COST
COUNCIL ON STATE TAXATION

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

Via Email

Re: Opposition to Mandatory Unitary Combined Reporting Provisions in House Bill 1610

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

On behalf of the Council On State Taxation (COST), I respectfully submit this testimony in opposition to House Bill 1610 that would impose Mandatory Unitary Combined Reporting (MUCR), authorize tax haven designations, and make several other significant negative changes to Pennsylvania's corporate net income tax. COST opposes MUCR because it creates an unpredictable revenue impact, negatively affects the economy, arbitrarily assigns income, and would impose significant administrative burdens on both taxpayers and the Commonwealth.

About COST

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

COST's Policy Position on Mandatory Unitary Combined Reporting

The COST Board of Directors has adopted a formal policy statement on MUCR.[1] COST's policy position is:

> *Mandatory unitary combined reporting ("MUCR") imposed on domestic entities is not a remedy for the problem of how to accurately determine multistate business income attributable to economic activity in a state. For business taxpayers, there is a significant risk that MUCR will arbitrarily attribute more income to a state than is justified by the level of a corporation's actual economic activity in the state. A switch to MUCR may have significant and unintended impacts on both taxpayers and states. Further, MUCR is an unpredictable and burdensome tax system that has no federal analogue to facilitate state compliance and conformity. COST opposes MUCR but supports elective state conformity to the federal consolidated filing group to facilitate compliance in both separate filing and unitary combination states.*

[1] https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/mucr-policy-statement-final.pdf

COST's policy position against MUCR is supported by several studies including Maryland's 2016 Economic Development and Business Climate Commission report ("Augustine Commission");[2] a 2016 Indiana Legislative Services Agency Combined Reporting Study;[3] and a 2021 Virginia Work Group.[4] Estimated revenue reports from actual informational unitary combined reporting filings for each state validated the conclusions. The Augustine Commission, established at the request of the General Assembly's leadership, recommended that Maryland avoid adopting MUCR because it would: (1) create revenue volatility, (2) pick winners and losers among taxpayers, and (3) lead to additional litigation and administrative costs.[5] Virginia's Work Group, established by the Virginia General Assembly, concluded that "[a]t this point in time, Virginia should not proceed with further study into the implementation of unitary combined reporting in the Commonwealth."[6] The Indiana Legislative Services Agency, as charged by the Legislative Council, conducted a study in 2016, finding that any potential positive revenue impact from adopting MUCR would be only short-term and would likely decline to zero in the long term.[7]

Problems with Mandatory Unitary Combined Reporting

One of the most controversial business tax policy issues debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate and multinational corporations. The first approach, "separate entity reporting," treats each corporation as a separate taxpayer. This is the method Pennsylvania currently uses; it is also used by the Commonwealth's regional competitor-states, including Delaware, Maryland, and Virginia. The second approach, MUCR, treats affiliated corporations (parents and subsidiaries) engaged in a "unitary business" as a single group for purposes of determining taxable income.[8] Thus, in addition to bringing income from other members of the unitary business into a state, MUCR also allows losses incurred by members of the unitary group to offset the income of other members of the group. MUCR has several drawbacks:

- **Uncertain and Unpredictable Revenue Impact –** Implementing MUCR would have an unpredictable and uncertain effect on Pennsylvania's corporate net income tax collections. Regardless of whether MUCR is employed, the corporate income tax is the most unpredictable

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[2] Report of the Maryland Economic Development and Business Climate Commission, Phase II, Taxes, January 2016.

[3] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal and Management Analysis, Indiana Legislative Services Agency, October 1, 2016.

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

[5] Report of the Maryland Economic Development and Business Climate Commission, Phase II, Taxes, January 2016, Finding 5 and Recommendation 5.

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

[7] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal and Management Analysis, Indiana Legislative Services Agency, October 1, 2016.

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

tax in every state in which it is levied, because it is subject to economic volatility. The adoption of MUCR has the potential to make corporate collections even more volatile.

- ***Maryland*****:** Maryland's commission found significant uncertainty and volatility, with MUCR increasing revenue in some years and reducing it in others. Maryland presently has five years of data on combined reporting, and, depending on which type of apportionment is used, MUCR may have resulted in less revenue than the State's current corporate income tax structure in two or three of those years.[9]

- ***Virginia*****:** Based on informational unitary combined reporting filings for the 2019 tax year, Virginia's 2021 Work Group found that "73% of corporations showed essentially no change in tax liability, 13% showed an increase in tax liability, and 14% showed a decrease in tax liability before tax credits were applied."[10]

- ***Indiana*****:** The Indiana Legislative Services Agency conducted a study in 2016, finding that any potential positive revenue impact from adopting MUCR would be only short-term and would likely decline to zero in the long term.[11]

- **Regional Outlier** – Most of the states that utilize MUCR are west of the Mississippi River. Apart from New Jersey, New York, and West Virginia, few of Pennsylvania's regional competitor states currently utilize MUCR; *i.e.*, it is not used in Virginia, Delaware, or Maryland.

- **Administrative Complexity** – MUCR is, by definition, complex, requiring extensive fact-finding to determine the composition of the "unitary group" and to calculate combined income. This complexity results in unnecessary and significant compliance costs for both taxpayers and the State.

  - *Determining the Unitary Group*: The concept of a "unitary business" is uniquely factual and universally poorly defined. It is a judicially constructed constitutional (Due Process) concept that looks at the totality of the business rather than individual separate entities or separate geographic locations. To evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine at a detailed level how a taxpayer and its affiliates operate to determine which affiliates are unitary. This determination requires state auditors to obtain detailed operational information from the taxpayer and its unitary affiliates. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states. Additionally, expensive and time-consuming litigation often results from the subjective nature of the determination of a unitary group

  - *Calculating Combined Income*: Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition, increased compliance costs result from not only complying with the variations in the state apportionment formulas

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[9] Andrew Schaufele, Director, MD Bureau of Revenue and Estimates, Report on Combined Reporting to Governor, President and Speaker, March 1, 2013.
[10] Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes, published November 1, 2021, p. 17.
[11] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal and Management Analysis, Indiana Legislative Services Agency, October 1, 2016.

but also from state-specific statutory adjustments to the tax base. From a financial reporting perspective, adopting MUCR is a significant change that requires states to consider ways to mitigate the immediate and negative impact that those tax changes have on a company's financial reporting.[12] An alternative approach that avoids this complexity would be to authorize consolidated filing elections, with such elections being binding for a term of years to avoid manipulation of the filing method. This is the approach recently adopted by Virginia.

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

House Bill 1610 Contains Several Problematic Provisions Unrelated to Combined Reporting

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

- Disallowance of the deduction for foreign-derived intangible income (FDII), which is a tax provision enacted as part of the 2017 federal tax reform to encourage investment in the United States.

- Granting the Department of Revenue additional broad powers to reallocate income and deductions among taxpayers.

- The replacement of industry-specific apportionment rules, the most accurate reflection of these industries' income attributable to the State, with a single sales factor.

- Authorizing the Department of Revenue to designate certain foreign nations as "tax havens." COST has long advocated against tax haven designations as this approach is arbitrary, misleading, and fraught with Constitutional infirmities. The current trend among states that had previously adopted tax haven provisions is to repeal them.

Conclusion

Transitioning from Pennsylvania's current methodology of determining corporate income attributable to the Commonwealth to Mandatory Unitary Combined Reporting would have an unpredictable (and possibly negative) effect on state revenue, impose significant administrative burdens on both the taxpayers and the State, and be detrimental to attracting new business investment or encouraging the expansion of existing businesses. For these reasons, COST respectfully urges members of the committee to vote "no" on House Bill 1610 and any other instrument introduced with similar provisions or amended to include them.

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

Respectfully,

Leonore F. Heavey

cc: COST Board of Directors
Patrick J. Reynolds, COST President & Executive Director