CORPORATE NET INCOME TAX

COMBINED REPORTING METHODOLOGY

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Background

- Current Law
  - Corporations are required to file tax reports on a separate company basis.
  - Affiliated groups of corporations separately account for each of the affiliated companies in computing PA CNIT liabilities.
  - Only members of an affiliated group with nexus in PA are required to file a PA return.
- Mandatory Unitary Combined Reporting
  - Affiliated companies engaged in a unitary business enterprise in PA would be required to combine their income and apportionment factors in calculating PA tax liability.

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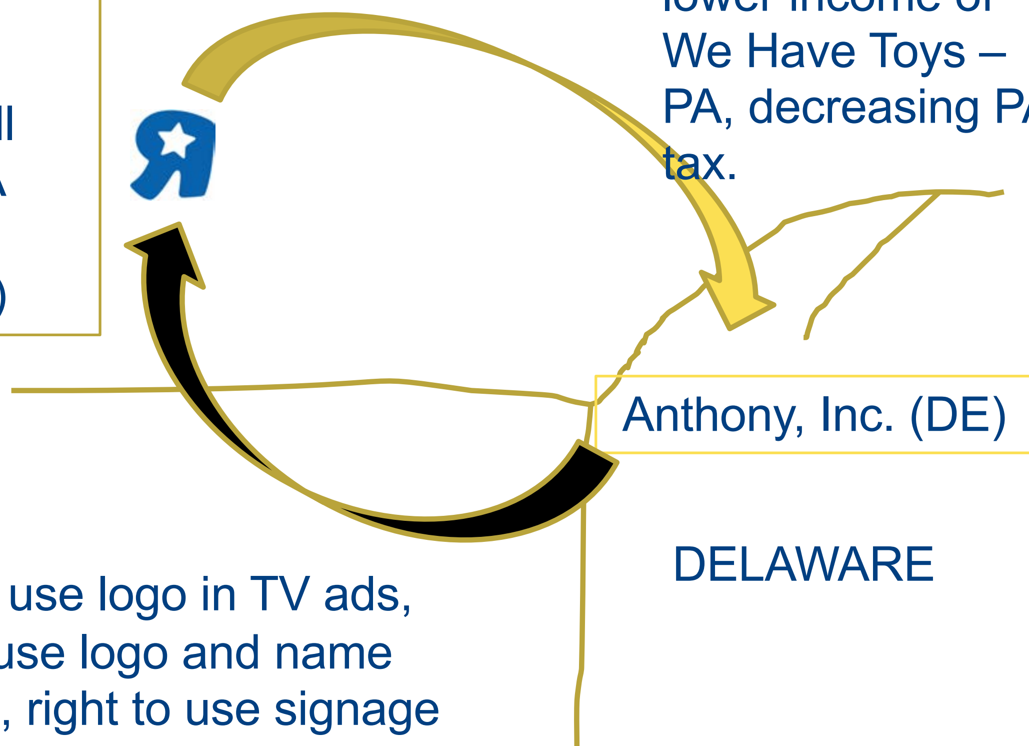
How Corporations Shift Income

PENNSYLVANIA

We Have Toys– PA (operates all stores in PA under one corporation)

Licensing fees lower income of We Have Toys – PA, decreasing PA tax.



Income of Anthony, Inc. not taxable in PA (and not taxed in DE).
Fees determined by HQ (may or may not be based on going rates)

Right to use logo in TV ads, right to use logo and name on bags, right to use signage with brand, etc.

How Corporations Shift Income

- This shifting is not just limited to intangibles like licensing.
- Companies can shift money from one related company to another using:

Intercompany loans	Computer fees
Transfer pricing	Leases of equipment
Management fees	Shipping charges
Accounting fees	

- All can be legitimate charges, used to determine performance and manage costs within corporate group – but can also be used to shift funds. Impact often not known until audited by revenue agency.

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What is an Addback?

- Addback laws attempt to deny a tax deduction for a transaction between related companies if it meets certain criteria, by “adding back” the deduction to income.
- Apply to one transaction at a time, considering the purpose of the transaction, whether it is priced at a market rate, and other details.
- States typically only use addbacks to prevent abuses of intangibles like patents, copyrights and trademarks.
- Because of these limitations, addbacks are a weak substitute for combined reporting – adopted only to support the claim that it has already been fixed.

PA Addback Statute – Act 52 of 2013

- Disallowed deductions with an affiliated entity for the following:
  - Intangible expense or cost
  - Interest expense
- Provides a credit based on tax paid by the affiliate on the disallowed expense
- Add-back requirement does not apply to:
  - Transaction that did not have the principal purpose of tax avoidance and done at arm’s length rates and terms
  - Transaction with affiliated entity in a nation with a comprehensive tax treaty with US
  - Transaction where affiliate passed it on to an unaffiliated entity (conduit)

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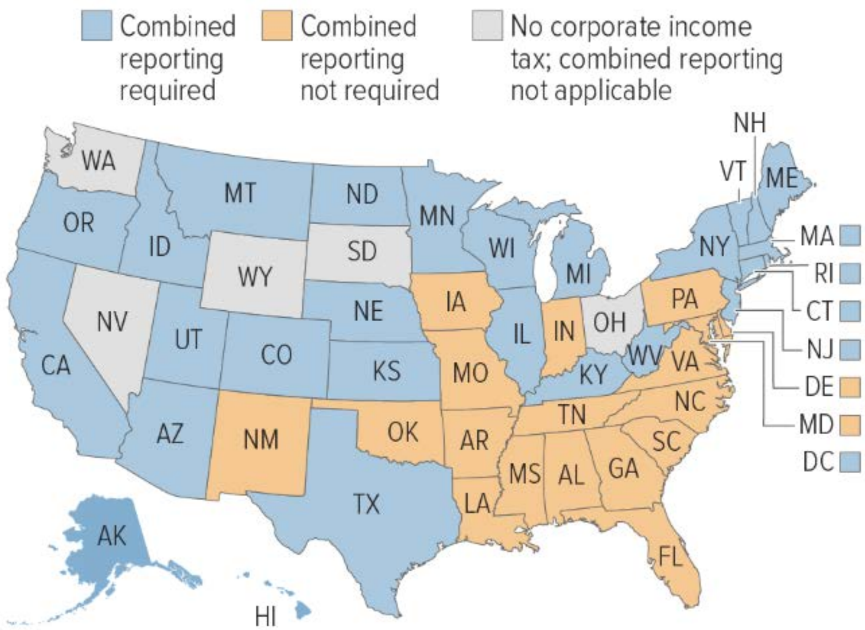
Why Shift to Combined Reporting?

27 States Plus D.C. Require Combined Reporting for the State Corporate Income Tax



Note: Combined reporting treats a parent company and its subsidiaries as one entity for state income tax purposes, thereby helping prevent income shifting.

Source: John C. Healy and Michael S. Schadewald, "2018 Multistate Corporate Tax Guide, Vol. 1," Kentucky HB 487 (2018), effective January 1, 2019; New Jersey AB 4262 (2018), effective July 1, 2019.

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Why Shift to Combined Reporting?

- Levels playing field for corporations
  - Small companies do not have the ability or resources to devote to tax planning. If operating completely in Pennsylvania, must pay 9.99% on all income. Under current law, big corporations have much more ability to determine their own tax.
- Helps stop corporate tax avoidance
  - Eliminates intercompany transactions – these are the primary vehicles to shift profit from company to company and from place to place.
- Modernizes the tax system
  - Most corporations part of a group of companies. CR better reflects and taxes activity of the entire group.
- Helps pay for corporate tax rate cuts
  - Expanding the tax base helps provide the ability to lower the rate (and still yield similar amounts of total tax collected)

Background

- Tax year 2015 with 2019 law
- Returns used for analysis
  - Pennsylvania separate company returns
  - Pro-forma federal information
    - Schedule 7004 or Form 851
  - Minnesota returns
- Methodology change
  - Focus on individual corporations instead of combined groups

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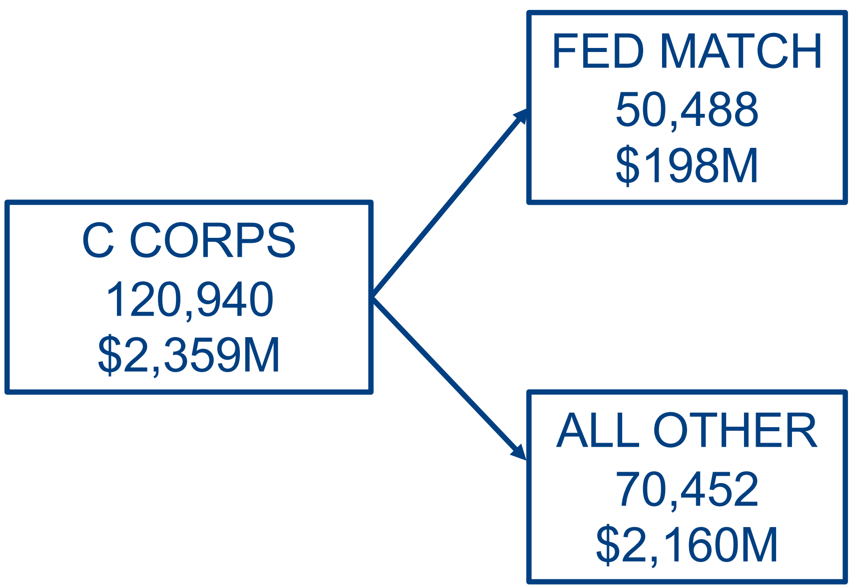
Flowchart



- If EIN matches federal data (both tax period and income), then it is assumed that the corporation is unaffected by combined reporting.

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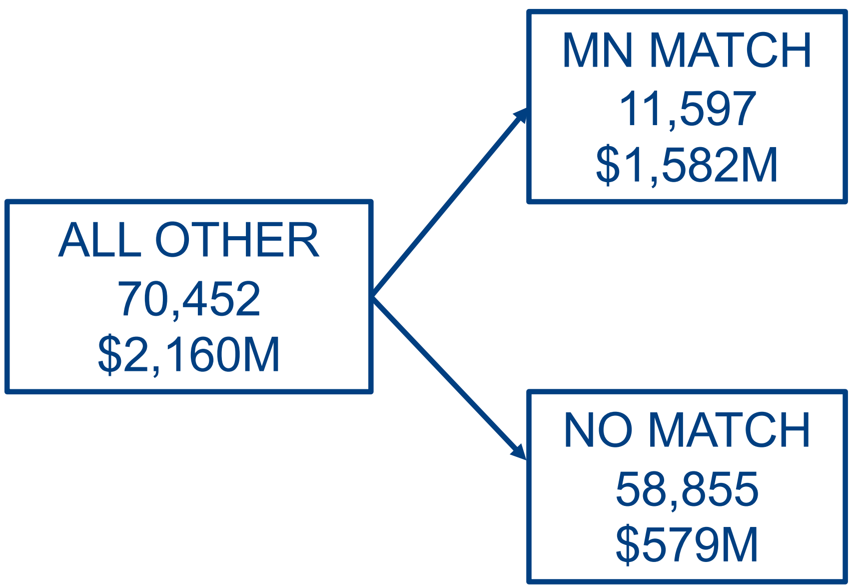
Flowchart



- If EIN matches the MN returns, it is possible to directly calculate CR impact.
- MN Information needed
  - Income to be apportioned
  - Apportionment denominator
- PA information needed
  - Apportionment numerator
  - Net operating losses

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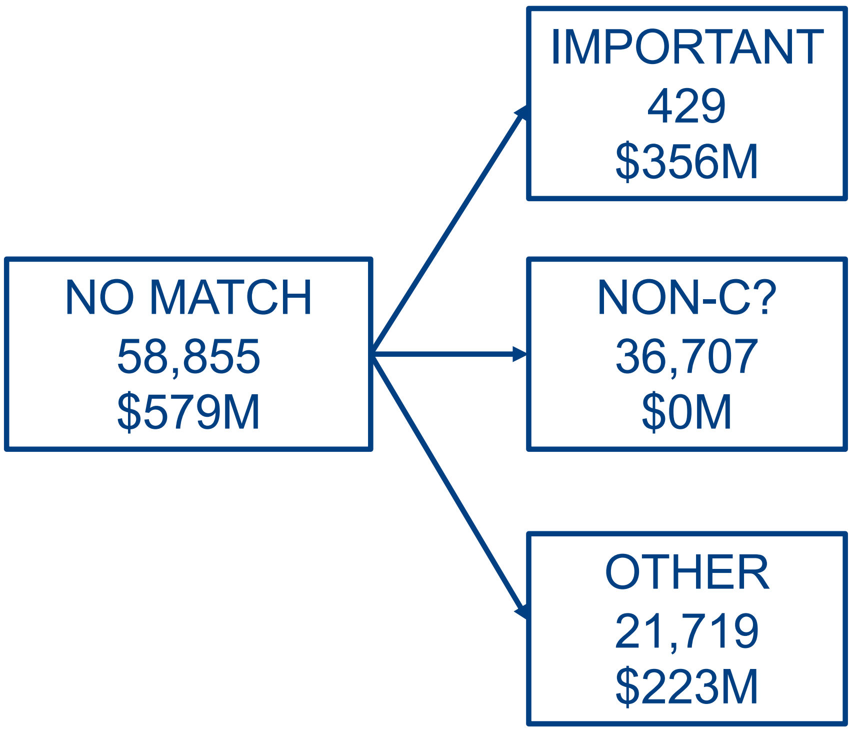
Flowchart



- Important
  - CNIT liability > $1M or
  - PA sales > $50M
- Non-C?
  - Filers with no income or apportionment information
  - Do not ‘check the box’ to declare that they are not C corps
- Other
  - All corporations not included in either of the categories above

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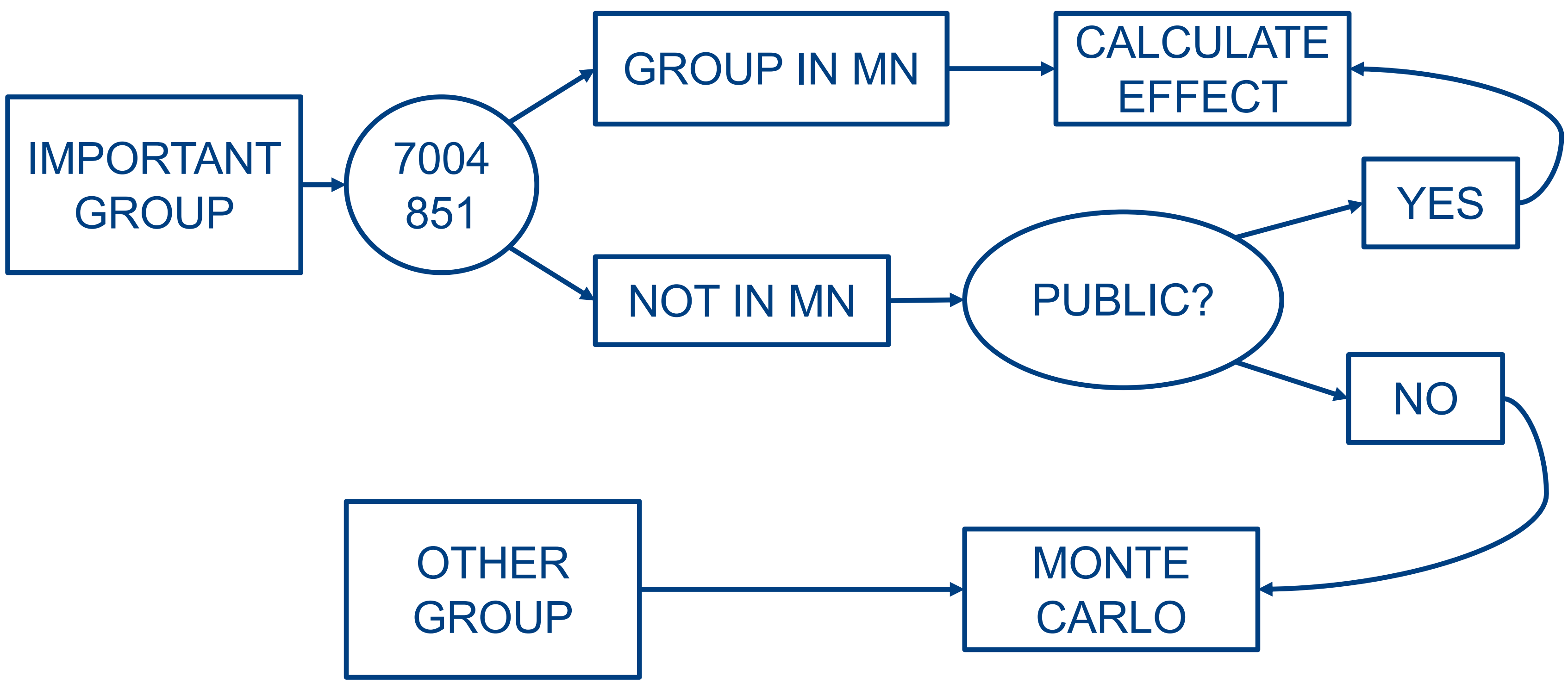
Flowchart



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CNIT Calculation – MN or Public Data

GROUP INCOME CALCULATION				
Federal Line 28 Income	3,000,000,000			
Additions to Income	0			
Subtractions from Income	0			
Intercompany Eliminations	500,000,000			
PA Net Income	2,500,000,000			
Total Nonapportionable Income	0			
PA Apportionable Income	2,500,000,000			
APPORTIONMENT CALCULATION				
	B_1	B_2	...	B_N
EIN	111111111	222222222		NNNNNNNNN
Total Sales	20,000,000,000	20,000,000,000		20,000,000,000
PA Sales	800,000,000	5,000,000		20,000,000
Apportionnment Factor	0.040000	0.000250		0.001000
TAX CALCULATION				
	B_1	B_2	...	B_N
EIN	111111111	222222222		NNNNNNNNN
PA Apportionable Income	2,500,000,000	2,500,000,000		2,500,000,000
Apportionment Factor	0.040000	0.000250		0.001000
Net Income Apportioned to PA	100,000,000	625,000		2,500,000
PA Nonapportionable Income	0	0		0
Income Prior to NOL	100,000,000	625,000		2,500,000
Net Operating Loss Deduction	(40,000,000)	0		(800,000)
Taxable Income	60,000,000	625,000		1,700,000
Regular Tax	5,994,000	62,438		169,830

- BLUE
  - Minnesota data
  - 10-K
- GOLD
  - Pennsylvania data
- MN Match
  - SAS used for calculations
- Public Data
  - Manual process

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CNIT Calculation - Monte Carlo

- A Monte Carlo simulation is necessary to calculate a combined reporting CNIT liability for two reasons:
  - Lack of information
  - Time constraints
- Pre-net operating loss (PRENOL) income

SEP/COMBINED	Σ PROBABILITY	RATIO
+/+	0.8331	1.2213
+/-	0.9522	-1.0278
+/0	1.0000	0.0000
-/+	0.4097	-0.8677
-/-	0.9345	0.8535
-/0	1.0000	0.0000

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Results

C CORPS
120,940
$2,359M / $3,036M

FED MATCH
50,488
$199M / $199M

ALL OTHER
70,452
$2,160M / $2,837M

MN MATCH
11,935
$1,601M / $2,104M

IMPORTANT
1,110
$370M / $445M

NON-C?
36,604
$0 / $0

OTHER
20,803
$190M / $288M

Results

GROUP	COUNT	CURRENT	COMBINED	% CHANGE
IN MINNESOTA	11,935	$1,600M	$2,104M	31%
IMPORTANT	1,110	$370M	$445M	20%
OTHER	20,803	$190M	$288M	52%
FED MATCH	50,488	$199M	$199M	0%
NON-C?	36,604	$0	$0	0%
TOTALS	**120,940**	**$2,359M**	**$3,036M**	**29%**

- 9.99% rate
- 40% cap on net operating losses

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Results - Two Digit NAICS

INDUSTRY	CURRENT	COMBINED	DIFFERENCE	% CHANGE
AGRICULTURE	$5.5	$4.5	-$1.0	-19%
MINING	$33.0	$49.1	$16.1	49%
UTILITIES	$116.4	$144.4	$28.0	24%
CONSTRUCTION	$59.5	$66.5	$7.0	12%
MANUFACTURING	$327.8	$468.3	$140.5	43%
WHOLESALE TRADE	$418.0	$570.1	$152.2	36%
RETAIL TRADE	$238.2	$341.6	$103.5	43%
TRANSPORTATION / WAREHOUSING	$79.4	$71.1	-$8.3	-10%
INFORMATION	$207.7	$216.0	$8.3	4%
FINANCE / INSURANCE / REAL ESTATE	$215.9	$237.5	$21.6	10%
SERVICES	$361.2	$464.2	$103.1	29%
OTHER / MISCELLANEOUS	$297.0	$403.2	$106.2	36%
TOTALS	**$2,359.4**	**$3,036.5**	**$677.1**	**29%**

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Other Considerations

- Rate Reduction
  - The results are at the current law rate of 9.99%.
  - As a result of the expansion of the base, the rate could be reduced.
  - The revenue neutral rate is 7.76%
- Treatment of NOLs
  - The results use the current law cap of 40% of taxable income
  - The NOLs are not permitted to be shared within the group
  - The current amount of the NOL bank is estimated to be more than $220 billion.
  - Uncapping the NOLs or allowing sharing would significantly reduce (if not eliminate) the revenue gain.

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Other Considerations

- Joyce vs Finnigan
  - The results are based on the Minnesota data, which is a Finnigan state
  - The change in revenue from Joyce is unknown

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W/L/T AT REVENUE NEUTRAL RATE

CLASS	COUNT	CURRENT	CR NEUTRAL
WINNERS	40,073	$2,038.8	$1,136.4
TIES	74,427	$0.0	$0.0
LOSERS	6,440	$320.7	$1,222.3
TOTAL	**120,940**	**$2,359.4**	**$2,358.7**

- Majority of corporations owe $0 under both separate and combined reporting (TIES).
- In the WINNER category, many of these corporations are not affected by CR and so just see the rate cut.
- Only 5% of corporations would see their liabilities increase with CR at the 7.76% rate.

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Q&D Method - Publicly Available Data

Can publicly available data be used to estimate an increase from combined reporting?

Many shortcomings in this methodology

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Q&D Method - Publicly Available Data

- Alternate calculation using publicly available information
  - Corporate net income tax collections from Census Bureau
  - Gross State Product from BEA
- Tax collections are first divided by the CNIT rate in effect in that state for the period (yielding taxable income).
- The comparison is then done on a ratio:
  - TAXABLE INCOME / GROSS STATE PRODUCT
- If combined reporting is successful in expanding the CNIT base, then the ratio for CR states will be larger than for those that do not have CR.

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Q&D Method – Publicly Available Data

	RATIO	INCREASE
CR STATES	0.0432	
NON-CR STATES	0.0366	18%
PENNSYLVANIA	0.0321	34%

- CR states have a RATIO that is 18% larger than non-CR states.
- Pennsylvania is about 12% below other non-CR states.
- If Pennsylvania can become an average CR state, that would imply that liabilities would increase by 34%.
- Current estimate – 29% increase.

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SUMMARY – COMBINED REPORTING

- Pennsylvania is a state with a very narrow base and a high rate for CNIT.
- PA DOR has done four studies using MN data – the results have been roughly consistent. The 2015 estimate is a 29% increase in the base at the current rate.
- The treatment of NOLs is crucial to revenue gains from combined reporting
- PA does plan to request other state's data – NJ is of most interest as it is a border state

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Any questions?

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