5</u>	<u>50.1</u>	<u>45.6</u>
Total	475.1	423.0	411.0

G. Fiscal Impact with Rate Reduction to 7.22 Percent CNIT Rate

Combined Reporting
\$2M NOL Carry-ins; Uncapped Group NOLs
100% Sales Factor; Market-Based Sourcing of Sales
CNIT Rate Reduction at 7.22 Percent
Entity-Level Tax

	<u>ESTIMATE</u> (\$ Millions)
Estimated 2005 CNIT – Current Law	\$1,700
Combined Reporting = 100% Sales Factor	410
Market-Based Sourcing of Sales	<u>-</u>
CNIT Subtotal @ 9.99%	\$2,110
Revenue per CNIT Point	211
CNIT Rate Cut to 7.22%	(585)
CNIT Subtotal @ 7.22%	<u>1,525</u>
Net CNIT Revenue Effect	(175)
4.07% Entity-Level Tax ¹	175
(Option #2 with a 3.07% PIT Credit) ²	
Net General Fund Revenue Effects	<u>\$ -</u>

¹ Entity-level tax imposed on S corporations, LLCs, LLPs, and LPs (not general partnerships).

² Option 2 is estimated to increase PIT collections by \$30 million related to income distributed to individual owners of pass-through businesses that is underreported.

H Fiscal Impact with Rate Reduction to 6.99 Percent CNIT Rate

Combined Reporting
\$2M NOL Carry-ins; Uncapped Group NOLs
100% Sales Factor; Market-Based Sourcing of Sales
CNIT Rate Reduction at 6.99 Percent
Entity-Level Tax

	<u>ESTIMATE</u> (\$ Millions)
Estimated 2005 CNIT – Current Law	\$1,700
Combined Reporting = 100% Sales Factor	410
Market-Based Sourcing of Sales	<u>-</u>
CNIT Subtotal @ 9.99%	\$2,110
Revenue per CNIT Point	211
CNIT Rate Cut to 6.99%	(634)
CNIT Subtotal @ 6.99%	<u>1,476</u>
Net CNIT Revenue Effect	(224)
4.07% Entity-Level Tax ¹	175
(Option #2 with a 3.07% PIT Credit) ²	
Net General Fund Revenue Effects	<u>(\$ 49)</u>

¹ Entity-level tax imposed on S corporations, LLCs, LLPs, and LPs (not general partnerships).

² Option 2 is estimated to increase PIT collections by \$30 million related to income distributed to individual owners of pass-through businesses that is underreported.

I. Commission Member's Comments on Recommendations – Fiscal Impact

The Commission believes that the recommendations contained in this Report would dramatically improve Pennsylvania's business climate by improving business tax fairness across business structures and sectors. Cutting the CNI Tax rate by 30 percent would make Pennsylvania more competitive with other states. Imposing a pass-through entity tax would allow a more even-handed treatment of all business types. Increasing the weighting of the sales factor of the CNI Tax apportionment formula would provide a powerful incentive for economic growth, especially in the manufacturing sector. Implementing mandatory unitary combined reporting would allow Pennsylvania's business tax system to better reflect two decades of significant changes in the structure of the state's economy. Those changes have resulted in the formation of new business structures and business arrangements that affect the nature of business taxation in the Commonwealth. Overall, this package of recommendations would achieve the goals of the Executive Order.

The Commission's recommendations, if adopted as a package, would be revenue neutral with a CNI Tax rate of 7.22 percent. For competitive reasons and to help offset the impact of other recommendations in its Final Report, however, the Commission strongly recommends that the CNI Tax rate be lowered to 6.99 percent. The lower rate, together with the other recommended changes, would cost \$49 million. Reducing the corporate income tax rate to 7.22 percent would move Pennsylvania's rate from third highest among the states to 25th highest and lower than all but one of our neighboring states. The 6.99 percent rate would move Pennsylvania to 26th highest and lower than all neighboring states.¹

FOOTNOTES

20. Static Revenue Estimate of Integrated Recommendations on the General Fund

1. Commission Member's Recommendations as noted in the Executive Summary.

21. **Global Insights: Review of Pennsylvania Department of Revenue Static Revenue Estimate for 2005 and Dynamic Modeling Analysis of Major Recommendations**

A. General Comments on Global Insight's Report

Global Insight prepared two final reports dated September 7, 2004 and November 16, 2004, that are enclosed in respective Sections C and D below. Global Insight, Inc. also prepared a draft report which was presented and entered into testimony on October 6, 2004. Global Insight presented its evaluation of the "Pennsylvania Department of Revenue static revenue estimates of the revenue impact of combined reporting for 2005" on October 6, 2004. As part of Global Insight's review of the Pennsylvania Department of Revenue estimates based on Minnesota state tax return data for 2000, Global Insight recommended that the Pennsylvania Department of Revenue reproduce the results with the returns of another tax year. Global Insight's report provides in part:

"The stimulation procedure was, though efficient, based on a statistical sample. As such, there is some degree of sampling error that results. Corporate income tax liability is notoriously volatile, both across corporations and across time. The confidence of any revenue estimate improves if the sample size is increased." Gains to increasing the sampling rate from the year 2000 Minnesota returns would not be expected to be large. However, owing to the variability over time of corporate income, it is advisable that the DOR attempt to reproduce the results with the returns of another tax year. This would add greatly to statistical confidence in any case. Moreover, as the year 2000 represented a U.S. business cycle peak, it is especially important to evaluate the revenue implications of the complex interlocking web of corporate relationships at an alternative point in the business cycle. The use of NOLs by corporate taxpayers is, for instance, highly cyclical."

Subsequently, the Pennsylvania Department of Revenue analyzed two additional years of Minnesota state tax returns.

The Pennsylvania Department of Revenue secured the data from Minnesota and prepared separate static revenue estimates of combined reporting using tax return data for 2001 and 1999. The results of the static revenue estimates are listed in Tab 20. Global Insight reviewed the additional data in conjunction with its initial analysis. Based on that subsequent review,

Global Insight concurred on the methodology utilized stating as follows:

“Global Insight, upon extensive evaluation, finds that the methodology the DOR used in estimating the revenue impact of combined reporting under the CNIT is sound and represents best practice.”

Global Insight also prepared a dynamic modeling analysis of the major recommendations. Global Insight’s report provides in part:

“Global Insight has found that the impact of corporate income taxation in Pennsylvania has been negative, though very small in magnitude. Indeed, we cannot with high statistical confidence conclude that there is any significant impact. Table 3 summarizes the effects of four proposals considered by the Commission. Scenario 11 has negative net impacts on the state economy, while Scenarios 4, 8 and 12 are generally positive. These results are derived entirely from our estimation of the impacts of business taxation across the state's industries. It is important to note that, given the statistical uncertainty about the size of the relevant elasticities, and of the distribution of the shifts in tax burdens across industries, these differences could be viewed as insignificant. We also note that the impacts are based solely on the ultimate tax liability implications of the considered scenarios. They do not shed light on the relative merits of the type of tax structure implied by any scenario.”

Global Insight reviewed four scenarios in preparing its dynamic modeling report. The report provided in part:

“The Commission has considered four scenarios, each of which incorporates some combination of the aforementioned reforms. The cumulative result of each of these sets of changes would, by design, neither increase nor decrease the aggregate business tax burden in the Commonwealth. However, the Commission recognizes that the distribution of impacts might not be identical across individual corporations, or across industry sectors. The purpose of this research is to evaluate the economic impacts of the reforms at the industry level, and to assess the net impact on the Pennsylvania economy.”

The four scenarios were prepared based on static revenue estimates prepared by the Pennsylvania Department of Revenue for the Commission. The four scenarios were based on different tax scenarios which incorporate some combination of the proposals under consideration so the Commission members could see the dynamic modeling effect and the distributional effect

by industry. Table three contains the dynamic impacts of business tax reform proposals for four scenarios for a five year period. In evaluating the impacts on business taxation, Global Insight's conclusion was, "it is important to note that, given the statistical uncertainty about the size of the relevant elasticities, and of the distribution of the shifts in tax burdens across industries, these differences could be viewed as insignificant."

B. Overview of Global Insight's Methodology

The methodology described below is compiled from Global Insight's Report dated November 16, 2004. See page 3 and 4 of the Report.

"The Pennsylvania Department of Revenue has provided estimates, based upon its database of PA corporations and other businesses, of the impact, by industry, of each of the proposed reforms. Global Insight uses these estimates as the starting point in its analysis.

"Global Insight maintains, as part of its US Regional Service, a large econometric model of the Pennsylvania economy. This model is capable of quantifying the resulting changes, at all levels of economic activity, of shifts in industrial structure and performance. While federal, state, and local taxes play a significant role in our standard model, we had not previously incorporated a separate role for state business taxes. In this research we have augmented our standard PA model with the inclusion of direct CNIT incidence for every industry sector. (In particular, for each 2-digit NAICS industry we have included a corporate income tax variable among the explanatory variables for employment and for gross product.) The result is that for each industry we have econometrically estimated an elasticity of employment or production of that sector with respect to the corporate tax rate. These elasticities are presented in Table 1. These elasticities represent the responsiveness of activity in each sector with respect to changes in the corporate income tax rate. As corporate income tax liability is a fraction of the overall tax burden on business, it is much smaller than the full elasticity of activity with respect to all taxes. They also are expressed relative to changes in current tax liability, rather than versus tax rates.

Table 1

	Elasticity
Construction & Mining	-0.005
Non-durables Manufacturing	-0.013
Durables Manufacturing	-0.018
Wholesale & Retail Trade	-0.002

Transportation & Warehousing	-0.002
Information	-0.035
Finance, Insurance & Real Estate	-0.002
Business Services	-0.012
Educational and Health Services	-0.002
Leisure and Hospitality Services	-0.010
Other Services	-0.001
Miscellaneous	

“These impacts represent the direct effects of corporate taxation on business activity in the state.

“But the impact of corporate taxation does not end there. As individual businesses and industries expand or contract they create further economic feedback effects. For instance, these industries purchase materials, supplies, and finished goods and services from other industries in the state, boosting their production, employment, and income. Further, the increased income thus earned, most notably by workers, generates increased demand and spending for consumer goods and personal services. Our economic models fully account for these multiplier effects and the results presented in Table 2 document our findings as to the full economic impacts of the proposed reforms.

C. Review of Pennsylvania Department of Revenue's Static Revenue Estimate for 2005

An Evaluation of the Estimation, by the Pennsylvania Department of Revenue, of the Revenue Impact of Combined Reporting on the Corporate Net Income Tax

Submitted to:

The Pennsylvania Department of Revenue

Prepared by:

Global Insight, Inc.

September 7, 2004

Global Insight

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Introduction

The Commonwealth of Pennsylvania imposes a Corporate Net Income Tax (CNIT) upon corporations doing business in the state. Under the CNIT, corporations account for income by filing on a separate entity basis. For tax purposes, the corporate entity files a return based only on its activity, notwithstanding its relationship as parent, subsidiary, or member of an affiliated group of corporations. Many tax experts and authorities in numerous states now believe that separate reporting is conducive to aggressive tax planning by corporate groups and results in reduced state corporate income tax revenues. The Pennsylvania Business Tax Reform Commission has considered a tax reform that would require the filing of combined tax returns, often termed unitary taxation. The Pennsylvania Department of Revenue (DOR) has estimated the revenue implications of such a reform. The purpose of this report is to evaluate the methodology used in preparing that revenue estimate and to advise as to its robustness.

The effect of the reform is to broaden the reach of the CNIT by inclusion of the activities of related corporations currently not subject to Pennsylvania's taxation. This new income is, of course, apportioned to Pennsylvania through a calculation of its share of the larger entity and, as such, does not necessarily generate an increase in Pennsylvania's CNIT liability. Because current corporate taxpayers report income on a separate basis, the DOR does not have corporate tax accounting information available to directly compute the tax liability of its taxpayers under the reform proposal.

In such circumstances, revenue estimators typically resort to a methodology based on an estimate of more general economic variables that can be expected to serve as proxies for the relevant tax variables. In the case of state corporate income taxes, however—due to the volatility of profits over time, their variation over industries, and especially their sensitivity to corporate structure and inter-company transactions—any such estimates are far too imprecise to be credible policy guides. The best strategy, and the one subscribed to by revenue estimators across the country, is to attempt to simulate directly the tax accounting changes to a representative panel of sample tax returns.

The comparison of Federal tax returns with Pennsylvania returns would provide an imperfect basis for a revenue estimate; but the lack of relevant multi-state accounting necessary for the exercise, and the confluence of related and unrelated business income within a consolidated group of corporations, would add considerable error to any estimate so derived. DOR has devised a methodology based upon an alternative data set that is directly relevant to the problem at hand. That is, it sought to directly use the tax return information revealed by combined returns as filed in other states. Minnesota, in particular, already requires the type of combined reporting under consideration as business tax reform in Pennsylvania.

It is the opinion of Global Insight that the availability of these returns, filed on a combined reporting basis, represent the best available source data to use in construction of a Pennsylvania revenue estimate. The remainder of this report will evaluate the use by

DOR of this resource.

Methodology

Minnesota is one of sixteen states that requires combined reporting for corporate income tax liability. The Minnesota economy is roughly one-half the size of Pennsylvania's. It is not dramatically different in industrial structure, although its manufacturing sector has a greater high-technology component, and its private educational and health services sectors are less significant. One variant of the methodology might have utilized the impact for Minnesota of combined reporting and extrapolated that to Pennsylvania. However, while offering some insight, the revenue implications would be very inexact owing to the importance of unique corporate relationships between each state and its neighbors and the rest of the U.S. economy. These relationships affect the apportionment of the unitary group's income and may vary systematically with geography, size, and industry structure. The DOR, however, wisely realized that the Minnesota sample could be utilized in ways that were more directly representative of Pennsylvania. DOR's investigation directly uncovered a sample of unitary groups for whom at least one member was a Commonwealth taxpayer and whom would be required to file a combined return under the proposed reform. This sample would then provide the basis for the simulated tax impact analysis.

Combined reporting would only affect a fraction of Pennsylvania's corporations. Those corporations, whether doing business entirely in-state or in multiple states, are not affected unless they are related to foreign (out-of-state) corporations in a related line of business. (Foreign members of an affiliated group who are in unrelated lines of business would not be required to file as part of the unitary group). In developing a sample of taxpayers containing members who currently are Pennsylvania taxpayers and who would be required under the reforms to file as part of a larger combine group, DOR chose precisely those unitary groups in Minnesota that contained members subject to the Pennsylvania CNIT. It has thus developed a sample database of tax returns that are directly applicable to the desired Pennsylvania tax simulation. These groups would be actual filers under combined reporting in the state. Therefore, it is an excellent database. The logical next question to address is whether it is representative of the true "universe" of all combined groups that would be mandated to file. If so, the inferences and estimates drawn from it would be subject only to the usual statistical prediction errors that occur in any well-drawn random sample.

To evaluate the degree to which the sample is representative, we consider the following factors. First, as the sample is derived from the set of firms that operate in both Minnesota and Pennsylvania, does this set constitute a representative sample of all multistate unitary groups? Second, is the selected sample representative of this group?

On the first point, Minnesota is the 16th largest state in the nation. In an era when multi-state corporations dominate the U.S. business landscape from the East to West Coast, it is reasonable to consider the match of Minnesota and Pennsylvania firms as representative

of large U.S. firms active nationwide. This group of 4,643 unitary groups-also constitutes a large share of corporate tax liabilities and payments in most states. This group is the most important component of liability to simulate; it adds great confidence to the resulting revenue estimate that it is truly representative.

In addition, there exist what the DOR refers to as regional groups: those multi-state (generally in the Northeast) groups of corporations who do not operate nationwide, but may be significant taxpayers who would not be represented at all in Minnesota and hence not subject to sampling. The DOR did estimate the contribution of these groups; we will return later to this part of the methodology.

On the second factor, the sample was selected in an efficient stratified manner. The largest taxpayers of interest, those whose unitary income (as indicated by the Minnesota returns) exceeded Pennsylvania income by more than \$1 billion, were all included. These 83 groups accounted for 57% of the total income difference. Those with income differences from \$1 million to \$1 billion were sampled at a lesser rate, with 56 of 3,311 chosen. Finally, the smaller firms were sampled at the rate of 13 of 1,249. Stratification was also based on industry class. Based on an overview of the distribution of corporate income across the sample, the choices of strata appear to be sufficient for a good estimate. This sampling methodology represents "best practice" in statistical sampling methodology. The sample itself was a large portion of the CNIT, constituting about one-quarter of the total state CNIT liability.

An adjustment was made by DOR to account for the effect of inter-company transactions on Pennsylvania apportionment. The treatment of transactions between members of the unitary group needs to be considered in any move to a combined reporting requirement. Other states generally apply a wash rule to negate the impact of such transactions. DOR used a sample of publicly available corporate records to adjust the reported Pennsylvania apportionment factors downward. It is unclear how accurate (a 3.27% reduction in Pennsylvania sales and property numerators) such an estimate is, but we judge it to be reasonably conservative.

The results of tax calculations under combined reporting were then tabulated directly for the sample. The sample weights were then used to construct an estimate of all Pennsylvania taxpayers. This also is standard, and best, practice in sampling methodology for this type of estimation. The DOR provided Global Insight, under strict confidentiality agreements and with corporate identifiers removed, the raw data of the match of Pennsylvania and Minnesota tax returns. The organization of the data was transparent, and the techniques used to cumulate the return information were sound and straightforward to reproduce. We have no doubt as to the veracity of the results obtained.

DOR simulated the revenue impact of combined reporting under two scenarios, distinguished by the treatment of Net Operating Loss (NOL) deductions. The calculation from the database is straightforward. It is important to note that in each alternative, it was assumed that NOL carry forwards could only be used by the taxpayer who, on a separate

company basis, earned them. If the final legislation implementing the proposal were to allow the sharing of NOLs among group members, the revenue impact could be significantly different.

DOR found, among Pennsylvania taxpayers, 208 corporations with either CNIT liability in excess of \$1 million or Pennsylvania sales in excess of \$100 million, who were not included in the Minnesota match. The latter criterion is especially important as over half of the corporations meeting this criterion had no Pennsylvania CNIT liability in 2000. To simulate how these taxpayers, termed regional groups, would be affected by combined reporting, it applied the average income and apportionment adjustments implied by the moderately sized corporations (with income difference less than \$1 billion) in the matched sample. The estimate for this group, which represents almost 30% of the revenue impact, is the weakest major part of the methodology. In statistical terms, it is comparable to applying the sample results of the moderately sized national groups to regional corporations. There is no reason to think that this is a biased estimate of the impact, but it does serve to increase the level of uncertainty and statistical error. A significant part of this uncertainty was ameliorated by an additional treatment for utilities, which accounted just over 50% of the liability of this category. For that sector, publicly available information from SEC filings was used to calculate alternative apportionment factors, which replaced those from the sample when smaller. This had the conservative effect of reducing the estimated revenue under combined reporting

Acknowledgements

Global Insight acknowledges the valuable professional assistance of the DOR staff in preparing this evaluation. In addition to providing the sample database in a wellorganized and documented medium, the staff answered numerous questions regarding the development of the methodology. The information and explanations offered greatly clarified many issues. Among the topics discussed were the treatment of unrelated business income, the selection of sample statistics appropriate for the regional groups, the matching process among the three (federal, Pennsylvania, and Minnesota) taxpayers, the role of Pennsylvania nexus, and inter-company transactions.

Recommendations

The stimulation procedure was, though efficient, based on a statistical sample. As such, there is some degree of sampling error that results. Corporate income tax liability is notoriously volatile, both across corporations and across time. The confidence of any revenue estimate improves if the sample size is increased. Gains to increasing the sampling rate from the year 2000 Minnesota returns would not be expected to be large. However, owing to the variability over time of corporate income, it is advisable that the DOR attempt to reproduce the results with the returns of another tax year. This would add greatly to statistical confidence in any case. Moreover, as the year 2000 represented a U.S. business cycle peak, it is especially important to evaluate the revenue implications

of the complex interlocking web of corporate relationships at an alternative point in the business cycle. The use of NOLs by corporate taxpayers is, for instance, highly cyclical.

Conclusion

Global Insight, upon extensive evaluation, finds that the methodology the DOR used in estimating the revenue impact of combined reporting under the CNIT is sound and represents best practice. It is recommended that the DOR, in order to reduce the statistical uncertainty of the estimates, expands its sample to include information from additional tax years. The methodology itself can and should be retained for this analysis.

D. Dynamic Modeling Analysis of Major Recommendations

The Economic Impact of Proposed Reforms to the Corporate Net Income Tax of the Commonwealth of Pennsylvania

Submitted to:

The Pennsylvania Department of Revenue

Prepared by:

Global Insight, Inc.

November 16, 2004

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Introduction

The Commonwealth of Pennsylvania imposes a Corporate Net Income Tax (CNIT) upon corporations doing business in the state. The Pennsylvania Business Tax Reform Commission has considered a series of modifications to the Pennsylvania tax code. These proposed changes are based on principals of fairness, equity, and efficiency. In this report, however, we restrict our analysis to the economic impact of each of the proposed reforms. We present our findings as to the distribution of monetary gains and losses across the distribution of Pennsylvania businesses. We also assess the resulting impacts upon the Commonwealth in general, and its constituent industries, in terms of jobs, income, and the production of goods and services.

The Proposed Reforms

The Commission has considered five fundamental, significant reforms in the CNIT. First, corporations would be required to file combined returns, wherein the income of all members of an affiliated group of corporations, including those not doing business in the state, is apportioned to Pennsylvania and subject to the CNIT. Second, an entity-level tax would be imposed on all or most "pass-through" entities: Subchapter S Corporations, Limited Liability Partnerships, Limited Partnerships, and Limited Liability Corporations, who are currently not subject to direct business taxation on net income. Third, the apportionment factor would be modified in two ways: by a revised treatment of transactions involving services (market-based sourcing) in the calculation of the salesfactor portion of apportionment; and by revising the weight of the sales factor. Fourth, a "Business Benefits Tax," a low rate levy on a broad base, the value added for every business in Pennsylvania, might be imposed. Finally, to offset the significant positive tax revenue impacts for the state of these changes, the CNIT tax rate would be reduced from 9.99%.

The Commission has considered four scenarios, each of which incorporates some combination of the aforementioned reforms. The cumulative result of each of these sets of changes would, by design, neither increase nor decrease the aggregate business tax burden in the Commonwealth. However, the Commission recognizes that the distribution of impacts might not be identical across individual corporations, or across industry sectors. The purpose of this research is to evaluate the economic impacts of the reforms at the industry level, and to assess the net impact on the Pennsylvania economy.

The Economic Impact of Business Taxation

The magnitude of the tax burden on business is continually cited as a critical cost of doing business in a state or locality. In the past quarter century, states have increasingly stressed their economic competitiveness as the key economic factor in attracting and growing business in the state. Taxes are a visible component of business costs, vary across states, and are directly subject to the control of state governments. They have thus become the

focal point of many economic development incentive programs and much discussion.

Corporate income taxes are, however, a relatively small fraction of business tax costs. Moreover, those tax costs are but a small fraction of total business costs. In the consideration of alternative business locations, land or office costs, energy and transportation expenses, and wage costs and labor availability are factors of far greater importance. Nevertheless, in cases where wage levels and other cost factors are very similar, tax levels or tax incentives can play a decisive role in site selection.

Economic research upon the degree to which business taxes are important determinants of the location of economic activity, best summarized by Wasylenko et al. (1997)¹, has come to mixed conclusions. The consensus is that, while taxes matter, they matter far less than state economic development officials tend to assume. We thus expect to find in our analysis elasticities, which quantify the responsiveness of activity to tax levels, to be small.

Methodology

The Pennsylvania Department of Revenue has provided estimates, based upon its database of PA corporations and other businesses, of the impact, by industry, of each of the proposed reform scenarios. Global Insight uses these estimates as the starting point in its analysis.

Global Insight maintains, as part of its U.S. Regional Service, a large econometric model of the Pennsylvania economy. This model is capable of quantifying the resulting changes, at all levels of economic activity, of shifts in industrial structure, and performance. While federal, state, and local taxes play a significant role in our standard model, we had not previously incorporated a separate role for state business taxes. In this research, we have augmented our standard PA state model with the inclusion of direct CNIT tax incidence for every industry sector. (In particular, for each 2-digit NAICS industry we have included a corporate income tax variable among the explanatory variables for employment and for gross product.) The result is that for each industry, we have econometrically estimated an elasticity of employment or production of that sector with respect to the corporate tax rate. (These elasticities are presented in Table 1.) These elasticities represent the responsiveness of activity in each sector with respect to changes in the corporate income tax rate. As corporate income tax liability is a fraction of the overall tax burden on business, it is much smaller than the full elasticity of activity with respect to all taxes. They also are expressed relative to changes in current tax liability, rather than versus tax rates.

These elasticities have been estimated econometrically. They are thus subject to statistical error. The upper bounds in Table 1 indicate the maximum degree of responsiveness in each industry, evaluated at a 95% confidence level. In general, a 95% confidence interval cannot rule out the conclusion that corporate taxes have no effect on activity in that sector.

Table 1

	<u>Elasticity</u>	<u>Upper Bound</u>
Construction & Mining	-0.1024	-.1251
Non-durables Manufacturing	-0.0120	-.0176
Durables Manufacturing	-0.0359	-.0576
Wholesale & Retail Trade	-0.0002	-.0024
Transportation & Warehousing	-0.0006	-.0056
Information	-0.0316	-.0697
Finance, Insurance & Real Estate	-0.0033	-.0051
Business Services	-0.0161	-.0459
Educational and Health Services	-0.0072	-.0124
Leisure and Hospitality Services	-0.0216	-.0370
Other Services	-0.0010	-.0031

These impacts represent the direct effects of corporate taxation on business activity in the state. For instance, a 10% increase in the effective corporate tax rate on the average manufacturer of durable goods in the state will lead to reduced activity in that sector of 0.359% ($.0359 \times 10\%$). This reduction, relative to the baseline of no tax change, is due to some combination of a reduction of activity at existing plants and a reduced incentive for expansion in the state. For each scenario considered by the Commission for which the DOR provided direct tax impacts by industry, we have applied these elasticities to calculate the direct industrial impacts.

Table 2 describes the estimated direct impacts at the industry level for each of the four scenarios. (See page 6 for the tax law changes associated with each scenario.) In each case, the direct tax impact of the slate of reforms has a direct impact on the industry as estimated by our model. It is these effects that in turn drive further impacts on the PA economy, as their expansion or contraction increases or decreases spending in other sectors. For instance, the tax increases in the non-durables manufacturing sector implied by scenario 11 lead to the loss of 1,230 jobs in that sector.

Table 2
Direct Impact Analysis: Corporate Income Tax

	<u>Scenario 4</u>	<u>Scenario 8</u>	<u>Scenario 11</u>	<u>Scenario 12</u>
Employment Total, Thousands, SA	1,440	(900)	(4,207)	1,420
Natural Resource & Mining	0	0	(17)	0
Manufacturing	(440)	660	(227)	80
Durable Manufacturing	1,020	1,460	1,002	1,300
Non-Durable manufacturing	(1,440)	(840)	(1,230)	(1,220)
Non-Manufacturing	1,860	(1,560)	(3,963)	1,340
Construction	1,440	(520)	161	1,080
Finance	680	420	(1,250)	640
Information	20	(40)	(152)	20
Wholesale Trade	(20)	0	2	(20)
Retail Trade	(20)	0	2	(20)
Transportation and Warehousing	20	0	61	20
Professional and Business				
Services	140	(60)	(837)	100
Leisure and Hospitality	(820)	(1,520)	(1,231)	(900)
Other	420	160	(719)	420

Individual businesses are affected in different ways by the proposed reforms. The effects of combined reporting, and the associated net tax increases, only impact PA businesses that are part of a multi-state affiliated group. On the other hand, single, unaffiliated domestic PA corporations benefit from rate reductions. Our analysis is restricted to an industry basis only. Within each industry there will likely exist a combination of these types of businesses, some with significant tax burden increases, and others with tax decreases. We estimate the net effect of gains and losses, and hence of incentives to increase or decrease business activity in PA for each industry.

But the impact of corporate taxation does not end there. As individual businesses and industries expand or contract, they create further economic feedback effects. For instance, these industries purchase materials, supplies, and finished goods and services from other industries in the state, boosting their production, employment, and income. Further, the increased income thus earned, most notably by workers, generates increased demand and spending for consumer goods and personal services. Our economic models fully account for these multiplier effects and the results presented in Table 3 document our findings as to the full economic impacts of the proposed reforms.

Table 3
ESTIMATED DYNAMIC IMPACTS OF BUSINESS TAX REFORM PROPOSALS
(Evaluated at Projected 2009 Levels)
(Percent of PA Total)

	<u>Employment</u>	<u>Wages</u> (\$ Thousands)	<u>Personal Income</u> (\$ Thousands)	<u>Gross State Product</u> (\$ Thousands)
<u>Scenario 4</u>				
Combined Reporting				
\$2M NOL Carry-ins; Uncapped Group NOLs				
60% Sales Factor; Market-Based Sourcing of Sales	2,736	230,451	304,356	481,853
CNIT Rate Reduction (6.99%)	0.05%	0.08%	0.06%	0.08%
<u>Scenario 8</u>				
Combined Reporting				
\$2M NOL Carry-ins; Uncapped Group NOLs				
100% Sales Factor; Market-Based Sourcing of Sales	(1,710)	24,428	30,732	51,077
CNIT Rate Reduction (7.36%)	-0.03%	0.01%	0.01%	0.01%
Entity-Level Tax (1%)				
<u>Scenario 11</u>				
Combined Reporting				
\$2M NOL Carry-ins; Uncapped Group NOLs				
100% Sales Factor; Market-Based Sourcing of Sales	(7,573)	(349,814)	(463,570)	(670,996)
CSFT Elimination; CNIT Rate Reduction (6%)	-0.14%	-0.13%	-0.09%	-0.12%
Business Benefits Tax (0.75%)				
<u>Scenario 12</u>				
Combined Reporting				
\$2M NOL Carry-ins; \$20M Cap on Group NOLs				
75% Sales Factor; Market-Based Sourcing of Sales	2,698	234,975	310,947	491,312
CNIT Rate Reduction (7.05%)	0.05%	0.09%	0.06%	0.08%

Conclusion

Global Insight has found that the impact of corporate income taxation in Pennsylvania has been negative, though very small in magnitude. Indeed, we cannot with high statistical confidence conclude that there is any significant impact. Table 3 summarizes the effects of four proposals considered by the Commission. Scenario 11 has negative net impacts on the state economy, while Scenarios 4, 8 and 12 are generally positive. These results are derived entirely from our estimation of the impacts of business taxation across the state's industries. It is important to note that, given the statistical uncertainty about the size of the relevant elasticities, and of the distribution of the shifts in tax burdens across industries, these differences could be viewed as insignificant. We also note that the impacts are based solely on the ultimate tax liability implications of the considered scenarios. They do not shed light on the relative merits of the type of tax structure implied by any scenario.

FOOTNOTES

21. **Global Insights: Review of Pennsylvania Department of Revenue Static Revenue Estimate for 2005 and Dynamic Modeling Analysis of Major Recommendations**
1. Wasylenko, Michael, Timothy J. Bartik, Harley Duncan, Therese McGuire, "Taxation and Economic Development: The State of the Economic Literature" *New England Economic Review*, Mar/Apr, 1997.

OTHER RECOMMENDATIONS

22. Evaluating Economic Development

The Commission in evaluating economic development within the Commonwealth has received substantial commentary and presentations considering the focus of the incentives for the development of such growth. Presently, the State of Pennsylvania has numerous programs designed to increase jobs, improve communities and stir economic development. The Commission has recommended an annual report be prepared detailing the utilization of the various credits and incentives.

OTHER RECOMMENDATIONS

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OTHER RECOMMENDATIONS

23. Other Issues Raised During the Commission's Deliberations but not Included in the Final Report Because They Were Outside the Parameters of the Commission's Executive Order

The Executive Order creating the Business Tax Reform Commission required that its recommendations be revenue neutral within the purview of business taxes alone. The Commission, therefore, issued a package of recommendations in its final report that it believes would create a more attractive climate for economic development by establishing a more fair and balanced approach to business taxation. The Commission discussed the possibility that achieving these objectives solely by being revenue neutral among business taxes is not the only way, or perhaps not even the best way, for the Commonwealth to retain existing employers or to attract new employers .

The Commission supports lowering the Corporate Net Income Tax Rate and has recommended a rate of 6.99 percent. However, some Commissioners believe that the CNIT rate should not exceed 6 percent and that the exemption of pass through entities from direct income taxation should be retained.

In order to achieve a 6 percent CNIT rate without imposing an entity level tax on pass through entities, some Commissioners suggested that other approaches could be considered to achieve revenue neutrality for the Commonwealth, such as:

1. Increase the PA PIT rate for all taxpayers and provide for certain exemptions and/or deductions in arriving at Pennsylvania Personal Income Taxable Income. For example, the revenue shortfall estimates for the Commonwealth based on the Commission's recommendations without the entity level tax and by lowering the CNIT rate to 6 percent, could be made up with an increase in the PA PIT rate of .153 percent based on Pennsylvania Department of Revenue estimates for the year 2005.
2. Further study could also be given to the dynamic impact and economic development that may result from significantly lowering the CNIT rate and increasing the PIT rate.

24. Comments Concerning the Executive Order

The comments below are the opinion of Commissioner Michael Cortez and should not be interpreted as the position of the Commission as a whole, or any other Commissioner.

Commentary of Commissioner Michael Cortez

I wanted to take this opportunity to express certain reservations regarding the recommendations made by the Pennsylvania Business Tax Reform Commission (the Commission). To be sure, I believe that our recommendations are well thought out. I also believe that these recommendations reflect the best thoughts of fourteen extraordinarily capable individuals who had nothing but the best interests of the Commonwealth at heart. However, it is my belief as well that the work of the Commission was necessarily limited by the constraints of the Executive Order that created it.

Specifically, the Commission operated under the mandate that its recommendations were to be “revenue neutral” within the scope of “major corporate taxes.” In my opinion, this mandate hindered the Commission’s ability to craft potentially meaningful solutions. Two pieces of testimony perhaps best illustrate my concern.

First, Dennis Yablonsky, Secretary of the Department of Community and Economic Development, testified that:

“the direction that you [*the Commission*] are heading in is terrific. It would really help to improve our competitiveness in the business climate in Pennsylvania. But I also want to underline that most of those things will level the playing field. They are not going to make us significantly better than our competitor states. They will level off the playing field for us.” (*Bracketed language added*).

He later added:

“I want to also underline the fact that we are not at the top of the heap in terms of economic performance in America.

We were 47th out of 50 states in job growth during the 1990’s. We were 48th out of 50 states in population growth during the 1990’s. And we led America in one statistic, a dubious one. We led America in the export of 25 to 30 students. We lost more young people than any other state in the union.

So we are moving from a baseline of very poor performance.”

Second, the Commission heard testimony regarding the “Pennsylvania 21st Century Tax Policy Project” (PA 21). This project was years in the making. It involved some of the best minds in business, law, accounting, labor and government. It had many of the same

goals as the Commission, that is, to create job growth, stimulate Pennsylvania's economy, and make it more competitive. Yet, in trying to create an optimum solution to Pennsylvania's business tax problems, PA-21 recommended changes to our tax structure which were "out of balance" (net revenue loss to the Commonwealth) by approximately \$760 million dollars, if one considers only the corporate net income tax and the capital stock and franchise tax. The Commission, however, was directed to look at these same two taxes and "create solutions" that were "revenue neutral." No other revenue generators outside of business taxes were considered. No spending solutions were addressed.

Together, Secretary Yablonsky's testimony and the PA 21's recommendations point out the difficulties inherent in "revenue neutrality" when one considers only the corporate net income tax and the capital stock and franchise tax. Pennsylvania's current tax system has made it uncompetitive. The mandate of revenue neutrality has only allowed the Commission to "push money around." As a result, the Commission was not granted the flexibility to make the kind of changes necessary to attract business, increase employment, and stimulate growth. Simply stated, if Pennsylvania is currently in a poor competitive position, doesn't the mandate of revenue neutrality, mean that Pennsylvania, after the recommendations, will end up in the same economic position?

This concern is compounded by the fact that the Commission was limited in its use of dynamic modeling to determine the tax revenue impact of our recommendations. For example, I believe that a significant reduction in the CNI tax rate would stimulate economic growth. It seems obvious to me that such economic growth would lead to economic activities (additional jobs, additional income, additional purchases, additional construction activities, etc.) which themselves would be taxed. As a result, the use of dynamic modeling could have helped the Commission measure this offsetting positive revenue impact. Instead, we principally utilized "static" modeling and assumed that a reduction in rate would lead to a corresponding reduction in revenues (with no offsetting gains in revenues resulting from any increased economic activity).

The result of these constraints is that the Commission was forced to make difficult choices. Choices that may have been unnecessary if the Commission had greater flexibility. For example:

The Commission has recommended mandatory unitary combined reporting. A reporting system that I believe is business unfriendly and carries with it the possibility of tremendous uncertainty and litigation. A reporting system that I also believe may scare business away from the Commonwealth.

In part, to offset the potentially harmful impact of combined reporting, the Commission's interim report suggested a need for the reduction in the CNI rate to approximately 6 percent. The Commission could not achieve such a rate reduction. Instead, we settled at a rate of 6.99 percent. A rate that I am concerned may not be sufficient to offset the negatives associated with combined reporting.

The Commission could not uncap, or even liberalize NOLs that corporations may have had prior to the date combined reporting would be adopted. This, even though the Commission recognized that capping NOLs is bad tax policy.

The Commissioners recommended an entity level tax on “pass-through” entities. This recommendation may be contraproductive for job growth when others are currently recommending that such entities should in fact be encouraged.

This is not to say that the Commission’s recommendations are “incorrect” given the constraints of the Executive Order. It is merely to point out that the recommendations are in fact the product of the Executive Order.

One final thought, during the initial stages of the work of the Commission, we heard considerable testimony regarding passive investment companies (PIC’s). PIC’s are not evil. In fact, I believe that PIC’s were actually encouraged by the Commonwealth. While I understand the desire to curb abusive PIC’s in the future, I sensed an undercurrent regarding the current use of PIC’s. Let me simply state that any attack on PIC’s on the basis that they are tax planning devices and that the business purpose was to reduce Pennsylvania taxes, is inappropriate and unwarranted.

**OTHER PROPOSALS CONSIDERED BY THE COMMISSION
BUT NOT RECOMMENDED**

25. Other Proposals Considered by the Commission but Not Recommended

A. Throwback, Throw-out Rule

A throwback or throwout rule is designed to prevent or limit "nowhere" sales that arise because some portion of income is not taxed in any state. In calculating the share of sales in Pennsylvania, a throwback rule would include in the numerator (in addition to sales in Pennsylvania) sales shipped from Pennsylvania to states where the CNI taxpayer is not subject to a corporate income tax. A throwout rule excludes from the denominator sales by the corporation in states where it is not subject to a corporate income tax. Under current sales factor sourcing rules, it is expected that a throwback/out rule would primarily affect manufacturers, wholesalers and distributors.

Pennsylvania has not adopted the throwback rule, which would attribute to the numerator of the Pennsylvania sales factor sales made from Pennsylvania by a taxpayer into a state in which the taxpayer is not subject to tax. The purpose of the throw-back rule is to ensure that 100 percent of a taxpayer's sales are assigned to some state in which the taxpayer is subject to tax, thus ensuring that 100 percent of the taxpayer's business income is taxed among the states in which it is taxable.

B. Equalization of Pass-Through Taxation Rate with Reduction in Pennsylvania Corporate Net Income Tax Rate

The Keystone Research Center suggested "that there is no economically meaningful difference between different types of business entities, and therefore, no tax policy rationale for taxing them differently. For that reason, it recommended to the Tax Reform Commission that C corporations, S corporations, Limited Liability Corporations (LLCs) and Limited Liability Partnerships (LLPs) pay the same tax rate on their profits. This could be accomplished by an entity level tax equal to the gap between the CNI rate and the Personal Income Tax rate already paid on the income of pass-through entities.

The equalization of tax rates proposed in the previous paragraph is only equitable if businesses are taxed on equivalently broad tax bases.¹ For these reasons, a second recommendation to the Commission is that Pennsylvania adopt combined reporting to eliminate the uncertainties associated with separate company tax reporting.

One question raised by the two recommendations above is to what level they would allow a new and common corporate (and partnership) income tax rate to be lowered. Analysis estimates 6.5 percent to be the revenue neutral common rate if imposed on C and S corporations, along with LLCs.

If Pennsylvania implements combined reporting and establishes an entity tax on S corporations and LLCs that is equal to the difference between the CNI and the PIT, it could raise the same revenue as it currently does (i.e., from a 9.99 CNI with separate company reporting) via a 6.5 percent CNI and a 3.43 percent entity level tax.” See Keystone Research Center’s testimony before the Commission.

Another recommendation to the Commission is that the Pennsylvania Constitution be amended to permit personal exemptions that eliminate taxes on the first part of income. However, this recommendation is deemed to be outside the scope of the Commission’s charge.

C. Fixed License Fee for all Entities

The Commission was also urged to support an entity license fee. Under PA-21’s proposal, “C corporations would pay a flat fee of \$1,000 annually. Similarly, S corporations and LLCs would pay a flat fee of \$100 annually. Partnerships would not be required to pay the fee. In tax year 2005, it is estimated that approximately 110,500 C corporations, 135,000 S corporations, and 25,000 LLCs would be subject to these fees. See PA-21 Project, Page 99 and Appendix A starting at page A-35.)

Pennsylvania does not impose a minimum tax on corporations and other limited liability entities, such as limited liability companies (LLC) and limited partnerships (LP).

A minimum tax of a specified dollar amount (the same for all taxpayers) is a tax based on an entity's utilization of a state's market rather than a tax based on net income. Therefore, a business entity otherwise exempt from corporate net income tax as a result of federal P.L. 86-27284 or the state's pass-through provisions would still be subject to a state's minimum tax. Flow-through entities that would otherwise not be subject to an entity level tax (such as electing S corporations) would also be required to pay the minimum tax.

Business License Fee. The PA21 package recommended a new annual license fee of \$1,000 on C corporations and \$100 on limited liability pass-through entities, which include S corporations, LLCs and LPs. The license fee would not be imposed on general partnerships or personal trusts. This license fee would be imposed on all limited liability entities utilizing

Pennsylvania's market, even if they otherwise have no taxable income, are exempt from the CNI or have no taxable net worth”²

D. Stand Alone Passive Investment Company Addback Provisions
(Addressed in Definition and Adoption of Combined Reporting)

Affiliated passive investment companies (PICs) may be established purely for the purpose of tax reduction with no other economic or legal reason to exist. Some states, such as Delaware and Nevada, do not tax the income of PICs. Other states, such as Pennsylvania, do tax this income, but do not tax royalty payments that corporations make to out-of-state affiliated PICs. This gives corporations a tax incentive to establish affiliated PICs that operate in the no-tax states. Therefore, Pennsylvania's current rule allows corporations to shift taxable income in the form of royalty and interest expense deductions from a jurisdiction where it would otherwise be taxed, such as Pennsylvania, to a jurisdiction where it is not taxed.

A passive investment holding company is a company that is formed to hold passive investments. A PIC is usually located in a state that does not impose a tax on corporate income or in a state that does not impose a corporate income tax on PICs. In addition, PICs may be located in a state that taxes affiliated entities on a combined basis with eliminations for intercompany transactions. Delaware is one such state.

States have taken various approaches to remedy the Delaware Holding Company (DHC) strategy. Actions by states that tax on a separate company basis have included the following:

- (a) Taxing the DHC on a theory that the DHC has economic nexus with the state or that it is nothing more than a phantom corporation.
- (b) Disallowing expenses paid to the DHC based on explicit statutory authority or the common law sham transaction doctrine.
- (c) Redistributing corporate income and expenses based on statutory authority similar to that found in Internal Revenue Code § 482.

Note: There are constitutional challenges pending on the application of certain state anti-passive investment company add back provisions.

The PA 21 Project contained a provision for an add back provision relating to passive investment companies.³ See Page 93, 94 and 95 of the PA-21 Report

E. Stand Alone Section 482 Powers (Intended Incorporation in Definition and Adoption of Combined Reporting)

Pennsylvania could join several neighboring states in implementing provisions directed at curbing Passive Investment Companies (PICs) that lack business purpose other than saving in-state corporate income taxes. Such provisions could ensure that taxable income has not been reduced by the amount or the deduction for interest expenses and intangible expenses paid, accrued to, or incurred, in connection with one or more transactions if the corporation(s) receiving the payments fails the business purpose test. The provisions could also ensure that the corporation is required to maintain and make available upon the request of the Department of Revenue records to establish that such transactions have a valid business purpose other than the avoidance of in-state corporate income taxes.

The Secretary of Revenue could be given §482-type powers that could be used to prohibit a wider range of tax avoidance abuses than occur through PICs. As stated in 26 U.S.C. §482, "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." The Department currently possesses the power to issue administrative summons requiring corporations to provide certain information (72 P.S. § 1602), which enables the Department to access information necessary to evaluate the need for adjustments to income to prevent tax evasion. These powers are similar to those granted the U.S. Secretary of the Treasury (implemented through the IRS) under 26 U.S. §7602(a)(2) and (3) and will be more meaningful in conjunction with 482-type powers.

In lieu of adopting Section 482 for domestic transactions, the Commission recommends the adoption of combined reporting. In conjunction with combined reporting, however, the Pennsylvania Department of Revenue would still need 482 powers to combat foreign abuses in administering a water's edge combined reporting tax structure.

F. Acceleration of the Capital Stock Franchise Tax (CSFS)

A. Current Pennsylvania Law

The Commonwealth taxes the capital of corporations through a Capital Stock and Foreign Franchise Tax, which is imposed on the capital stock of domestic corporations and upon the exercise of the corporate franchise in Pennsylvania by a foreign entity. The tax obligation is computed utilizing a statutory formula less an exemption and is presently assessed at a statutory rate of .00699. The CSFT is scheduled to expire according to the schedule below:

January 1, 2002 to December 31, 2002 – 7.24 mills
January 1, 2003 to December 31, 2003 – 7.24 mills
January 1, 2004 to December 31, 2004 – 6.99 mills
January 1, 2005 to December 31, 2005 – 5.99 mills
January 1, 2006 to December 31, 2006 – 4.99 mills
January 1, 2007 to December 31, 2007 – 3.99 mills
January 1, 2008 to December 31, 2008 – 2.99 mills
January 1, 2009 to December 31, 2009 – 1.99 mills
January 1, 2010 to December 31, 2010 – 0.99 mills

Franchise Taxes

The capital stock tax applies to all domestic corporations (entities organized under Pennsylvania law) and the foreign franchise tax applies to foreign corporations (entities organized under the laws of another jurisdiction) that conduct business in Pennsylvania. Both the capital stock and the foreign franchise tax are generally computed in the same manner, therefore, for purposes of this report, both taxes are referred to as the capital stock/franchise tax (CSFT).

The CSFT is calculated based upon a combined tax base that includes an income and a net worth component using a statutorily defined fixed formula. The tax is calculated by taking one-half of the average net income for a five-year period that has been capitalized at the rate of 9.5 percent, plus 75 percent of the company's net worth. Average net income is net income or loss of the current year and each of the preceding four years, divided by five. Net worth is the sum of the entity's capital stock, paid in capital, and retained earnings. If a corporation holds investments in subsidiary companies, then consolidated net worth, as computed under generally acceptable accounting principles, is used in the calculation. A \$125,000 valuation allowance is subtracted to arrive at the company's capital stock tax value. The capital stock tax value is then multiplied by either the portion of taxable assets, or by an apportionment percentage to

arrive at the taxable value. The taxable value is multiplied by the tax rate to determine the tax liability.

Pennsylvania, Delaware, Massachusetts, North Carolina, and West Virginia all impose a franchise tax in addition to an income tax. New Jersey, New York, and Ohio apply a franchise tax as an alternative to the income tax. Taxpayers pay a franchise tax in those states if the franchise tax liability is greater than the income tax liability. Maryland and Virginia do not impose a franchise tax.

The most common base for the franchise tax is total net worth, as measured by the sum of capital stock, capital surplus, and retained earnings. However, there is considerable diversity among the states studied in terms of the franchise tax base employed. As described above, Pennsylvania uses a formula that takes into account net income and net worth. Delaware's franchise tax is either based on the number of authorized shares of capital stock or on the value of the capital stock. Massachusetts bases its franchise tax on the value of property used in the state. North Carolina's franchise tax base is the greater of net worth; net historical cost of in-state tangible property; or 55% of appraised tangible property plus taxable intangible property. West Virginia bases their franchise tax on apportioned net worth. New Jersey imposes a tax on either gross receipts or gross profits called the alternative minimum assessment ("AMA") that is applicable to tax years beginning on or after January 1, 2002. The AMA is scheduled to sunset for tax years beginning after June 30, 2006. A five-year binding election is required under the AMA; taxpayers choose to use either the gross receipts or the gross profits base and pay on the higher of the income tax or the AMA. New York's franchise tax requires taxpayers to compute their tax upon four tax bases and pay the highest of the four tax liabilities. The bases are entire net income, allocated business and investment capital, minimum taxable income, and a fixed dollar amount. The Ohio franchise tax is calculated upon the corporation's net book value of assets less the net carrying value of liabilities and other items excluded by statute.

B. Discussion of the Recommendation

1. Testimony Presented at Commission Meetings

Repeal the Capital Stock/Franchise Tax

The PA21 package would entirely eliminate the current Pennsylvania Capital Stock/Franchise Tax (CSFT).⁴ It is currently imposed at a tax rate of 6.99 mills and is scheduled to phase out by 2010. Eliminating the CSFT would improve Pennsylvania's business tax competitiveness and also reduce

administrative and compliance costs to the Commonwealth and taxpayers.

The CSFT is imposed in addition to the corporate net income (CNI) tax, which is effectively the highest corporate income tax rate in the country. Currently, Pennsylvania's CSFT rate is the highest corporate franchise tax rate that is also imposed partly on net income. The proposition is to eliminate the CSFT.

Eliminating the CSFT will remove the element of double taxation of income in Pennsylvania, which will improve the tax competitiveness for corporations that do business in Pennsylvania. Repealing the tax will also align Pennsylvania with most of its competitor states and also make Pennsylvania potentially more attractive to corporations seeking to relocate from a neighboring state with an alternative tax such as New Jersey's new Alternative Minimum Assessment. Eliminating the capital stock/franchise tax would also reduce administrative and compliance costs to the Commonwealth and taxpayers.

Repeal the Loans Tax

The PA21 package would repeal the Pennsylvania corporate loans tax.⁵ The tax is an impediment for foreign corporations having their headquarters or financial operations located in Pennsylvania. Repealing this tax would also simplify the tax system and provide greater horizontal equity.

The loans tax is imposed on the taxable indebtedness of domestic corporations and foreign corporations having a Pennsylvania corporate treasurer. The Corporate Loans Tax is imposed on resident individuals who hold the debt, but the corporations who issue, assume or pay interest on the debt must withhold and remit the tax to Pennsylvania. The proposition is to repeal the Pennsylvania Corporate Loans Tax.

Pennsylvania is the only state that imposes a tax on the nominal value of each scrip, bond, certificate or evidence of indebtedness owned by residents, where the domestic or foreign corporation is doing business within the Commonwealth. Currently, this archaic tax, which is not widely understood, produces only \$12.5 million per year.

Recommendations from the PA-21 Tax Commission as to a substitution for the existing capital stock franchise tax system.

The capital stock franchise numbers are as follows

	<u>\$Millions</u>
Repeal Tax	\$(847)
Alternative Net Worth Tax @ 2.5 mills; pay larger of NWT or:	
CNI Tax @ 7.99% CNI rate	\$260
Pass-through Entity Tax @ 0.5%	\$ 34
License Fee:	
CNI Taxpayers @ \$1,000	\$134
Pass-through Entities @ \$100	<u>\$ 15</u>
Total Franchise	<u>\$(404)</u>

Net Worth Minimum Tax. The first example is a net worth tax to replace the capital stock and franchise tax. The tax base would be net worth (basically, a firm's assets minus liabilities); the tax would apply to both C and S corporations. Based on Department of Revenue estimates a net worth tax at the rate of 1.5 mills (.0015) with an exemption of \$125,000 would have raised \$228.8 million in fiscal year 2003. The tax would be applied to C and S corporations that are currently taxable under the capital stock franchise tax and would include a manufacturing exemption. The tax would raise more revenue if applied to all corporations.⁶

Capital Stock and Franchise Tax as a Minimum Tax. Another example for a business minimum tax would be to retain the capital stock and franchise tax, but make it an alternative to the corporate franchise tax. A taxpayer would pay the larger of the two taxes, not both taxes. Preliminary Department of Revenue business tax simulation runs indicate that the capital stock and transfer minimum tax would raise \$627.8 million and the corporate net income tax would raise \$1,337.5 (for what year?) under this alternative. The total, \$1,965.3, would be a reduction of \$410.2 million from the fiscal year 2003 sum of the CNIT and CSFT collections under current law. Note that the CSFT will sunset under current law in 2010.

2. The Commission members' after extensive discussion and testimony, are not recommending an acceleration of the scheduled phase out of the capital stock franchise tax. The Commission members' recommendation is premised that the reduction in the Pennsylvania corporate net income tax rate is the overriding priority.

G. The Adoption of a Business Benefits Tax

A. Current Pennsylvania Law

1. Presently, no Pennsylvania law exists as to the establishment of this proposed Business Benefits Tax.

B. Discussion of the Recommendation

Pennsylvania's business tax system is believed by many to be complicated, inequitable and uncompetitive with other states. The Pennsylvania Business Tax Reform Commission has received a recommendation to immediately eliminate one business tax (the Capitol Stock and Franchise Tax) and lower another (the Corporate Net Income Tax) by 40 percent. To keep its recommendations revenue neutral, a new form of business taxation would be created: a Business Benefits Tax. The new tax would be modeled after the New Hampshire Business Enterprise Tax. Its underlying methodology would be that of a value added tax (VAT).

1. What is a Value Added Tax?

In a U.S. Supreme Court case, *Trinova*,⁷ concerning the constitutionality of Michigan's form of VAT, the court commented as follows:

Value added is an economic concept. "Value added is defined as the increase in the value of goods and services brought about by whatever a business does to them between the time of purchase and the time of sale." Haughey, *The Economic Logic of the Single Business Tax*, 22 Wayne L.Rev. 1017, 1018 (1976) (hereinafter Haughey). The value a business adds to a single product at sale and the cost of goods purchased from other businesses that went into the product." Taxation and Economic Policy Office, Michigan Department of Treasury, *Analysis of the Michigan Single Business Tax* 20-21 (1985) (hereinafter SBT Analysis). It follows that the sale price of a product is the total of all value added by each step of the production process to that point. "The value added of a loaf of bread is the sum of the value contributed at each stage of the production and distribution process. Among others, it includes the contribution of the farmer, miller, baker, wholesaler and retailer." Haughey 1019.

A VAT differs in important respects from a corporate income tax. A corporate income tax is based on the philosophy of ability to

pay, as it consists of some portion of the profit remaining after a company has provided for its workers, suppliers, and other creditors. A VAT, on the other hand, is a much broader measure of a firm's total business activity. Even if a business entity is unprofitable, under normal circumstances it adds some VAT. Because value added is a measure of actual business activity, a VAT correlates more closely to the volume of governmental services received by the taxpayer than does an income tax. Further, because value added does not fluctuate as widely as net income, a VAT provides a more stable source of revenue than the corporate income tax. See generally Kleine 3, figure 1. "The logic or rationale of the [VAT] rests squarely on the benefits received principle to the operation of any business enterprise... and a part of these public service costs should properly be included in the cost of doing business." *Id.*, at 4 (citation omitted).

2. Testimony Presented at Commission Meetings

- a. Testimony presented to the Commission indicated that the Pennsylvania corporate net income tax statutory rate should be reduced below the national rate of 7.5 percent. (See Section 13 of this report)
- b. Testimony presented to the Commission indicated that the present Pennsylvania capital stock franchise tax repeal should be accelerated.
- c. The Commission is required under the Governor's Executive Order to make recommendations that are revenue neutral.
- d. Substantial testimony regarding New Hampshire's Business Enterprise Tax was presented. The value added tax (VAT) utilized by New Hampshire is being considered as a model for the establishment of a Pennsylvania Enterprise Tax to be known as a Business Benefits Tax (BBT).

3. Comments by Commission Members

- a. During the course of testimony, it has been determined that there is a substantial spread in the statutory tax rate established for corporations within the Commonwealth versus the net income tax that is paid by other business enterprises. The present corporate net income tax system has a high tax rate and a very narrow base.

- b. The Commissioners in their evaluation of the present tax system recommend a broadening of the tax base and the establishment of a low rate tax.

4. Commission Members' Final Recommendation

After extensive discussion and testimony, the Commission members are not recommending the adoption of a Business Benefits Tax. In lieu of adopting a Business Benefits Tax, the Commission members recommend the adoption of an additional entity tax on pass through entities of 1 percent.

5. Overview of the Michigan Single Business Tax

For most taxpayers, the calculation of the Michigan Single Business Tax, hereafter referred to as the SBT, begins with the federal taxable income (without any adjustments to the federal taxable income). If foreign income taxes are deductible at the federal level, then they are also deducted to arrive at the SBT starting point. However, they are later added to the tax base as an addition to the extent deducted in arriving at federal taxable income.

For the most part, Michigan follows the additive method of arriving at the SBT base. MCL 208.9(3) requires the addition of all taxes on or measured by net income and the tax imposed by this act (SBT) to the extent the taxes were deducted in arriving at federal taxable income. Therefore, taxes not based upon income such as the Ohio Franchise Tax -- net worth portion or Texas Franchise Tax -- net worth portion are not a required addback.

The original concept behind the SBT was to impose a form of value-added taxation that would permit firms to deduct 100 percent of investment expenditures from taxable income, thereby encouraging business investment. It was also hoped that the SBT would offer a more stable source of revenue than did its corporate income tax predecessor in Michigan, that the SBT would simplify and broaden business taxation in Michigan and provide a revenue windfall to address Michigan's short-term fiscal needs. While the evidence suggests that the SBT has generated a more stable revenue stream than that produced by the corporate income taxes of other states, investment incentives under the SBT differ significantly from those produced by textbook value-added taxes. The SBT also has the vexing property of imposing significant taxes on firms that lose money. In the wake of multiple tax reforms, the SBT became sufficiently unattractive to enough of the state that

legislation (passed in the summer of 2002) mandated its removal by 2010.

Problems with the Single Business Tax emerged in the 1990s due to the multi-state nature of many of Michigan's businesses. Michigan legislators were understandably concerned that investment incentives under Michigan's Single Business Tax might reward Michigan firms for investing outside of Michigan. The SBT was designed to minimize the extent to which firms could obtain Michigan tax deductions for out-of-state investment expenditures, but this design feature came under increasing fire from those who maintained that such provisions violate the interstate commerce clause of the U.S. Constitution. The Single Business Tax was amended in 1995 (effective starting in 1997) to permit favorable treatment only for assets put in place in Michigan, but legal challenges to this provision prompted the elimination of capital acquisition deductions in 1999 (effective starting in 2000), and their replacement with a new system of investment tax credits. Among the costs of these frequent changes, however, were political compromises that ultimately led to phased elimination of the Single Business Tax by 2010.

Legislation signed on July 14, 1999 by Michigan Governor John Engler "phases out the Michigan single business tax (SBT) over a 23-year period, provided that certain revenue targets are met (Sec. 208.31). Effective retroactive to January 1, 1999, the SBT rate is reduced to 2.2 percent from 2.3 percent. As of January 1 of each subsequent year, the rate will be reduced 0.1 percentage point if the comprehensive annual report for the state reports an ending balance of at least \$250 million until the tax rate is reduced to 0 percent. The SBT is repealed effective January 1 of the year in which the rate is reduced to 0 percent and is not effective for tax years that begin on or after that date. Act 115 (H.B. 4745), Laws 1999, effective as noted above.

Testimony was presented by Mr. Stanley Arnold of Rath, Young & Pignatelli on the application of the single business enterprise tax.⁸

6. Overview of New Hampshire Business Taxes

New Hampshire imposes a business profits taxes and a business enterprise tax. The business profits tax is imposed on any enterprise, whether corporation, partnership, limited liability company, proprietorship, association, business trust, real estate trust, or other form of organization organized for gain or profit and carrying on any business in New Hampshire. Businesses with gross

receipts of \$50,000 or less are not required to file a business profits tax return. The business enterprise tax is imposed on the compensation, interest, and dividends paid by taxpayers engaged in business activities in New Hampshire. Enterprises with more than \$150,000 of gross receipts from all their activities, or an enterprise value tax base more than \$75,000 are required to file a business enterprise tax return. Single member limited liability companies are required by New Hampshire to file a tax return even though the single member limited liability company does not file a separate Federal tax return.⁹

A. Business Profits Tax

The business profits taxes (BPT) is imposed on any business organization, be it a corporation (including an S corporation), partnership, limited liability company (LLC), proprietorship, association, business trust, real estate trust, or any other form of organization, organized for gain or profit and carrying on any business in New Hampshire.¹⁰

Any business organization whose income or expenses are reportable by the underlying owners for federal income tax purposes (that is, a pass through entity) must include all of its items of income and expense in its BPT return rather than passing through those items for reflection on the return of the underlying shareholder, partner, member, or other owner. Any element of income or expense that must be reported at the entity level for BPT purposes, rather than by the underlying owner, must be removed from the owner's BPT return. In short, no pass through of income items is permitted for state tax purposes, contrary to what is permitted for federal income tax purposes.

S corporations

An S corporation, including a qualified Subchapter S subsidiary (QSub), must report the amount shown as "taxable income" on the federal Form 1120S return as its gross business profits; or, in other words, the amount that would have been shown on federal Form 1120, line 28, had the corporation been fully taxable as a C corporation under federal income tax law.¹¹

Partnerships

For BPT purposes, a partnership must report and pay tax on any income that is reported and taxed at the partner level for federal income tax purposes. In the case of a partnership, or any other

business organization required to file a federal partnership return of income (i.e., federal Form 1065), "gross business profits" means the amount of ordinary income that would be determinable under the IRC, as incorporated by a specified date, increased by:

- the amounts shown as payments to partners on the federal partnership return;
- the net amount of any gains from the sale of a partnership assets; and
- items of income specifically allocated to partners.¹²

B. New Hampshire Business Enterprise Tax

In addition to the business profits tax discussed a business enterprise tax is imposed on the compensation, interest, and dividends paid by taxpayers engaged in business activities in New Hampshire. The business enterprise tax is imposed on the taxable enterprise value tax base, which is the sum of compensation, interest, and dividends paid after adjustments and apportionment.

The tax is computed and reported on Form BET, Business Enterprise Tax return for Corporations, Partnerships, Fiduciaries and Nonprofit Organizations. Businesses with business activity both inside and outside New Hampshire, must use Form BET-80, Business Enterprise Tax Apportionment, to compute the amount of compensation, interest, and dividends apportioned to New Hampshire for purposes of the business enterprise tax.

Taxable compensation

"Taxable compensation" is defined as all wages, salaries, fees, bonuses, commissions, and other payments paid or accrued to employees, officers, or directors of the business enterprise. Taxable compensation also includes the amount of compensation specifically exempt from federal withholding.¹³

Rev 2402.01 Compensation Element of the Tax Base is defined as follows:

- (a) Remuneration for services paid or accrued, in accordance with the business enterprise's method of accounting, shall be included in the compensation element of the tax base when an employer and employee relationship exists.

- (b) An employer and employee relationship shall exist when the individual for whom the services are to be performed has the right:
 - (1) To control and direct the individual performing the activities in areas greater than the overall results of the work; or
 - (2) To determine the methods and individuals used in performing the activity.
- (c) The following types of remuneration shall be included in the tax base:
 - (1) The amount of wages subject to federal income tax withholding included in an employee's Wage and Tax Statement, federal form W-2;
 - (2) The amount of compensation which is specifically exempt from federal withholding such as, but not limited to, the following:
 - a. The amount contributed on behalf of employees to qualified pension, profit-sharing and stock bonus plans under IRC section 401;
 - b. The amount contributed on behalf of employees to annuity or deferred-payment plans described in IRC sections 403 and 404; -
 - c. Fringe benefits provided to, and included in, the gross income of employees for federal income tax purposes unless such benefits are excluded under (d), below, or are included in gross income solely because the recipient is a partner or shareholder of an "S" corporation; and
 - d. The imputed interest on a below market compensation related loan between an employer and employee to which IRC section 7872 applies;
 - (3) The amount taken as a compensation deduction for the personal services of a proprietor or partner for business profits tax purposes;
 - (4) The net earnings from self employment, but such shall not include the individual's distributive share from a trade or business conducted by another business enterprise or the amount included under (c)(3); and

- (5) The amount reported as guaranteed payments to partners on the partnership's federal income tax return if such amount has not been included under (c)(3).

Taxable dividends

"Taxable dividends" are defined as any distribution of money or property (other than the distribution of newly issued stock of the enterprise) paid to owners of a business enterprise from the accumulated revenues and profits of the business. For non-corporate business enterprises such as proprietorships and partnerships, the accumulated revenues and profits of the enterprise are the total undistributed net income from all business activities since the inception of operations. In instances where an item of income or expense is treated differently between an "S" corporation and a "C" corporation under federal income tax provisions in arriving at the accumulated revenues and profits of the enterprise, the "S" corporation must treat the item in a manner consistent with that of the "C" corporation. Property distributed as a dividend is measured by the property's fair market value determined as of the date of the distribution.¹⁴

Rev 2402.03 Dividend Element of the Tax Base is defined as follows:

- (a) The following transactions between a business enterprise and its owners shall be considered a dividend for the purposes of RSA 77-E, except as provided in (n) below:
- (1) All property transferred from a business enterprise to an owner with respect to the owner's ownership interest from the accumulated profits of the organization;
 - (2) All personal expenditures made by a business enterprise on behalf of an owner which have not been properly reported as compensation or loans to the owner for federal income tax purposes;
 - (3) Forgiveness of an owner's indebtedness to the business enterprise unless:
 - a. The forgiveness is reported as compensation or interest to the individual for federal income tax purposes; and

- b. The amount forgiven is included in the compensation or interest elements of the enterprise value tax base; or
- (4) The “automatic re-investment” of property deemed distributed to the owners from accumulated profits into additional stock of the enterprise.
- (b) In instances where property, other than cash, is distributed as a dividend the computation of the dividend amount paid to the owner shall be measured by the property's fair market value determined as of the date of the distribution.
- (c) For purposes of the business enterprise tax, the inclusion of dividends shall occur when distributions are made by the subsidiary to its parent and a reduction in the subsidiary's earnings and profits shall be recognized for state tax purposes at that time.
- (d) All distributions by a business enterprise shall be presumed to be made sequentially from:
 - (1) The current year profits of the enterprise;
 - (2) The enterprise's accumulated revenues and profits; and
 - (3) The capital of the enterprise.
- (e) Distributions made by "S" corporations shall be from:
 - (1) The accumulated adjustment account (AAA) or the previously taxed income (PTI) categories shall be considered by the department to be a dividend and included in the tax base; and
 - (2) The earnings and profits of the corporation accumulated prior to the "S" corporation election being made shall follow the provision in (g).
- (f) In instances where an item of income or expense is treated differently between an "S" corporation and a "C" corporation under federal income tax provisions in arriving at the accumulated revenues and profits of the enterprise, the "S" corporation shall treat the item in a manner consistent with that of the "C" corporation.

- (g) For corporate business enterprises, other than "S" corporations, the current earnings and profits of the enterprise shall be determined as they are for federal income tax purposes by making adjustments to taxable income such as, but not limited to, the following:

(1) Deductions from federal taxable income including:

- a. Federal income taxes paid or accrued;
- b. Net capital loss;
- c. Premiums paid or accrued on officers' life insurance that exceed the increase in the cash surrender value;
- d. Charitable contributions that exceed the limitation on deductibility;
- e. Local benefit assessments such as sewer assessments that are not deductible but included as a basis increase in the property;
- f. Non-deductible fines and penalties;
- g. Non-deductible interest which is not considered construction period carrying charges under IRC section 312 (n);
- h. Non-deductible travel and entertainment expenses;
- i. Amount of gain on sale of an asset resulting from the excess of accelerated depreciation method over the straight line method;
- j. Political contributions; or
- k. Losses, expenses or interest with respect to related parties that are non-deductible under IRC section 267; and

(2) Additions to federal taxable income, including:

- a. Dividends received that qualified for the dividend received deduction;

- b. Excess depreciation resulting from the use of an accelerated method of depreciation over the straight line method;
 - c. Life insurance proceeds to the extent that they exceed the cash surrender value of the policy;
 - d. Tax-exempt interest income;
 - e. Net operating loss carryforwards;
 - f. Bad debt recoveries that were not taxable;
 - g. Refund of federal income taxes from a prior year;
 - h. Excess of percentage depletion over cost depletion; or i. Capital loss carryforwards.
- (h) The accumulated earnings and profits of a corporate business enterprise shall be the total of all earnings and profits less taxable dividend distributions previously made to shareholders.
- (i) For non-corporate business enterprises such as proprietorships and partnerships, the accumulated revenues and profits of the enterprise shall be the total undistributed net income from all business activities since the inception of operations.
- (j) Undistributed net income that is retained by the enterprise and considered capital for federal income tax purposes shall not be considered as such for purposes of the business enterprise tax.
- (k) Amounts that are deducted under RSA 77-A:4, III, for the personal services of the proprietor or partners shall:
- (1) Be considered an expense in determining the net income from business activities; and
 - (2) Not be included in the dividend element of the tax base.

- (1) Any deemed dividend election that may be made by members of an affiliated group shall not:
 - (1) Be considered a dividend for purposes of this statute; or
 - (2) Reduce the earnings and profits of the subsidiary.
- (m) Patronage dividends shall not be considered as dividends for business enterprise tax purposes but shall be included in the income of the member-patrons.
- (n) Distributions made by a business enterprise in liquidation or in complete redemption of an owner's interest in the enterprise shall not be considered as a dividend for business enterprise tax purposes.

Taxable interest

The business enterprise tax is imposed on interest paid or accrued on business debt. The amount included is not reduced by interest income or other fee income and without regard to any federal deductibility limitation or federal capitalization requirements. Also included in interest is property transferred by a business enterprise not classified as interest if the substance of the transaction and/or the relatedness of the parties indicates that the payment was made in lieu of interest.¹⁵

The amount of deemed interest is equal to the amount paid in excess of the fair market value of the property transferred. Excluded from tax is interest paid by insurers or voluntary employees' beneficiary associations.

Rev 2402.02 Interest Element of the Tax Base is defined as follows:

- (a) Interest, as defined in RSA 77-E:1, XI, shall be included in the tax base which is recognized as an expense under the method of accounting for the financial accounting purposes of the enterprise without regard to:
 - (1) Any limitation on deductibility for federal income tax purposes; or
 - (2) The capitalization requirements provided in IRC section 263A.

- (b) The interest element of the tax base shall not be reduced by any interest income or other fee income received for the use of its money or property.
- (c) In instances where an amount of property is actually transferred by a business enterprise and is not classified as interest, but the substance of the transaction and/or the relatedness of the parties indicates that the payment was made in lieu of interest, then:
 - (1) An amount of interest shall be deemed to have been paid; and
 - (2) The amount of deemed interest shall be equal to the amount paid which is in excess of the fair market value of the property transferred.

Adjustments in Calculating the BET

To calculate the "business enterprise tax, certain adjustments must be made to the enterprise value tax base in order to determine the amount of tax due.

Deduction for self-employment income. A business enterprise whose enterprise value tax base includes compensation derived from self-employment income subject to tax under IRC Sec. 1401 is allowed a deduction for the amount of compensation retained for use in the business enterprise. However, no amount of compensation allowed as a deduction under the business profits tax for the personal services of a proprietor or partner.

Affiliated corporations/businesses. For a business enterprise that is part of an affiliated group of corporations, a deduction is allowed in an amount equal to the dividends received from the affiliated corporation, to the extent that such dividends have previously been included in the payor corporation's taxable enterprise value tax base. Similar rules apply to members of an affiliated group of noncorporate business entities.

In instances where a business enterprise entitled to a dividend deduction has not paid dividends to its owners, the business enterprise must apportion the dividend deduction using the apportionment factor determined in accordance with Rev 2404.05 and use such apportioned amount as an offset to either the taxable compensation portion of the tax base, or the taxable interest portions of the tax base.

Enclosed are three tables which summarize New Hampshire BET.
(See Appendix A, B and C).

Business Enterprise Tax Credit

For corporations, the Corporation Business Profits Tax Return states that the Business Enterprise Tax paid shall be applied as a credit against Business Profits Tax. Any unused portion of the credit may be carried forward and allowed against Business Profits Tax due for up to the taxable periods from the period in which the Business Enterprise Tax was paid.

For partnerships, the Partnership Business Profits Tax Return states that Business Enterprise Tax paid shall be applied as a credit against Business Profits Tax. Any unused portion of the credit may be carried forward and allowed against Business Profits Tax due for up to 5 taxable periods from the period in which the Business Enterprise Tax was paid.

H. Expand the Sales Tax Base to Include Sales and/or Use Tax on Additional Services.

Taxation of business-to-business sales of goods and services results in tax pyramiding. This means that products are subject to tax at more than one stage of production. The tax included in the final purchase can be more than the statutory tax rate, because the tax is imposed on production inputs as well as the sale of the final product or service.

The imposition of the sales tax on services creates an incentive for companies to vertically integrate their operations in order to avoid tax. For example, it may be less costly for a company to utilize an in-house legal team as opposed to an outside firm, even if the outside firm is able to produce the service more efficiently.

The imposition of sales tax on any business input, including services, becomes an aspect of the cost of doing business in the state and may create a competitive disadvantage in attracting firms to locate or expand in Pennsylvania.

Over the years, there has been a gradual expansion of the sales-tax base to selected services. States, however, exhibit great diversity in the extent to which they tax the full range of potentially taxable services. These services include such transactions as the repair of tangible personal property, repair of real property, data processing services, information services and cleaning services. However, professional services have not been added to the sales tax base except in West Virginia. Florida attempted such an expansion of the tax base; however, that expansion was repealed shortly after being enacted.

If Pennsylvania broadens its sales and use tax base, it would join many of the comparison states that tax clothing. However, if Pennsylvania taxes many personal services, among the comparison states, it would join only West Virginia that presently taxes many services.¹⁶

I. Increase of PA PIT Tax Rate for all Taxpayers and Provide for Certain Exemption and/or Deduction in Arriving at Pennsylvania Personal Income Taxable Income.¹⁷

J. Increase Pennsylvania Research and Development Tax Credit

The Commission heard testimony concerning the impact of the Pennsylvania Research and Development as follows:

“Six years of data has been recorded by the Department of Revenue and in each of those years a significant increase in company’s Research and Development activities - demonstrating the ability of the credit to create incentives for increased activity by providing in a sense a subsidy for the increase. The most recent statistic show:

Larger businesses increased research expenditures in taxable year 2002 over 2001 by 17.2 percent. Small businesses increased their expenditure by almost 38 percent in the same time period. Manufacturing firms, particularly pharmaceutical manufacturers apply for credit more than any other at 70 percent of the total applications. If Pennsylvania is committed to helping our manufacturing sector it must continue the credit. In the pharmaceutical sector the average wage is over \$80,000 compared to Pennsylvania median of \$36,000, Jobs created as a result of Research and Development are good paying job for Pennsylvania.”

The PA 21 reform package includes an increase in Pennsylvania's research and development tax credit to \$60 million from \$15 million.¹⁸ In addition, companies that take advantage of this tax credit will be able to reduce their Corporate Net Income Tax, Capital Stock and Franchise Tax, and/or PIT liability by up to 75 percent on each tax versus the current 50 percent limit. Companies could also sell unused tax credits, generating immediate cash.

K. Recommend a Study to Consider Credit for Maintenance of Targeted Wage Base

After hearing substantial testimony the Commission considered a proposal to establish a new wage credit. The purpose of this credit would be to assist existing Pennsylvania employers and to support the creation and attraction of new jobs.

The definition of eligible Pennsylvania wages has been recommended to be compensation for full time employees that would range between \$25,000 to \$75,000 on an annual basis. The purpose of the range is to provide “good jobs” within the Commonwealth. These positions are defined as quality positions that provide substantial benefits; such as, retirement, healthcare, life insurance, etc., thus, improving the quality of life for Pennsylvania employees.

a. Study Would Address Definitional Issues

The study that is recommended would define the compensation base for the calculation of the credit for wages. The suggested wage base would range between \$25,000 to \$75,000 of

Pennsylvania compensation. This compensational base is flexible and may be modified for inflation.

b. Evaluate Cost Effectiveness – as to Fiscal Policy

It is recommended that the effectiveness of this credit be analyzed by the Department of Revenue. This analysis would be done in coordination with the other wage credits that presently exist within the Commonwealth in order to determine the appropriateness of this expanded relief. The purpose is to evaluate the cost effectiveness and it's impact on business expansion.

c. For all Defined Eligible Pennsylvania Wages

The definition of eligible Pennsylvania wages has been recommended by the Commission to be compensation for full time employees that would range between \$25,000 to \$75,000 on an annual basis. It is recommended that employers not benefit through the providing of lower wage positions below the \$25,000 level. Compensation in excess of \$75,000 is excluded as these would be highly compensated individuals that would be employed under any circumstances by the company and it is believed would not necessarily need to be enhanced. The purpose of the range is to provide "good jobs" within the Commonwealth. These positions are defined as quality positions that have attached to it substantial benefits; such as, retirement, healthcare, life insurance, etc., thus, providing for quality of life for Pennsylvania employees. The mechanics of the various definitions are to be developed by the Department of Revenue.

d. Credit Would be Available for all Subsequent Businesses.

FOOTNOTES

Other Proposals Considered by the Commission but Not Recommended

1. See Testimony presented by Stephen A. Herzenberg from the Keystone Research Center – April 29, 2004.
2. See PA-21 Project Report, page 99 and Appendix A, starting at page A-35.
3. See PA-21 Project Report, page 93, 94 and 95.
4. See PA-21 Project Report, page 97 and Appendix A, starting at page A-28.
5. See PA-21 Project Report, page 99
6. See PA-21 Project Report, page 98
7. Trinova Corp. v. Michigan Department of Treasury, 498 U.S. 358,362-64 (1991).
8. Testimony before the Pennsylvania Business Tax Reform Commission by Stanley Arnold of Rath, Young & Pignatelli on November 4, 2004
9. See Instructions to 2003 Business Profit Tax Return Instructions
10. See Instructions to 2003 Business Profit Tax Return Instructions
11. See Instructions to 2003 Business Profit Tax Return Instructions
12. See Instructions to 2003 Business Profit Tax Return Instructions
13. See Appendix with BET instruction defining taxable compensation and regulations
14. See Appendix with BET instruction defining taxable compensation
15. See Appendix with BET instruction defining taxable interest expense 2003 tax BET return
16. See PA-21 Project Report, page 100
17. See PA-21 Project Report, page 101
18. See PA-21 Project Report, page 95

26. Summary

The Tax Reform Commission was established in 2004 by Governor Edward G. Rendell, who directed the Commissioners to make recommendations to the Governor and General Assembly to improve the business tax structure within the Commonwealth. The Executive Order creating the Commission requested changes to make the tax system fairer, simpler and more competitive with other states.

The Governor commented that under the existing tax system, too many businesses pay little or no tax, while the state's perceived high tax burden makes the Commonwealth unattractive to new businesses and uncompetitive with other states.

The Commissioners have developed an integrated approach to the recommendations that are made in the body of this report, considering both economic development issues and revenue neutrality limitations. The Commission believes that only through the integration of the various suggestions will the Governor's goals be achieved with resulting fairness in the tax system, and thus a benefit to the Commonwealth and its taxpayers.

The recommendations were developed with the understanding that elements of the package do not and cannot stand alone. The interaction between each of the provisions is critical to the integrity of the entire package. Changing one or more elements would affect the overall balance built into the package.

Summary of Proposals and Recommendations

A. Reduction in Business Taxes Considered by the Commission

Reduction in Corporate Net Income Tax From 9.99% to 6.99%	Adopted as a Major Recommendation
Continued Allowance of Precombination Existing PA Net Loss Carryforward Amounts Subject to \$2,000,000 Annual Limitation and Separate Company Computation	Adopted as a Major Recommendation
Allowance of Future Net Losses Based on Federal Rules for Post Combination Years	Adopted as a Major Recommendation
Adoption of Sales Factor Apportionment	Adopted as a Major Recommendation
Change in Apportionment for Service Industries Based on Location of the Customer	Adopted as a Major Recommendation
Acceleration of Phase Out of Capital Stock/Franchise Tax and Possible Substitution of Net Worth Tax and Alternatives	Not Adopted as a Major Recommendation
Revision of Appeal Process	Adopted as an Administrative Recommendation
Allowance of Existing PA Net Loss Carryforward Amounts for an Extended Carryforward Period	Not Adopted as a Major Recommendation
Credit for Creation and Maintenance of Targeted Wages Would be Available for all Pennsylvania Based Employers	Not Adopted as a Major Recommendation
Increase in Pennsylvania Research and Development Credits	Not Adopted as a Major Recommendation

B. Base Broadening or Enabling Provisions to Achieve Reduction in Pennsylvania Corporate Net Income Tax Rate from 9.99 percent to 6.99 percent considered by the Commission

Mandatory Combined Reporting	Adopted as a Major Recommendation
Throwback Provision and Throwout Provision	Considered but Not Included in the Recommendations
Stand Alone Passive Investment Company Targeted Addback Provisions	Considered but Not Included in the Recommendations. This issue is Addressed in the Definition and Design of a Combined Reporting Statute Provision
Minimum License Fee on all Entities	Considered but Not Included in the Recommendations
Increase in PA PIT Rate for all Taxpayers Subject to PA PIT with the Provision of Exemptions and/or Deductions in Arriving at Pennsylvania Taxable Income	Testimony Presented but Not Included in the Recommendations. Executive Order was Confined to Pennsylvania Corporate Net Income Tax and Scheduled Phase-Out of Pennsylvania Capital Stock/Franchise Tax
Expansion of the Pennsylvania Corporate Net Income Tax Structure with the Adoption of an Alternative Tax Structure as an Enabler to Reduce the Pennsylvania Corporate Tax Rate to 6.0 percent and to Accelerate the Phase Out of the Pennsylvania Capital Stock Franchise Tax.	Considered but Not Included in the Recommendation
Equalization of Pennsylvania Personal Income Tax Rate on Pass-Through Entities Excluding Sole Proprietors to the PA Corporate Net Income Tax Rate	Considered but Not Included in the Recommendation
Expansion of the Pennsylvania Sales Tax Base to Include Tax on Services	Testimony Presented but Not Included in the Recommendations. Executive Order was Confined to Pennsylvania Corporate Net Income Tax and Pennsylvania Capital Stock/Franchise Tax
Stand Alone Section 482 Provisions	This Issue is Intended to be Incorporated Under the Definition of Combined Reporting

C. Major Recommendations Adopted by the Commission

Streamlining Tax Administration

Major Administrative Recommendation

D. Other Recommendation Adopted by the Commission

1. Fiscal Policy

Annual Report on Utilization of Economic Incentives

E. Summary of Other Proposals Not Recommended

Throwback/Throw-out Rule	Other Proposal Considered but Not Recommended
Equalization of Pass-Through Taxation Rate with Reduced Pennsylvania Corporate Net Income Tax Rate	Other Proposal Considered but Not Recommended
Fixed Entity License Fee	Other Proposal Considered but Not Recommended
Stand Alone Passive Investment Company Addback Provisions (This issue is addressed in the Definition and Design of Combined Reporting)	Other Proposal Considered but Not Recommended
Stand Alone Section 482 Provisions (Intended to be Incorporated in the Adoption of Combined Reporting)	Other Proposal Considered but Not Recommended
Increase of PA PIT Tax Rate for all Taxpayers and Provide for Certain Exemptions and/or Deductions in Arriving at Pennsylvania Personal Income Taxable Income.	Other Proposal Considered but Not Recommended
Expand the Sales Tax Base to Include Sales and/or Use Tax on Additional Services. Discussed in Testimony	Other Proposal Considered but Not Recommended
Adoption of a Business Benefits Tax	Other Proposal Considered but Not Recommended