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Bill to Close Tax Loopholes Doesn't Get the Job Done

An Analysis of the Addback Rule in House Bill 2150

By Pennsylvania Budget and Policy Center Staff

Overview

A recent proposal to close corporate tax loopholes that rob Pennsylvania schools, colleges, homeless shelters and other vital services of millions of dollars each year would fall far short of its goal and aggravate our state's financial problems. While House Bill 2150 aims to prevent corporations from unfairly shifting profits earned in Pennsylvania to Delaware and other low- or no-tax states, it would be ineffective at stopping the practice and even creates new tax loopholes corporations could exploit.

Because the bill's loophole-closing measure would be largely ineffective, its cuts in corporate tax rates would actually end up costing hundreds of millions of dollars and force further cuts to the assets that make Pennsylvania a good place to do business in the first place.

Corporate tax avoidance is a growing problem that leaves Pennsylvania companies and individuals who play by the rules to pick up more of the tab. But fixing this must be done carefully, and there are better alternatives than House Bill 2150.

During the last 10 years, many states took steps to close these loopholes and collect taxes on income earned in-state. They took two approaches: enacting "combined reporting" laws that keep corporations from shifting profits to their operations in other states to avoid taxes; or adopting "addback" laws requiring that fees, royalties and other transactions between related companies, done primarily to avoid taxes, are added back to the companies' income and taxed. Some states did both. Of the two, combined reporting is the more foolproof approach.

In January, Pennsylvania State Representatives Dave Reed (R-Indiana) and Eugene DePasquale (D-York) proposed a limited addback rule. Their proposal, House Bill 2150, would use revenue from closing the loophole to enact a new round of business tax cuts. It reflects a bipartisan recognition that corporate tax avoidance is a serious problem in Pennsylvania and signals a new willingness to address the issue. But it would fail to achieve its stated goal.

- The bill's addback requirement would generate little new revenue to offset the new tax cuts, creating bigger economic and budget problems for Pennsylvania than the ones we already have.
- The legislation would create new loopholes that would allow corporations to continue to shelter income through sham transactions and fail to end other basic tax avoidance techniques.

trademarks and similar types of “intangible assets.” A company would be required to add back the expenses paid to the related company to its taxable income – and pay tax on it.

However, the legislation has a number of exceptions that would nullify its goal of closing the Delaware loophole:

- **The bill’s deduction allowance is too broad.** The bill would allow corporations to continue to deduct royalty and other intangible expenses if the transaction is “directly related to a valid business purpose.” Most companies will have little difficulty claiming a valid business purpose for a Delaware trademark holding company – such as centralized management of their trademarks by employees dedicated to the task – even if their primary reason is tax avoidance. The burden of proof will be on the Pennsylvania Department of Revenue to demonstrate that a certain expense does not have a valid purpose – a difficult hill to climb.
- **Getting an exemption to the rule would be easy.** The legislation presumes that any transaction equal to market prices is for a valid business purpose, so it would not be required to be added back to income. Royalties or other intangible expenses paid to related companies could be set at the fair market value and still accomplish the same goal – shifting income from Pennsylvania, where it would be taxed, to a state where it would not be taxed. This creates a blanket exemption to the addback rule.
- **The bill creates a loophole allowing some companies to get double tax benefits.** A company would be able to get a credit for taxes paid by an affiliate on the income even when it is allowed to take the deduction of the royalty expense in Pennsylvania – getting tax benefits twice for the same transaction. A company should only get credit for taxes paid by an affiliate on income that has been added back to taxable income.
- **The bill leaves other loopholes intact.** Interest payments on loans from a related company could still be deducted under the legislation. Companies will pay interest essentially to themselves to shift income into or out of a state. All but two of the dozen or so states that have adopted addback rules require the interest payments to be added back to the state taxable income of the company that borrowed the money.

A Better Solution

One way to improve the bill is to replace its addback requirement with the Multistate Tax Commission’s model legislation.ⁱⁱ Pennsylvania doesn’t need to reinvent the wheel. This is a subject that other states have been grappling with for many years, and the Commission has taken the most effective ideas from states that have adopted addback language and created legislation that Pennsylvania could adopt.

The Commission’s model is superior in a number of ways:

- **It requires both intangible expenses (such as royalties) and interest payments to be added back to income.** This addresses the two easiest ways companies redirect income and shield it from taxes.

- **It eliminates complicated shell games by requiring both direct and indirect payments between related companies to be added back.** Without such a requirement, companies can create complex corporate structures to avoid directly shifting profits from one related company to another.
- **It ensures a company isn't taxed twice, but doesn't allow it to double up on deductions.** The model legislation gives a corporation credit for taxes paid by affiliates on income that has been added back. This helps ensure that the income is not taxed twice – but this deduction is only permitted when the affiliate actually adds back the income.
- **It sets clear standards for allowing legitimate interest and intangible expense deductions by a corporation:**
 - If the related company is ultimately funneling royalty and interest expenses to a truly non-related business *and* the transaction was made for a valid business purpose;
 - If the related company was subject to tax on the income and pays an effective tax rate equal to a certain percentage of the tax that would be due on it if it were taxed by Pennsylvania. However, this does not include taxes paid on the combined or consolidated returns of a corporation.
 - If the related company paid tax on a transaction with a foreign government that has a comprehensive tax treaty with the United States, the rate of tax paid is at least equal to the rate in Pennsylvania, and the transaction was for a valid business purpose; or
 - If the taxpayer has a written agreement with the state revenue department to deduct the expense.
- **It requires corporations to provide clear and convincing evidence that they meet the criteria for allowing a deduction.** This evidence must be presented when the returns are filed – not during an audit years later.

Combined Reporting: A More Comprehensive Approach

Rather than addressing one specific loophole at a time, as addback rules do, combined reporting takes a more thorough approach to combating tax avoidance. This is the direction 23 other states have taken.

Combined reporting recognizes that most companies are not fully independent entities making decisions on their own. Rather, they belong to a web of related companies that make numerous transactions with one another.

Under combined reporting, the companies pay taxes based on their combined activities. This taxes the corporation based on its total economic activity, rather than its individual parts, eliminating many opportunities for companies to shelter profits.

Combined reporting has no impact on smaller corporations with no related companies.

Conclusion

The Reed-DePasquale bill is a sign that concern is growing about Pennsylvania’s corporate tax avoidance problem. It is a positive start – but in its current form, it is not a solution. The bill needs to be strengthened to close other obvious loopholes, and it includes unnecessary corporate tax cuts.

Adopting the Multistate Tax Commission model legislation would provide Pennsylvania with a more sound and effective addback rule than trying to make up a version from scratch. However, if Pennsylvania wants to truly reform its corporate tax system, it should adopt combined reporting. This would eliminate a wider array of tax dodges and close off other tax avoidance schemes that a more limited addback approach would invite.

Effectively closing tax loopholes would level the playing field for all corporations and bring additional revenue for schools, healthcare and environmental protection – or, when Pennsylvania can afford it, for making responsible corporate tax reductions that benefit all businesses.

An ineffective approach to closing loopholes, combined with tax cuts, would be the worst possible outcome. Corporations that exploit loopholes would continue to do so, maintaining their uncompetitive advantage over companies that operate only in Pennsylvania while enjoying another tax break. State revenues would be further eroded – leading to less investment in education, health care, and infrastructure that brings job growth and a strong economy.

ⁱ A company that often has no employees and merely exists to “hold” intangible assets – like copyrights, patents, or trade secrets.

ⁱⁱ The Multistate Tax Commission’s model addback legislation can be found here:

[http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A - Z/Add-Back - FINAL version.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Add-Back_-_FINAL_version.pdf)