

PA TAX LAW NEWS

COMMONWEALTH COURT DENIES MANUFACTURING EXCLUSION TO SERVICE PROVIDER

by Sharon R. Paxton



On August 6, 2013, in a case with possible implications for other providers of nontaxable services, Pennsylvania's Commonwealth Court ruled, *en banc*, that a medical group's MRI and CT scan equipment does not qualify for the manufacturing exclusion for Sales and Use Tax purposes. The Court affirmed the Board of Finance and Revenue's denial of a refund claim filed by Tristan Radiology Specialists, P.C. ("Taxpayer") for tax paid on such equipment. We expect the Taxpayer to appeal the Commonwealth Court's decision in this case.

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The Taxpayer argued that the process of producing an MRI or CT image constitutes the "manufacture" of "tangible personal property," as those terms are defined in the Sales and Use Tax statute. The term "manufacture" is statutorily defined to include "operations, engaged in as a business, which place any tangible personal property in a form, composition or character different from that in which it is acquired..." See 72 P.S. § 7201(c). The Taxpayer's argument was premised on the fact that the creation of an MRI or CT image, which is recorded on film, compact disc and/or a computer hard drive, constitutes the production of tangible personal property (an MRI or CT image) through operations which result in a transformation of tangible personal property acquired for use in the production process. The Sales and Use Tax manufacturing exclusion has been broadly construed by Pennsylvania's appellate courts, and application of the exclusion to the production of MRI and CT images would arguably be consistent with the Commonwealth's application of the exclusion to other types of operations not commonly perceived as "manufacturing."

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PA TELECOM GROSS RECEIPTS LITIGATION FINALLY MOVING

by James L. Fritz

For several years, cases have been piling up in anticipation that Verizon Pennsylvania, Inc. and other taxpayers would be arguing lead cases challenging the application of Pennsylvania's Gross Receipts Tax to various types of telecom charges. Finally, as briefly noted in our last newsletter, the first decision was rendered on July 5th by Pennsylvania's Commonwealth Court. (*Verizon Pennsylvania, Inc. v. Commonwealth*, No. 266 F.R. 2008) The court ruled that receipts from private telephone lines and directory assistance services are subject to tax. However, charges for non-recurring services such as telephone line installation, moves or changes to telephone lines and service and repair of telephone lines are not subject to tax.

Both sides filed "Exceptions" on August 2nd, stating their objections to the court's decision. The Commonwealth Court could hold another round of oral argument before issuing a decision responding to the Exceptions. However, the court most likely will issue an expedited decision because the parties have filed a joint motion to waive additional argument. Regardless of the disposition of the Exceptions, a further appeal to the Pennsylvania Supreme Court is expected.

Pennsylvania's Gross Receipts Tax, as applied to telecommunications companies, traces its history to 1889 when the tax was applied to gross receipts "received ... from telegraph, telephone or express business done wholly within this state." Over the years, the imposition language was amended and the tax was expanded to apply to interstate business and mobile telecommunications. Currently, the statute as applied to landline companies imposes tax on gross receipts received from:

telegraph or telephone message transmitted wholly within [PA] and ... messages transmitted in interstate commerce where such messages originate or terminate in this State and the charges for such messages are billed to a service address in this State, except for ..."

72 P.S. § 8101(a)(2).

Bell Telephone, predecessor to Verizon, litigated the scope of this tax several times before, but the last case was decided by the Pennsylvania Supreme Court in 1943. On its face, the current language seems to be limited to taxing message charges and not all revenues from the business of the telephone company. However, the 1943 case gave similar language a somewhat broad application, taxing revenues from specialized customer systems and equipment and from auxiliary phone lines. The specialized equipment was taxable because "without the use of the systems to notify the recipient of the call," the telephone call could not take place. Auxiliary line charges were taxed because the lines actually carried telephone messages.

In the current Verizon case, the Commonwealth Court ruled that, like the auxiliary lines in the 1943 case, receipts from Private Lines are taxable because the lines carry messages. Directory Assistance charges were taxable in the opinion of the court because the customer must transmit a message to an operator in order to receive information and because "Verizon transmits messages more effectively and satisfactorily by providing this service to its customers" Non-recurring charges are not taxable because, as held in a 1930 lower court case, these receipts were not from the "transmission of messages."

This is just the first decision in the first case at the present time to address the scope of this tax. Technology has changed substantially since the 1943 PA Supreme Court case and earlier lower court cases. Business practices have changed. Ideally, the Department of Revenue should have sought legislation and issued formal administrative guidance to make clear the application of this tax over the years. Instead, matters have been left to the courts. There are many cases and opinions yet to come.

Any telecom provider which has not yet filed protective refund claims and contested audits to keep Gross Receipts Tax issues alive should immediately do so, to the extent possible. ■



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PHILADELPHIA PROPERTY OWNERS TAKE NOTICE! REASSESSMENT APPEAL DEADLINE APPROACHING

by Randy L. Varner

In February, the Philadelphia Office of Property Assessment (“OPA”) issued new “Actual Value Initiative” reassessments for every property in Philadelphia. Property owners were given the chance to file an informal appeal. If you received a reassessment and the informal appeal process did not result in satisfactory relief, or if you skipped the informal process altogether and believe that your reassessment is too high, you may file a formal appeal on or before October 7, 2013.

The intention of the “Actual Value Initiative” was to value each parcel to reflect the actual market value of the property as of February 1, 2013. This initiative came on the heels of many months of confusion over common level ratios, rulings by the State Tax Equalization Board, and eventual state legislation over the ratios. The reassessment as a result of this initiative has taken all the mystery over ratios out of the process. Because each property has been reassessed, property owners should examine their notices closely to make sure that the reassessed value represents the actual value of the property. If the reassessment is higher than the actual value of the property, an appeal may be warranted to reduce the amount of taxes that must be paid.

If you own property in Philadelphia and would like assistance in filing an appeal, or have questions, please contact a member of the McNees SALT team. ■



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PA BUSINESS TAXES RANK MID-PACK

by James L. Fritz

A recent report compiled by Ernst & Young LLP for the Council on State Taxation (“COST”) provides some interesting tax statistics concerning Pennsylvania business taxes. The report is based on FY 2012 data.

In raw dollars, Pennsylvania’s total state and local business tax collections rank 6th among the 50 states and District of Columbia. However, as a percentage of private-sector gross product, Pennsylvania’s business tax collections tie for 29th place. The national average was 4.8%; Pennsylvania’s ratio was 4.7%.

Pennsylvania business taxes accounted for 41.2% of total state and local tax collections. The national average was 45.2%.

The study also used three different methodologies to gauge the value of business taxes paid as compared to the value of government spending benefitting business. If no part of education spending is allocated to business, Pennsylvania businesses paid \$3.10 for every dollar of benefit - a tie for the 33rd highest ratio in the US. Allocating 25% of education spending to business reduced the PA ratio to \$1.70 per dollar of benefit - a tie for 28th nationally. If 50% of education spending is allocated to business, the PA ratio falls to \$1.10 per dollar of benefit - a tie for 33rd.

The complete report may be downloaded at: www.cost.org. ■





UPCOMING SEMINARS - JOIN US!

The members of the McNees SALT group will present our annual Lancaster seminar “State and Local Taxes for Pennsylvania Businesses 2013” on October 10th at the Eden Resort.

The morning program will feature a review of recent Pennsylvania legislative changes as well as discussion of recent decisions, new regulations, rulings and other informal administrative guidance, and current issues - covering PA Sales & Use Tax, PA Corporate Taxes, PA Personal Income Tax and PA Fuel Taxes. Recent Abandoned and Unclaimed Property Developments as well as Federal legislation impacting state taxes also will be covered. The afternoon will include sessions on the basics of Business Privilege & Mercantile Taxes, a review of the Sales Tax Treatment of Construction Contracts and recent developments in Real Estate Assessment Appeals and Exemptions.

For additional information and registration forms please visit the McNees website at <http://www.mwn.com/events>.

Scranton/Wilkes-Barre - PA Update - October 23

Jim Fritz and Sharon Paxton will present a four-hour “PA State Tax Update” for the Northeast Chapter of Pennsylvania Society of Tax & Accounting Professionals. The four-hour session will be preceded by a two-hour ethics segment. The event will be held at the Woodlands Inn and Resort at Wilkes-Barre and is open to non-members for a fee of \$95. For information and registration, please contact the state office of the Pennsylvania Society of Tax & Accounting Professionals at 1-800-270-3352.

Harrisburg - Sales Tax - November 12 & Scranton - Sales Tax - November 13

Randy Varner will present on “Understanding Select Core Industry Issues and Considerations” and “Resolving Sales and Use Tax Disputes” as part of full-day Sales and Use Tax seminars sponsored by the National Business Institute at the Clarion Hotel and Conference Center in New Cumberland and at the Hilton Scranton & Conference Center. Additional information is available at <http://www.nbi-sems.com/Content.aspx?st=Pennsylvania&NavigationDataSource1=N:63943-39>.

Baltimore, Md. - PA Update - November 20

Randy Varner will present as part of a panel on Mid-Atlantic State Tax Developments at the Advanced Tax Institute in Baltimore. The Institute is presented jointly by the Maryland Association of Certified Public Accountants and the Maryland Bar Association. For more information, please visit <http://www.macpa.org/content/ATI-4-Agenda.aspx>.

Philadelphia - Property Assessment - December 5, 6

Bert Goodman and Randy Varner will speak at the Pennsylvania Bar Institute’s Real Estate Institute on December 5th and 6th in Philadelphia. They will present a session on how to challenge a real estate assessment. For more information, please visit <http://www.legalspan.com/pbi/calendar.asp?UGUID=&ItemID=20130402-229194-84410>.

Lancaster - Sales Tax - January 22, 2014

Jim Fritz and Sharon Paxton will once again be presenting a full-day seminar on “Sales and Use Tax in Pennsylvania” in Lancaster on January 22nd. The program will be sponsored by Lorman Education Services. Additional information will be forthcoming.

PA ISSUES ON APPEAL - CORPORATE TAXES *by James L. Fritz*

Under Pennsylvania's tax appeals system, many issues are not resolved at audit or before the Department's Board of Appeals and the Board of Finance and Revenue, resulting in numerous appeals to the Commonwealth Court. In court, most cases are resolved prior to argument, through negotiated settlement. Thus, to know whether your company is pursuing all reasonable issues, you must be aware of issues raised in appeals to the Commonwealth Court and, to the extent possible, how those issues have been resolved in settlements.

Many issues in court are susceptible of negotiated settlement. Occasionally, an issue cannot be resolved and the parties then pursue formal argument to the court. The article in this issue "PA Telecom Gross Receipts Tax Litigation Finally Moving" provides an example of issues going to argument before the Commonwealth Court.

If your company has an issue that another company is pursuing in a court appeal, and it is certain that the issue will not settle and have to be argued, your company may file protective petitions and have action on those cases deferred pending final resolution of the issue by the courts. In many instances, waiting to file until someone else has obtained a final decision will result in your company being closed out for many tax years by the statute of limitations for refund claims and assessment appeals. Pennsylvania courts have very tightly enforced the statutory limitations periods.

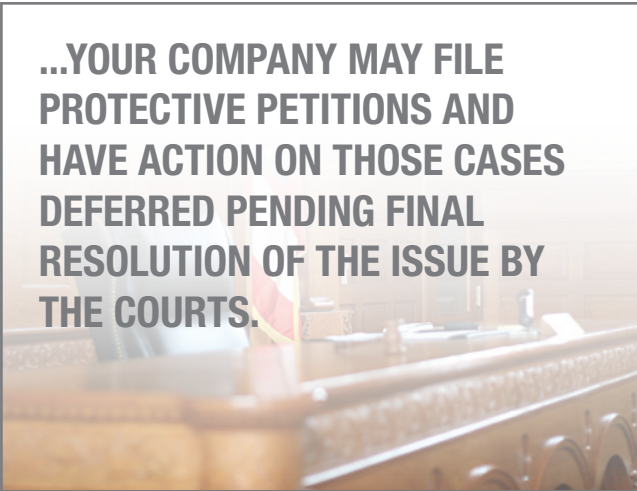
If your company has an issue which one or more other companies seem likely to settle in court, you may file your refund claim or assessment appeal and defer it temporarily while you wait to see what happens with the other cases. Or, what is generally a better choice, you can move your case through the administrative appeals boards and into court, assuming that by the time your case reaches court, you will have some idea what has happened in the cases ahead of yours.

Recently, a settlement process was implemented for cases before the Department's Board of Appeals and, with implementation of changes to the Board of Finance and Revenue in April 2014, a similar process will be put in place at that level. However, unless you are prepared to offer the Department a "sweetheart deal" for the Commonwealth, we believe there will continue to be many issues that will not be resolved prior to negotiation with the Office

of Attorney General after a court appeal is filed. And, of course, there always will be a few issues that will have to be formally resolved by the courts.

To understand the opportunities for your company, the first step is to identify issues which are being taken to court. Then you should discuss with your state tax legal advisors the best way to pursue the issues for your company.

To assist you in identifying possible issues for your company, the list below includes a number of arguments raised in Pennsylvania Corporate Net Income Tax, Capital Stock Tax and Franchise Tax appeals recently filed with the Commonwealth Court. Please contact a member of the McNeese SALT group if you would like to discuss any of these issues.



...YOUR COMPANY MAY FILE PROTECTIVE PETITIONS AND HAVE ACTION ON THOSE CASES DEFERRED PENDING FINAL RESOLUTION OF THE ISSUE BY THE COURTS.

1. Equitable Apportionment:

Many cases assert that the standard apportionment formula, as applied to a particular company's circumstances, does not fairly attribute income or capital stock value to Pennsylvania. Some cases request different composition or weighting of the standard Property, Payroll or Sales Factors, the addition of a fourth factor, or other alternative methodologies.

2. Unconstitutional Distortion in Apportionment:

Often an assertion of unconstitutional distortion of

income or value attributable to Pennsylvania is paired with an Equitable Apportionment argument. Note that, in Pennsylvania, the statutory Equitable Apportionment provision may be triggered at a lower threshold than is required to establish a constitutional violation.

3. Apportionment - Sales Factor - Cost of Performance:

Right to exclude receipts from numerator where greatest proportion of income-producing activity was performed in state other than Pennsylvania.

4. Apportionment - Sales Factor - Cost of Performance:

Revenue Department position equating income producing activity to where customer received benefit of service is contrary to the statute and represents the substitution of the Department's policy judgment for the Legislature's, in violation of state constitution.

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PA ISSUES ON APPEAL - CORPORATE TAXES *(continued from page 5)*

5. **Apportionment - Sales Factor - Receipt of Benefit:** Attributing sales to PA when all or virtually all service activities were performed outside PA is unconstitutional.
6. **Apportionment - Sales Factor - Costs of Performance:** Revenue Department adoption of the new definition of "sales factor" without formal rulemaking is invalid.
7. **CNI - Net Loss Cap:** Net Loss cap is unconstitutional.
8. **CNI/Franchise - Multiformality/Unrelated Assets/Unitary:** Right to exclude income, assets and activities unrelated to PA activities; right to exclude subsidiary dividends from book income where unrelated to PA activities.
9. **Franchise - Distortion - Equitable Apportionment:** Right to include values from subsidiaries in apportionment factors in order to fairly attribute value to PA.
10. **Franchise/Capital Stock - Value - Extraordinary Gain:** Company should be taxed on the basis of appraised value where inclusion of extraordinary gain produced excessive Capital Stock Value.
11. **Franchise/Capital Stock - Book Income - Royalty Addback - Sham Transaction:** Department lacked authority to add back royalties deducted from book income and failed to establish the elements of a sham transaction.
12. **Franchise - Capital Stock Value - Book Income:** Right to recognize decline in value of assets on balance sheet in computing book income.
13. **Franchise - Capital Stock Value - Net Worth:** Right to recognize decline in value of assets on balance sheet.
14. **CNI - Insurance Co. Exemption - Foreign Captive:** Foreign captive insurance company conducting insurance business outside PA should be exempt from tax.
15. **CNI - Basis - Tax Benefit:** Right to adjust basis and reduce gains because prior period losses did not provide tax benefit.
16. **CNI - Separate Co. Depreciation:** Member of consolidated group for federal tax purposes is entitled to use different basis for separate company state tax purposes.
17. **Franchise/Capital Stock - Book Income - Reduction by LLC Distributions:** Where members of an LLC provided management, distribution and performed all other activities of LLC, distributions to members should have been deducted in calculating income; provision for deduction was not intended to apply only to small businesses, as asserted by Board of Finance and Revenue.
18. **Capital Stock - Single Factor Apportionment:** Company should be allowed to use end-of-year values instead of average values.
19. **Capital Stock/Franchise - Apportionment - Processing, R&D, Manufacturing:** Three-factor method is unconstitutional because it fails to exclude subsidiary values and values attributable to processing, R&D and manufacturing which in-state taxpayers may exclude using single-factor method.
20. **Franchise/CNI - Apportionment Bifurcation:** Right to apply single-factor pipeline factor to receipts/value from natural gas business involving gas transmission via pipeline and apply three-factor apportionment to other receipts.
21. **Franchise/CNI Apportionment - Sales Factor - Electricity:** Sale of electricity constitutes sale of intangible property, not tangible personal property, which should be sourced based on costs of performance rule.
22. **Franchise/CNI - Nexus - PL86-272-Electricity:** If sale of electricity constitutes sale of tangible personal property, PL 86-272 bars imposition of tax because PA activities were limited to solicitation.
23. **Franchise/CNI - Apportionment - Sales Factor:** Sales Factor should include gross receipts, not net inflows from "swaps" engaged in as electricity and natural gas hedging transactions.
24. **CNI - Apportionment - Sales Factor - Treasury Transactions:** Sales factor denominator should include proceeds from sales of loans, leases, receivables and from securitization transactions.
25. **Franchise - Apportionment - Payroll Factor - Distortion:** Right to exclude exercise of nonqualified stock options because inclusion distorts attribution of value to PA.
26. **CNI/Franchise - Apportionment - Property Factor:** Right to exclude inventory and other property in transit, destined outside of PA, from numerator.
27. **CNI/Franchise - Apportionment - Property Factor:** Right to exclude idle property and construction-in-progress. ■

COMMONWEALTH COURT DENIES MANUFACTURING EXCLUSION TO SERVICE PROVIDER (continued from page 1)

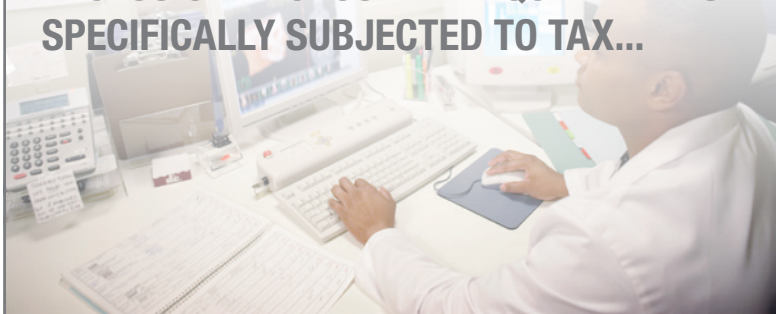
Somewhat surprisingly, the Court expressly declined to interpret the statutory definition of “manufacture” as applied to the production of MRI and CT images (other than to state that the statutory definition of “manufacture” is so broad that, if it were taken literally, it would produce an absurd result). Rather, the Court concluded that certain regulatory provisions, which are unrelated to the manufacturing exclusion, are controlling. The Court determined that the disputed equipment does not qualify for the manufacturing exclusion because the equipment is specifically subjected to tax under both 61 Pa. Code § 31.6 (“Persons rendering nontaxable services”) and 61 Pa. Code § 52.1 (“Purchases of medicines, medical supplies, medical equipment and prosthetic or therapeutic devices”). We believe the Court erroneously relied on these regulations because neither regulation was intended to restrict the scope of the manufacturing exclusion. In addition, the Court’s analysis arguably calls into question the applicability of the manufacturing exclusion, as well as other statutory exclusions and exemptions, to businesses rendering all types of nontaxable services - a result which likely was not intended by the Court.

Regulation § 31.6 merely explains the general rule that “[p]ersons rendering nontaxable services are consumers of the *taxable* personal property and services used in their business.” 61 Pa. Code § 31.6 (emphasis added). Regulation § 31.6 applies to all types of businesses that provide nontaxable services, and is not limited to services provided by “the learned professions.” We do not believe that this regulation can properly be interpreted to prohibit a service provider from claiming an exemption or exclusion, such as the manufacturing exclusion, to which it is otherwise entitled. Nevertheless, the Court’s analysis seems to do just that – by concluding that it was not necessary to consider whether the Taxpayer’s production of MRI and CT

images constituted “manufacture” because tax was specifically imposed by Regulation § 31.6.

Notwithstanding Regulation § 31.6, service businesses have historically been permitted to claim the manufacturing

... THE DISPUTED EQUIPMENT DOES NOT QUALIFY FOR THE MANUFACTURING EXCLUSION BECAUSE THE EQUIPMENT IS SPECIFICALLY SUBJECTED TO TAX...



exclusion for equipment used to produce “tangible personal property” for their own use. For example, service businesses could claim the manufacturing exclusion for equipment used in “in-house printing” operations or in the generation of electricity for their own use. Similarly, construction contractors could claim the manufacturing and processing exclusions for equipment used

to produce prefabricated concrete, asphalt, cabinets, metal staircases and many other items for use in their own construction activities. The Court’s decision in this case could potentially be interpreted to deny the manufacturing and processing exclusions in these situations, and to all providers of nontaxable services who produce tangible personal property for their own use in the provision of nontaxable services.

Finally, Regulation § 52.1 clarifies the scope of the statutory exemption at 72 P.S. § 7204(17) for medical supplies and equipment. That regulation also has nothing to do with the scope of the manufacturing exclusion. ■

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McNees State and Local Tax Group

The members of the McNees SALT group are widely recognized in the SALT community and the legal community at large. The Group’s Chair has been recognized as one of the *Best Lawyers in America*™. A member of the Group served several years as Secretary of the Board of Appeals in the Pennsylvania Department of Revenue. The Group’s members include a past Chair and the current Vice-Chair of the Tax Section of the Pennsylvania Bar Association. Members are active in the tax committees of the Pennsylvania and Harrisburg Area chambers of commerce, the ABA State and Local Tax Committee, the Institute for Professionals in Taxation and other professional groups. Members of the group have been published in a number of tax publications and speak frequently before industry groups, CPA groups, the Tax Executives Institute, the Pennsylvania Bar Institute and other venues in Pennsylvania, Maryland, Ohio and other states.

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