

PA TAX LAW NEWS

PA BUDGET: NO STATE TAX INCREASES FOR 2011-12 *by James L. Fritz*

On June 30th, Governor Corbett signed a state budget reducing Pennsylvania's state government spending by more than \$1 billion. These cuts, including substantial cuts to K-12 school funding and aid to higher education, however, virtually ensure tax increases by many local school districts and higher tuition for college students attending state-owned and state-related universities. Following are key highlights of interest to Pennsylvania businesses.

- **Capital Stock & Franchise Tax Phaseout:** remains in place. Rate will be reduced from 2.89 mills for 2011 to 1.89 mills for 2012. The tax will be eliminated in 2014.
- **Corporate Net Income Tax:** rate unchanged (9.99%).
- **Sales & Use Tax:** no change in state rate (6%) and no changes to tax base/exemptions. Semimonthly filings replaced by single filing with 50% estimate for current month and true-up for prior month.
- **Personal Income Tax:** rate unchanged (3.07%).
- **Misc. State Taxes:** no increases.
- **R&D Tax Credit:** annual allocation increased from \$40 million to \$55 million.
- **Job Creation Tax Credit:** allocation reduced from \$22.5 million to \$10.1 million.
- **Film Production Tax Credit:** allocation reduced from \$75 million to \$60 million annual cap; 1-year carryforward.
- **Education Improvement Tax Credit (EITC):** continues at \$67 million.

The budget reportedly uses only a small fraction of the 2010-11 General Fund surplus, which exceeded \$785 million. It also appears that 2011-12 revenue projections may not have been adjusted to account for better than expected revenue collections. Looking

ahead, this suggests that substantial surpluses may be available when legislators and the Governor reach the point of dealing with next year's budget.

The question of a tax or impact fee on natural gas drilling has been deferred until the Fall. It is possible that a Fall tax bill could include minor tax revisions in addition to dealing with natural gas issues.

While the tax news was good at the state level, it remains to be seen what impact state funding will have on local taxes. Among other cuts, Senate Democratic Leader Jay Costa pointed to more than \$900 million in cuts to support for K-12 education. While some school districts seem to have found ways to balance their 2011-12 budgets without tax increases, others have not. The impact of state cuts on school districts varies considerably in degree – for example, from \$104 per student to \$884 per student at districts in Dauphin County, from \$113 to \$731 per student in Lancaster County, from \$173 to \$506 per student in Centre County and from \$99 to \$1,156 per student in York County. Taken together with cuts impacting services at the county level, it would not be surprising to see substantial local tax increases in many areas around the Commonwealth – impacting both homeowners and business property owners.

As noted elsewhere in this newsletter, businesses would be well-advised to examine their real estate assessments to make sure the valuations are appropriate, so that no more than a fair share of local taxes will have to be paid. ■



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JUNE COLLECTIONS: +8.3%

PA General Fund collections for June exceeded projection by \$246.1 million (8.3%), bringing the year-end surplus to \$785.5 million (2.9% above projection). All major tax categories, except Realty Transfer Tax, exceeded annual projections by 3% or more. The Motor License Fund (including gas and diesel taxes) exceeded annual estimates by \$197.6 million (8.5%). ■

ASSESSMENT LAW AUTHOR BERT GOODMAN JOINS McNEES



Bert M. Goodman, author of the 1994 through 2010 editions of the Pennsylvania Bar Institute publication *Assessment Law & Procedure in Pennsylvania*, the preeminent guide to Pennsylvania real estate assessment law, has joined McNeese Wallace & Nurick's State and Local Tax group.

Bert handles tax assessment appeals across Pennsylvania. His cases have included exemption appeals, "clean and green" agricultural appeals and public utility appeals, as well as numerous property valuation appeals. He represents clients before county boards of assessment appeals as well as in county Common Pleas courts and the appellate courts of the Commonwealth.

He also provides assessment law and procedure consulting services, and has served as a lecturer in assessment law for the Pennsylvania Bar Institute, Appraisal Institute and Assessor's Association of Pennsylvania, as well as other professional real estate associations.

Bert served as chair and Chief Administrator of the Montgomery County Board of Assessment Appeals from 1990 to June 1993, where he presided over more than 11,000 hearings. Prior to that, he held positions as Solicitor for the Montgomery County Board of Assessment Appeals, Executive Assistant District Attorney of Montgomery County, Chief of Special Prosecution Unit for the Montgomery County District Attorney's Office, and Assistant District Attorney for the Montgomery County District Attorney's Office. While he served as Solicitor for the Montgomery County Board, he began working on a manual on assessment law and procedure, which led to authorship of his current publication.

Bert is a graduate of Temple University with a Juris Doctor degree (1975), a Master of Arts degree (1972) and a Bachelor of Arts degree (1971). He resides in Chester County and has three children, Rachel (a 2010 graduate of the Pennsylvania State University), Heather (a senior at Temple University) and Daniel (a sophomore at Temple).

Bert will join Randy Varner, Tim Horstmann and other members of the McNeese SALT group in assisting clients to ensure they pay only their fair share of local real estate taxes. ■

PA TAX TIPS - LOCAL TAX EXEMPTIONS FOR MANUFACTURING, BY-PRODUCTS OF MANUFACTURING AND INDUSTRIAL ESTABLISHMENTS *by James L. Fritz and James Welch*

In the January 2011 edition of the PA Tax Law News newsletter, we offered a broad overview of the production-based exemptions under Pennsylvania's Sales & Use Tax, Capital Stock and Franchise Taxes, local Business Privilege Taxes and Real Property Tax. In our May newsletter we discussed some of the Sales and Use Tax exemptions in depth. This article focuses on a more detailed discussion of the activities qualifying under the "manufacturing" and "by-product of manufacturing" exemptions from local business privilege and mercantile taxes levied by school districts and municipalities outside of Philadelphia. This article also discusses the local real estate tax exemptions for "mills, mines, manufactories and industrial establishments."

Local Business Privilege and Mercantile Taxes

The Local Tax Enabling Act ("LTEA") provides broad taxing authority to municipalities and school districts outside of Philadelphia. However, the LTEA also provides fairly broad production-based exclusions limiting local business privilege and mercantile taxes levied on gross receipts.

Tax may not be collected on receipts from:

- Goods and articles manufactured in the political subdivision
- By-products of manufacture
- Minerals, timber and other natural resources produced in the political subdivision
- Farm products produced in the political subdivision
- Preparation or processing of minerals, timber, natural resources or farm products for use or market
- "Any privilege, act or transaction related to" the business of manufacturing, or to the production, preparation or processing of minerals, timber, natural resources or farm products

These exemptions may be claimed only by manufacturers, producers and farmers with respect to their own products.

The LTEA also exempts receipts from:

- Any privilege, act or transaction relating to the processing of manufacturing by-products
- Transportation, loading, unloading or dumping or storage of goods, articles, products or by-products listed above

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Real Estate Deadlines Fast Approaching!

The annual deadlines to file real estate property tax appeals are fast approaching. Most counties have set deadlines of either August 1st or September 1st. Though time is fast running out, there is still time to analyze your assessment to be sure that you are being taxed on a fair and equitable basis. For more information, contact Randy Varner at 717-237-5464 or rvarner@mwn.com, Bert Goodman at 610-240-0345 or bgoodman@mwn.com, or any other member of the McNeese SALT Group.

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“Manufacturing” Exemption

Unlike in Pennsylvania’s Sales and Use Tax statute, “manufacturing” is not defined in the LTEA. In determining whether an activity constitutes “manufacturing” under the LTEA, the courts apply the same narrow standard that is used in the Capital Stock/Franchise Tax context. (See our discussion of the “manufacturing” prong of sales tax exclusion in our May newsletter.) As defined by case law under the local mercantile and business privilege taxes, as well as the capital stock and franchise taxes, “Manufacturing” is the application of labor and skill to material which changes the original material into something different. Whether manufacturing has taken place will depend on the existence of a substantial transformation in the form, qualities and use of the original material. Superficial changes which do not create a new identity in the material are not manufacturing.

The manufacturing exemption applies to more than receipts from outright sales. In *City of Pittsburgh v. IBM Corp.*, 391 A.2d 1126 (Pa. Cmwlth. 1978), a court held that gains from the leasing of manufactured products were exempt under the LTEA.

Following are some of the activities treated as “manufacturing” by Pennsylvania courts addressing local mercantile and business privilege taxes:

- Producing potato chips, which have “an entirely different use” from raw potatoes, oil and salt
- Production of flours by grinding, blending and processing many types of wheat
- Commercial printing involving the design, making of printing plates, printing onto paper which is folded, cut and bound
- Production of shirt boards, collar supports, ribbon reel covers and hosiery packaging inserts from cardboard through scoring, stamping, cutting and folding
- Production of apparel from material precut according to prescribed patterns and designs, where production process included sewing and fusing pieces of fabric, inserting zippers, buttons and other materials and pressing the garment
- Insertion of preprinted advertisements into a newspaper as a part of the larger process of manufacturing the newspaper
- The development of film or photofinishing which results in a photo-negative for use in newspaper printing

Following are some of the activities that do not constitute “manufacturing”:

- Document reproduction through photocopying
- Commercial illustrating
- Preparing bird and small animal feed by combining, cleaning and packaging various grains, seeds and corn (However, the cracking of corn was manufacturing)
- Processing and packaging of meat (But where the processing of meat would result in other products such as soap, glue,

cosmetics, or shortening, that portion of the activities was manufacturing)

- Preparation and cooking of food items
- Production of roasted coffee beans
- Addition of water and sucrose to slurry and powdered drink mixes to form fruit juice, fruit drinks and iced tea
- Preparing and publishing a newsletter, where independent contractor performed the actual printing
- Annealing and galvanizing of steel
- Rebuilding and reconditioning internal combustion engines and selling parts
- Collection of scrap metal which is separated out and resold
- Printing designs on ready-made clothing
- Cutting of leather into pieces, where no new product was produced and the cutting was for the convenience of the purchaser
- Dying and processing of cloth
- Providing cable television services

“By-Products of Manufacture”

Although the general “manufacturing” exemption is limited to manufacturers, the prohibition on the taxation of “any privilege, act or transaction” involved in the processing of “by-products of manufacture” is available to persons other than the manufacturer. *Harsco Corp. v. City of Pittsburgh*, 533 A.2d 1012 (Pa. 1987). In *Harsco*, the Pennsylvania Supreme Court held that a metal recovery company engaged in processing of slag generated in steelmaking operations of a manufacturing company qualified for exemption.

The by-products of manufacturing exemption focuses on the existence of a secondary or additional product. *Metaltech v. City of Pittsburgh*, 623 A.2d 401 (Pa. Cmwlth. 1993). In *Metaltech*, the court refused to characterize the galvanizing of steel as processing a by-product of manufacturing because the process did not produce a second product.

Real Property Taxes

In Pennsylvania, ad valorem taxes are levied on real property by counties, school districts and municipalities. Exemptions, however, are governed by state law. These include:

- “Machinery, tools, appliances and other equipment” contained in any “mill, mine, manufactory or industrial establishment”
- Farm silos used for processing or storage of animal feed
- Farm grain bins or corn cribs used for processing or storage of animal feed
- Structures and containments used predominantly for processing and storage of animal waste
- Composting facilities incidental to farm operation
- Wind turbine generators and related appliances and equipment (including towers and foundations)

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As the other exemptions are more or less self-explanatory, this discussion will focus on the so called “industrial equipment” exemption. Under this provision, the test for exemption from real property taxes requires satisfaction of two distinct elements: “1) the property at issue must constitute machinery, tools, appliances, or other equipment; and 2) the property must be contained in a mill, mine, manufactory, or industrial establishment.” *BFC Hardwoods, Inc. v. Bd. of Assessment Appeals*, Crawford Cnty., 565 Pa. 65, 771 A.2d 759 (2001).

“Machinery, Tools, Appliances and Other Equipment”

Whether an item is considered “machinery” or “equipment” will depend on whether it is an integral, as opposed to merely incidental, part of the manufacturing process. *Jones and Laughlin Tax Assessment Case*, 405 Pa. 421, 175 A.2d 856 (1961).

Therefore, it is our considered conclusion, under the statute involved, improvements, whether fast or loose, which are used directly in manufacturing the products that the establishment is intended to produce and are necessary and integral parts of the manufacturing process and are used solely for effectuating that purpose, are excluded from real estate assessment and taxation. On the other hand, improvements which benefit the land generally and which may serve various users of the land, are not in this category. Neither are structures, which are not necessary and integral parts of the manufacturing process and which are separate and apart therefrom within the exclusion. A structure used for storage, for example, is part of the realty and subject to real estate taxation.

Id. at 431-32. In evaluating whether an improvement is machinery or equipment, courts have applied a three part test. An improvement must be (1) “directly used to manufacture the product,” (2) “a necessary and integral part of the manufacturing process,” and (3) “used solely for effectuating that purpose.” *U.S. Steel v. Bd. of Assessment and Revision of Taxes of Bucks Cnty.*, 422 Pa. 463, 223 A.2d 92 (1966). Courts have focused on whether the “practical and economic use” of property is solely the purpose for which they were built, or if there is a benefit to the land generally.

Smokestacks, cooling towers and water intake structures had a practical and economic use of generating electricity and did not benefit the land generally, and therefore were “machinery and equipment.” *Allegheny Energy Supply Co., LLC v. Greene Cnty. Bd. Of Assessment Appeals*, 837 A.2d 665, 668 (Pa. Cmwlth. 2003).

“Mill, Mine, Manufactory or Industrial Establishment”

Even if an item is machinery or equipment, it will not be excluded from tax unless it is part of a “mill,” “mine,” “manufactory” or “industrial establishment.” The meanings of “mill” and “mine”

being sufficiently ascertainable, much of the courts’ interpretation has focused on what constitutes an “industrial establishment”. The primary contention among parties seeking exemption has been that while a use traditionally may not be considered manufacturing, and therefore not meet the “manufactory” standard; the inclusion of “industrial establishment” in the statute broadens the exemption.

“Industrial establishment” has been defined by the courts based on an ordinary man standard. See *North Side Laundry Co. v. Bd. Of Property Assessment*, Appeals and Review, 366 Pa. 636, 79 A.2d 419, 421 (1951). Courts have construed the additional term as expanding the exemption such that items which are taxed, and not exempted as manufacturing, in other contexts, may be exempted from real estate tax.

In *BFC Hardwoods, Inc. v. Bd. of Assessment Appeals, Crawford Cnty.*, 771 A.2d 759 (Pa. 2001), the Supreme Court held that a lumber drying business was an industrial establishment despite not being “manufacturing” for capital stock tax purposes. In *BFC*, the business property was comprised of office space, storage, undeveloped real estate and the kilns used to dry lumber. *Id.* at 765. The court characterized the entire parcel as making up the “industrial establishment.” *Id.* at 765. The court noted that the industrial establishment provision created a broader exclusion than under other forms of taxation.

Courts have applied the industrial establishment exemption in numerous contexts, which may or may not be exempt from other taxes under statutory “manufacturing” provisions.

- Various laundry machines were excludable as machinery and equipment used by a commercial laundry company that was an industrial establishment
- Television antenna was excludable as machinery because a television station was an industrial establishment

The industrial establishment provision, though broader than purely “manufacturing” activities, is not without limits.

- Communications towers have been held not to be part of an industrial establishment under the “ordinary man” test
- Nursery business was not an industrial establishment, but rather an agricultural establishment; therefore, a greenhouse was not excludable as equipment contained within it
- Warehouse used as storage facility was not an industrial establishment

Conclusion

Production-based exclusions under Pennsylvania’s state and local tax laws can seem confusing and, at times cases may seem inconsistent. If your company is performing activities you think may qualify for an exemption which has not been claimed, please contact Jim Fritz

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at 717-237-5365 or jfritz@mwn.com, or another member of the McNees SALT group to discuss whether you should assert a claim to exemption (and possibly file a petition for refund).

James Welch is a Summer Associate at McNees Wallace & Nurick LLC and will be a senior this fall at the William & Mary Law School in Williamsburg, Virginia. Jim Fritz will be presenting on "Pennsylvania Production Exemptions" as part of a Pennsylvania Bar Institute program:

"Pennsylvania Taxes – Update and Selected Topics" in Mechanicsburg (Monday, August 8th) and in Philadelphia (Tuesday, August 9th). The Philadelphia Session will be broadcast to several additional locations. He will be joined as a presenter by the Chair of the Pennsylvania Department of Revenue's Board of Appeals, Lauren Zaccarelli, Esq., the Secretary of the Board of Finance and Revenue, Jacqueline Cook, and Revenue Department Deputy Chief Counsel Jeff Snavelly. Further information is available at www.pbi.org. ■

PENNSYLVANIA PROPERTY TAX TASK FORCES CREATED

by Randy L. Varner

The Pennsylvania House of Representatives, in HR 343, effective 08/26/2011, appointed a task force to develop a set of uniform standards for county reassessment. The task force is charged with:

- developing a set of uniform standards for county reassessment contracting;
- developing standards for disclosing the county's system of property valuation and assessment;
- developing a self-evaluation tool for counties to determine when a reassessment is warranted;
- recommending a standard to be used for a statewide mandatory reassessment time frame; and
- presenting any other recommendations to improve the system of property tax reassessment in Pennsylvania.

A second task force was created by HR 344, effective 08/26/2011, to develop criteria and procedures for data submission, verification,

and collection to address issues during a reassessment. The task force is charged with developing criteria and procedures for counties to utilize when submitting data to the State Tax Equalization Board. The task force is also charged with developing criteria and procedures for data collection by those individuals or organizations conducting data collection on behalf of a county assessor.

Both task forces must report their results and present their findings to the Chief Clerk of the House of Representatives within six months. ■

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AN INTRODUCTION TO SALES AND USE TAXATION OF DIGITAL GOODS AND SERVICES IN PENNSYLVANIA

by Timothy J. Horstmann

Digital goods and services have become a major player in the modern marketplace. Today's businesses rely to an increasing degree on goods and services delivered "through the air" by vendors that often will have no traditional markers of presence in a jurisdiction. In most states, the revenue codes on the books do not consider the tax implications of a sale of a "digital good or service."

A "digital good or service" is an amorphous concept not easily defined. The concept revolves around a transaction between a buyer and seller, and typically will include a transfer, or transfers, of digital information – bits and bytes - electronically. A transaction involving a digital "good" generally will consist of a transfer by electronic means of computer software from seller to buyer. This form of

digital transaction is perhaps the most well-known, as consumers and businesses have likely purchased software, and software updates, from a seller, but received the purchased software electronically via a download.

In a "digital service," the seller will make available to the buyer the use of computer software, but no meaningful download of software from the seller occurs. Rather, the buyer will access the software via website, and have some ability to interact with the software by inputting its own data. The buyer's ability to interact with the software is typically restricted in ways not seen in a "digital download." "Digital service" transactions are commonly seen in business settings, and are used for data entry and management.

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Many states' taxing authorities have struggled with how to address for purposes of state and local taxation these goods and services and the companies that buy and sell them. Often, state revenue statutes and administrative codes are silent, leaving it up to the state taxing authority to issue guidance. In Pennsylvania, this has been the case, and the Department of Revenue has been left with the task of determining the tax implications of digital goods and services through administrative bulletins and private letter rulings.

With respect to the tax implications of a sale of a digital good, in Pennsylvania such purchases, when involving computer software, are subject to the sales and use tax, regardless of the method of delivery. Digital goods other than software are not taxed. Additionally, Pennsylvania distinguishes between sales of "canned" computer software and "custom" computer software, with the latter not being subject to tax. It is the Department's position that computer software is "custom" when it is designed, created and developed for and to the

specifications of an original purchaser; all other software is "canned." A purchase of "custom computer software" is not subject to sales and use tax.

The Department has issued two private letter rulings addressing the taxation of "digital services." In both rulings, the Department's position was that such services are taxable if and only if the software accessed by the purchaser is not "custom computer software," and is based on a computer server or data center that is located in Pennsylvania. If the server or data center is located in Pennsylvania, the software is taxable to the seller as a provider of computer services. However, if the buyer's access is evidenced by a "license to use" the software, such charges will be taxable at retail. ■

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PA CASE NOTES *By Timothy Horstmann*

Real Estate Tax – Valuation

In an unreported decision, the Commonwealth Court rejected an appeal by the taxing authorities, holding that it was not an error of law for the county court to reject the use of the income approach to valuation and rely only upon the sales comparisons submitted by the parties' appraisers, based upon the fact that the subject property under appeal did not generate any rental income. *Weis Markets v. Northumberland County Board of Appeals*, No. 1506 C.D. 2010 (June 14, 2011)

Real Estate Tax – Charitable Exemption

In an unreported decision, the Commonwealth Court affirmed a decision of the Montgomery County Court of Common Pleas, which denied the property owner's request for a charitable exemption from real property taxes because the property was not used primarily for religious worship. The evidence showed that the property was extremely dilapidated and was used principally as a residence for the caretaker and his family. *First Korean Church of New York v. Montgomery County Board of Assessment Appeals*, No. 1551 C.D. 2010 (June 14, 2011)

Personal Income Tax – Loss Carryforward

The Commonwealth Court has reaffirmed its previous decision, holding that differing treatment of losses incurred by C and S corporations did not violate the Pennsylvania and United States constitutions. The taxpayers, shareholders of an S corporation, had claimed that the refusal to permit the carryover of losses incurred by an S corporation was unconstitutional, where such loss carryovers are permissible if incurred by a C corporation. The Commonwealth Court restated its opinion that differing treatment is permissible, because shareholders of S corporations are not similarly situated to shareholders of C corporations. *DelGaizo v. Commonwealth of Pennsylvania*, Nos. 558 F.R. 2008 and 37 F.R. 2009 (June 16, 2011)

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