

PA TAX LAW NEWS

PA CAPITAL STOCK/FRANCHISE TAX PHASE-OUT DEFERRED; RELATED PARTY ADDBACK ENACTED; NUMEROUS OTHER TAX AND CREDIT CHANGES MADE *by James L. Fritz*



On June 30th Governor Corbett signed a \$28.4 billion state appropriations package which provides modest increases in some areas and flat funding in others. Although the popular press suggested that the budget included no general tax increases, the Tax Reform Code amendment bill (HB 465) passed by the General Assembly on July 3 and signed by the Governor on July 9, certainly will seem like a tax increase for many companies doing business in Pennsylvania.

Capital Stock & Franchise Tax Extended

After the House passed HB 440 in early May, we reported that the bill maintained the final phase-out of the Capital Stock and Franchise Tax as of December 31, 2013. Somewhere betwixt and between, the Republican legislative leadership and the Governor's Office apparently decided that more revenues will be required. The final tax bill - HB 465 - extends the phase-out for two additional years. The rate stands at 0.89 mills for tax years beginning in 2013, then is reduced to 0.67 mills for 2014 and 0.45 mills in 2015. The tax has been reprogrammed to expire after December 31, 2015. Reportedly, this change will generate \$58.4 million in FY 2013-14, \$183 million in FY 2014-15 and \$99 million in FY 2015-16.

Corporate Net Income Tax Addbacks

While some of the addback language from HB 440 is retained, HB 465 tightened up some of the provisions. The addback is projected to generate additional tax revenue of \$9.5 million in FY 2014-15 and \$30 million or more in each subsequent year.

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With certain exceptions, for taxable years beginning after December 31, 2014, no deduction will be allowed for an "intangible expense or cost," or an "interest expense or cost," paid directly or indirectly to an "affiliated entity." The statute includes a lengthy definition of "affiliated entity" but turns generally on a 50% ownership test. An "interest expense or cost" is added back if the deduction "is directly related to an intangible expense or cost." An "intangible expense or cost" includes "royalties, licenses or fees paid for the acquisition, use, maintenance, management, ownership, sale, exchange or other disposition of patents, patent applications, trade names, trademarks, service marks, copyrights, mask works or other similar expenses or costs."

Credit. If the affiliate receiving the taxpayer's payment is subject to tax in Pennsylvania, another state or possession of the United States, the taxpayer will be entitled to a credit computed by multiplying the taxpayer's apportionment factor times the greater of (1) the affiliate's tax attributable to the related party payment, or (2) the tax which would have been paid by the affiliate if not offset by a credit.

Exceptions. There will be no addback where: (1) the related party payment resulted from a transaction which "did not have as the principal purpose the avoidance of tax ... and was done at arm's length rates and terms;" (2) the related party payment resulted from a transaction with an affiliate "domiciled in a foreign nation which has in force a comprehensive income tax treaty with the United States ...;" or, (3) the affiliate receiving the related party payment, in turn, made a payment to a nonaffiliated entity.

CNI Rate Unchanged
Unlike HB 440, the final tax package includes no future phase-down of the Corporate Net Income Tax Rate, which remains at 9.99% - one of the highest state rates.

CNI Net Loss Deduction Limits

Currently, the net loss deduction for Corporate Net Income Tax purposes is limited to the greater of 20% of taxable income or \$3

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PA CAPITAL STOCK/FRANCHISE TAX PHASE-OUT (continued on from page 1)

million. For tax years beginning in 2014, the limits will be 25% or \$4 million. After December 31, 2014, the limits will be 30% or \$5 million. These changes will save businesses \$11.4 million in FY 2013-14, \$43.5 million in FY 2014-15 and \$63.2 million in FY 2015-16.

CNI/Capital Stock/Franchise Sales Factor

HB 465 made several changes to the Sales Factor numerator sourcing rules. Most significantly, for tax years beginning after December 31, 2013, receipts from services will be sourced to Pennsylvania “if the service is delivered to a location in” Pennsylvania. Where delivered to both a location in PA and a location outside the Commonwealth, the sale will be in PA “based upon the percentage of total value of the service delivered to a location in this state.” While some have referred to this as “market sourcing,” HB 465 contains no definition for where a service is “delivered,” leaving the door open to arguments about the meaning.

The bill did include some fallback rules, but it is not clear that these would come into play where the place of performance is known and the customer locations are known. The bill provides that if the place of delivery cannot be determined, services provided to an individual will be deemed delivered to the customer’s billing address and services provided to other customers will be sourced to “the location from which the services were ordered in the customer’s regular course of operations.” If the latter location cannot be determined, the sale will be sourced to the customer’s billing address. These provisions may provide planning opportunities for intercompany transactions.

The statute is clarified to source receipts from sale, lease, rental or other use of real property to the property location. Where a single parcel straddles state lines, sourcing will be based on the percentage of original cost attributable to the part of the property in Pennsylvania.

Receipts from the rental, lease or licensing of tangible personal property will be sourced to Pennsylvania, in the first instance, if the customer first takes possession in the state. If the tangible personal property subsequently is taken out of the state, the taxpayer “may use a reasonably determined estimate of usage in” the state.

Receipts from intangibles will continue to be sourced according to the current “income producing activity” and “costs of performance” rules.

The new sourcing rules will generate additional tax revenue of \$7 million in FY 2013-14 and \$22.4 million or more in subsequent years.

Satellite TV Apportionment

Satellite television service providers will receive their own apportionment rules, based on the location of property owned or rented by a controlled group member, costing the Commonwealth

approximately \$2 million per year in revenue.

Corporate Tax Late Filing Penalty

The penalty for failure to file, or for filing a knowingly false report is increased to \$500 plus 1% of any tax over \$25,000, for tax years beginning after December 31, 2013.

Sales & Use Tax

The good news on the PA sales tax front is what did not happen - the 1% vendors allowance again was not repealed or reduced! Among the additions to the statute is an exemption for aircraft parts, services to aircraft and aircraft components (includes fixed wing powered, tilt-rotor, tilt-wing, glider and unmanned craft). The call center credit is repealed. Appeal periods for license suspensions and revocation are reduced to 30 days. Other technical changes are also made.

Remote Sales. Looking forward to possible passage of federal legislation authorizing states to enforce collection of tax by mail order and online vendors, the Department of Revenue and the Independent Fiscal Office are ordered to provide a report and proposed legislation to the General Assembly after federal remote seller legislation is enacted.

Philadelphia Sales Tax Extended

HB 465 authorizes extension of the additional 1% sales tax authorized in 2009 and scheduled to expire at June 30, 2014. The total local rate will continue at 2%. The first \$120 million from the extended tax will be paid each year to the Philadelphia School District, if the state Secretary of Education annually certifies that reforms are being implemented by the school district to “provide for fiscal stability, educational improvement and operational control.” The first \$15 million above \$120 million will be paid to the City of Philadelphia to pay for debt incurred by the city to the benefit of the school district. Any additional amounts will be paid to the City to satisfy pension liabilities.

Loans Tax Repeal

Effective January 1, 2014, the Corporate Loans Tax will be repealed. (Note: This provision is in the Fiscal Code Bill (SB 591), which still required final passage by the House at the time this article was prepared.) The Loans Tax repeal will cost the Commonwealth only nominally in FY 2013-14 and \$9.2 million in FY 2014-15.

Partnership & S Corp Taxes

Effective for tax years beginning after December 31, 2013, partnership and S corporations which underreport taxable income by more than \$1 million, may be directly assessed tax, excluding interest and penalties, on that income. This will apply to Partnerships with eleven or more partners who are natural persons, to S corporations with eleven or more shareholders, to partnerships with at least one partner



which is a corporation, LLC, partnership, or trust, to partnerships with only natural person partners which elect to be subject, and to S corps which elect to be subject. The partnership-level tax does not apply to publicly-traded partnerships. Partners and shareholders will be entitled to credit for their share of the tax paid at the entity level and may file for a refund if they would not have owed tax individually on the underreported income.

Partnership Information to Partners

HB 465 includes a number of provisions intended to clarify, confirm or establish the obligations of partnerships, S corps, estates and trusts to provide annual statements to partners, shareholders and beneficiaries. This includes a requirement for reporting partnerships to provide “a copy of the Pennsylvania income tax form reporting corporate partner apportioned business income or loss” to each partner classified as a corporation, partnership, or disregarded entity for federal income tax purposes. The requirement will not apply if it can be determined that no corporation directly or indirectly owns part of the reporting partnership.

Other Personal Income Tax Changes

Companies qualifying for a \$5,000 start-up business deduction for federal tax purposes will be allowed a similar deduction for Pennsylvania tax purposes, for tax years starting after December 31, 2013 (tax savings of \$4.3 million in FY 2014-15). Although the statutory language is a bit muddled, it appears that for tax years beginning after December 31, 2013, an election may be made for Intangible Drilling and Development Costs to be currently expensed up to one-third, with the remainder recovered over ten years. (Note: A technical correction may need to be enacted to clarify the IDC provisions.) Classification of partnership and corporate (S corp) items of income or credits will be determined at the partnership or corporate level. Resident credit will no longer be allowed for taxes paid to a foreign country. (Note: This may raise questions of unconstitutional discrimination against foreign commerce.) Two new check-offs will be provided, starting with tax years beginning in 2014, for the Children’s Trust Fund and the American Red Cross. Check-offs for Wildlife Resource Conservation, Organ & Tissue Donating Awareness and Military Family are extended. Estates and Trusts with nonresident beneficiaries will pay a withholding tax starting with the 2014 tax year. The Department is given authority to issue citations for summary offenses to employers failing to file or timely pay withholding tax to the Commonwealth.

Bank Shares Tax Rewritten

Effective for calendar year 2014, the Bank Shares Tax has been redrawn on essentially a non-revenue-impact basis that should eliminate some concerns growing out of recent litigation. The tax is broadened to apply to any institution “doing business” in

the Commonwealth - a term defined with some specifics but also including any “activity sufficient to create a nexus in this Commonwealth for tax purposes under the Constitution of the United States.” Six-year averaging of the value is eliminated. Three-factor apportionment is replaced by a single receipts factor. The Act provides extensive receipts sourcing rules. The tax rate is reduced from 1.25% to 0.89%.

Realty Transfer Tax

Effective January 1, 2014, the so-called “89/11 loophole” will be closed by counting a “legally binding commitment or option, enforceable at a future date” toward the 90% transfer threshold that triggers tax for a “real estate company.” The definition of “real estate company” is expanded to include companies holding a direct or indirect ownership interest in a real estate company. Applicable retroactively to November 1, 2011, transfers from governmental entities for no or nominal consideration to volunteer emergency medical services agencies, volunteer fire companies and volunteer rescue companies are exempt, as are transfers between such volunteer organizations.

Inheritance Tax Family Business Exemption

Effective for the estates of decedents passing on or after July 1, 2013, Inheritance Tax will not apply to the transfer of a “qualified family business interest” to one or more “qualified transferees.” The business must have been in existence for five years, have fewer than 50 full-time equivalent employees, have a net book value less than \$5 million, and be owned as a proprietorship by the decedent or be an entity wholly-owned by the decedent or by the decedent and qualified transferees. An entity with the principal purpose of managing investments or income-producing assets owned by the entity will not qualify. A “qualified transferee” is the decedent’s spouse, lineal descendent, sibling (and the sibling’s lineal descendents) and ancestors (and the ancestor’s siblings). The exemption is lost if the business does not continue to be owned by a “qualified transferee” for seven years.

Nonlicensed Wagering Tax

A tax of 10% is imposed on pari-mutuel wagers, including “advance deposit account” wagers placed from within the Commonwealth through “nonlicensed corporations.” Somewhat counterintuitively, a “nonlicensed corporation” is defined to include a natural person, a partnership, a limited liability partnership, “any other form of unincorporated enterprise owned or conducted by two or more persons other than a private trust or decedent’s estate,” as well as a corporation, a joint stock association or business trust, that offers or accepts pari-mutuel wagers made within Pennsylvania. This includes wagering on both thoroughbred and harness horse races by phone and over the Internet. Revenues will be dedicated to support the state racing commissions and the Pennsylvania Race Horse Development Fund.

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Miscellaneous Administrative Changes

The following administrative changes are part of SB 591 (Fiscal Code amendments) which, at the time this article was written, still awaited final passage by the PA House (to approve Senate amendments) and signature by the Governor.

- Threshold for mandating payment by electronic funds transfer may be reduced from \$10,000 to \$1,000 (excepting personal payments of Personal Income Tax) upon amendment of regulations.
- Threshold for mandatory electronic filing of returns by third-party preparers may be reduced from 50 to 10 returns by the Department of Revenue and the requirement may be applied to any type of document.
- Contingent fee contracting authorization is clarified to prohibit the Department of Revenue from using such contracts to delegate field audits.
- Enhanced Revenue Collection Account is extended through fiscal year 2019-20, with up to \$15 million of the enhanced collections to be spent on increased tax enforcement and refund error reduction.

City Revitalization and Improvement Zones

HB 465 authorizes a new City Revitalization and Improvement Zone (“CRIZ”) program. Under the program, certain additional state and local tax revenues above and beyond initial year baseline amounts may be dedicated to pay debt and other expenses incurred for the construction (including site preparation and infrastructure), reconstruction, and renovation of facilities in a CRIZ. Two initial zones and then two additional zones per year (starting in 2016) may be approved on application by third-class cities with at least a population of 30,000 (excluding cities, such as Harrisburg, under receivership). An additional “pilot zone” will be established in a township or borough with a population of at least 7,000. Part of a CRIZ may not include a KOZ, KOIZ, KOEZ, KIZ, Keystone Special Development Zone, Neighborhood Improvement Zone or Strategic Development Area. Businesses fully or partially located in a CRIZ and construction contractors constructing, reconstructing, or renovating a subsidized facility in a CRIZ will be required to file annual state and local reports of taxes attributable to a CRIZ. Tax dollars must be matched on a ratio of five public dollars to one private dollar.

Mobile Telecom Broadband Investment Tax Credit

For tax years beginning after December 31, 2013, and ending before

January 1, 2024, providers of mobile telecommunications services may apply for a Corporate Net Income Tax credit equal to 5% of their annual investment in “qualified broadband equipment” (no more than 50% of tax liability in a given year). Credits may be carried forward not more than five years and are nonrefundable. Pass-through entities may transfer credit to shareholders, members or partners, but they must use it in the year of transfer. This credit program is limited to \$5 million per year.

Innovate In PA Tax Credit

The Commonwealth will effectively borrow funds for economic development by auctioning off up to \$100 million of deferred Insurance Premiums Tax Credits. A bidding floor will be established based on market conditions, but not less than 75% of the credit amount. Credits may first be used in 2017 for taxes incurred in 2016. Total usage of credits by all holders will be limited to \$20 million per year. Credits may be carried forward to taxable years beginning through December 31, 2025. Credits also may be transferred or sold. 50% of proceeds will go to the Ben Franklin Technology Partners Program, 45% will go to the Venture Investment Program and 5% will be distributed to three regional biotechnology research centers.

Other Credits

Several technical amendments have been made to the Film Tax Credit provisions, including limitations on the carry forward of purchased or assigned credits (2013 purchases may be used against 2014 taxes and 2014 against 2015). The Educational Opportunity Scholarship Tax Credit program is amended to allow a student to continue receiving scholarships after a school is removed from the list of low-achieving schools. The never-used Coal Waste Removal and Ultraclean Fuels Tax Credit is repealed, effective immediately. The total amount of a multi-year Job Creation Tax Credit may be awarded in the first year by the Department of Community and Economic Development.

Please contact Jim Fritz at 717-237-5365 or jfritz@mwn.com, or another member of the McNees SALT group for any question concerning recent PA tax changes. ■



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PA BOARD OF FINANCE AND REVENUE RECONSTITUTED AS INDEPENDENT TAX TRIBUNAL

by James L. Fritz

Effective April 1, 2014, Pennsylvania's Board of Finance and Revenue will be reconstituted with independent voting members and other improved procedures. (HB 465) This is a change we and many other practitioners, as well as the business community at-large, have sought for many years.

Independent Board Members

The primary objection to the current make-up of the Board has been the participation by the Secretary of Revenue or his designee as a member of the Board. Together with participation by the Auditor General (or designee), whose office also participates in the pre-assessment review of many tax returns, this has given many the impression that the decisions of the Board have not been truly independent. This impression has not been cured by the participation of the State Treasurer, Attorney General, Governor's General Counsel and Secretary of the Commonwealth (or their designees) as members of the Board.

Effective April 1st, there will be three members of the Board. Two will be appointed by the Governor and confirmed by the Pennsylvania Senate - one initially serving a four year term and one serving a six-year term, with all subsequent terms being six years. The State Treasurer or the Treasurer's designee will fill the third seat. The two gubernatorial appointees and the Treasurer's designee will be required to meet the following requirements:

- Citizen of US and Pennsylvania Resident
- Attorney or CPA qualified in Pennsylvania
- At least ten years experience in a position requiring substantial knowledge of Pennsylvania tax law
- Devote full time to Board duties

Appointed members will serve until their successor is qualified; they may be renominated.

Representation Before the Board

Taxpayers may be represented before the Board by themselves, by an attorney, by an accountant, or by another representative so long as the representation does not constitute the unauthorized practice of law. Both the taxpayer and the Department of Revenue will have the right to be represented before the Board.

Ex parte communications with Board members or staff on the merits of a case will no longer be permitted. A party submitting information or documentation to the Board will also be required to serve the other party.

Public Hearings and Published Decisions

Hearings of the Board, as at present, will be open to the public unless an executive session is necessary to protect a lawful privilege or confidentiality.

Decisions of the Board, including dissenting opinions, will be published (after deletion of certain confidential information) on a publicly accessible Internet website.

Appeals to Court

As at present, appeals from decisions of the Board will be taken to the Commonwealth Court and will be heard *de novo* (i.e., no formal record will be made before the Board and new evidence may be presented on appeal to court).

New Compromise Authority

HB 465 instructs the Board to establish procedures to facilitate compromise of cases before the Board. The statute does not detail how this process is to work.

Our View

We view the establishment of a truly independent Board as a very significant and positive development. We will withhold judgment on the compromise process at this level until we see how the process is implemented - this could be a very useful, cost-saving tool for all, or it could end up just being window dressing to satisfy a check-box on a survey of best appeal practices. The publication of decisions will be useful, but publishing all decisions in an online database risks the evolution of a bloated database filled with many marginally useful records. And, as attorneys, we wonder how a non-attorney CPA member of the Board can be expected to appropriately adjudicate cases turning on complicated and often close legal issues. On the whole, however, this is the most positive development in the Pennsylvania tax appeals process the author of this article has witnessed in more than 30 years of experience with the Department of Revenue's Board of Appeals and in private practice. We look forward to helping to make this work for the benefit of Pennsylvania taxpayers! ■



ANNUAL PA PROPERTY VALUATION APPEALS DUE SOON *by Bert M. Goodman*

Taxpayers in Pennsylvania once again have an annual opportunity to appeal the assessed value of property. Deadlines for these appeals vary by county, but most are August 1 while some of the smaller counties are September 1, so now is the time to analyze your assessment to determine whether you may be able to have it lowered to reduce your tax burden. In order to properly analyze your assessment, you must have an idea of what your property is actually worth. That is, what is the price at which you would be able to sell it to a willing buyer? Once you have made that determination, you must then apply your county's applicable common level ratio to your assessed value in order to determine the "implied market value." If the "implied market value" from your assessment is higher than what you believe your property is worth, your assessment is likely too high and you are paying more property tax than is warranted.

Please note that for property located in City of Philadelphia the deadline to file your 2014 tax year appeal is the first Monday of

October, which October 7, 2013. Philadelphia has just conducted a full reassessment of all property in the City so that every parcel of land has a new assessment based on a ratio of 100%. Therefore, if your 2014 assessment is \$1,000,000 that indicates the City has placed a fair market value of \$1,000,000 on your property.

If you believe your property may be over-assessed for tax purposes, please contact Bert Goodman (bgoodman@mwn.com) or Randy Varner (rvarner@mwn.com), or another member of the McNees SALT group to discuss your appeal options. ■



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TELECOM GROSS RECEIPTS TAX DECISION ISSUED *by James L. Fritz*

In a decision just issued as this newsletter was going to press, the Commonwealth Court has ruled that charges for private lines and for directory assistance are subject to Pennsylvania's Gross Receipts Tax on telecommunications companies. The court, however, ruled that charges for installation, repair, relocation and other "non-recurring charges" are not subject to the tax. Further appeal is anticipated. We will provide additional analysis in our next newsletter. ■

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