INCOME/FRANCHISE TAXES

Legislative Developments

1. *Single Sales Factor*: For taxable years beginning on or after December 31, 2012, all business income shall be apportioned using a single sales factor.

2. *Capital Stock / Foreign Franchise Tax Phase-out:* Despite Governor Corbett's commitment to phasing out the capital stock / foreign franchise tax, it's back for two more years. The tax is now set to phase out starting in 2016.

3. *Increase Cap on Net Loss Deductions.* Act 52 slightly relaxed the limitations on the amount of NOL deductions a taxpayer can utilize in a particular tax year. For tax years beginning in 2014, the cap is the greater of $4 million or 25 percent of taxable income. For tax years beginning after 2014, the cap is the greater of $5 million or 30 percent of taxable income.

4. *Related-Party Addback*: For tax years beginning after December 31, 2014, Act 52 requires taxpayers to add back related-party intangible expenses and certain interest expenses, unless an exception applies. The addback applies to related-party interest expenses directly related to intangible expenses. The legislature specifically rejected language that would have extended the addback to cover all related-party interest deductions. The addback provision includes a credit for tax paid by affiliated entities. The exceptions include:

    - *Principal Purpose/Arm's-Length Exception*: transactions that do not have as the principal purpose the avoidance of PA corporate income tax, and that are done at arm's-length

    - *Income Tax Treaty*: transactions with a foreign affiliate in a nation that has an income tax treaty with the United States

    - *Conduit Exemption*: transactions where an affiliate paid a non-affiliate for the intangible or interest expense, and is equal to or less than the taxpayer's proportional share of the transaction

5. *Market-Based Sourcing of Services.* Act 52 adds market-based sourcing for sales of services, sales/leases/rentals of real property, and rentals/leases/licenses of tangible personal property for tax years beginning on or after January 1, 2014. The Department is expected to draft guidelines regarding the new market-sourcing rules. Now that Pennsylvania's apportionment formula is based entirely on the sales factor, sourcing sales is more important than ever in Pennsylvania.

Sales of Services: Before Act 52, sales of services were sourced under the catch-all rule for sales other than tangible personal property. This means services were sourced to Pennsylvania only if more income-producing activity was performed in Pennsylvania than in any other state, based on costs of performance. Under Act 52's new market-based sourcing statute, the default rule is that services are sourced to where the service is delivered. If the delivery location cannot be determined, then the services are sourced to where the customer places the order for the services. If the location from which the services were ordered cannot be determined, then the services are sourced to the customer's billing address.

Sales/Leases/Rentals of Real Property: Before Act 52, sales of real property were sourced under the catch-all rule. Under Act 52, the new rule is that these receipts are sourced to Pennsylvania if the property is located in Pennsylvania. If the real property is located both within and outside of Pennsylvania, the portion sourced to Pennsylvania is based on the "percentage of original cost of the real property" in Pennsylvania. This is a change from the often-overlooked prior statutory rule that sources rental income from any property—including real property—based on cost of performance.

Rentals/Leases/Licenses of Tangible Personal Property: Before Act 52, rentals, leases, or licenses of tangible personal property were sourced under the catch-all rule. Under Act 52, the new rule is that these receipts are sourced to Pennsylvania if the customer "first obtained possession" of the property in Pennsylvania. If the property is subsequently taken out of Pennsylvania, taxpayers are permitted to use a "reasonably determined estimate" to source only a portion of the sale to Pennsylvania and the remainder outside Pennsylvania. Again, this is a change from the often-overlooked prior statutory rule that sources rental income from any property—including tangible property—based on cost of performance.

Sales of Intangibles: Under Act 52, sales of intangibles continue to be sourced under the UDITPA income-producing-activity rule. Following the Department's policy of interpreting income-producing-activity to mean the location where the customer received the benefit, taxpayers can continue to elect whether to follow the statute (cost-based sourcing) or the Department's policy (market-based sourcing) in sourcing intangibles.

Judicial Developments

Nonbusiness Income and the Saga of "And" Versus "Or": On January 22, 2013, the Pennsylvania Supreme Court affirmed the Commonwealth Court decision that a paper pulp

company's sale of timberland was business income because the functional business/nonbusiness income test identified in *Welded Tube* was met. (The functional test provides that income is business income if the acquisition, management, and disposition of the subject property constitute an integral part of a taxpayer's regular business.)

The taxpayer was in the business of producing and purchasing paper pulp, which it sold to its parent company for paper manufacturing. Prior to 2003, the taxpayer purchased 75 percent of the pulp that its parent needed and obtained 25 percent from timberlands that it owned. In 2004, the taxpayer sold most of its timberland so that it purchased 95 percent of the pulp that its parent needed and got only 5 percent from its own timberland. The sale of the timberland netted a $55 million gain. The sales proceeds were given as a dividend to the parent and used by the parent to pay down debt and pay a dividend to its shareholders.

On its 2004 Pennsylvania return, the taxpayer treated the $55 million gain as business income. The taxpayer later filed an amended return treating the gain as nonbusiness income and allocating it to Delaware, which is where the timberland was located. The Department then reclassified the gain as business income resulting in a tax increase of $2.2 million.

The taxpayer argued that in *Laurel Pipe,* the functional test was found not to be met by a company that liquidated a segment of its business, and because the sale of the taxpayer's timberland was a partial liquidation of a segment of its business, the gain is nonbusiness income. The commonwealth argued that if the facts in *Laurel Pipe* were raised today, the income would be business income and not nonbusiness income, because of the 2001 law change (from "the acquisition, management, AND disposition" to "either the acquisition, management, OR disposition").

Ultimately, the court held the sale of timberland located out-of-state was business income to the taxpayer and subject to Pennsylvania corporate net income tax and apportionment. The court found that the timberland, which was previously used to produce wood pulp for the taxpayer's parent company, was an integral operational asset of the company's unitary business, and was properly considered business income. *Glatfelter Pulpwood Company v. Commonwealth*, 62 MAP 2011 (January 22, 2013).

Trends/Outlook for 2013/2014

1. *Assessments in Connection with Payments to Delaware Holding Companies*: Although Pennsylvania law does not disallow an expense for royalty, related interest, or management payments made by Pennsylvania corporate net income or franchise tax filers to holding company affiliates, the Department has, at least under egregious circumstances, disallowed such expenses. The Department has even expressed interest in litigating one of such cases. In practice, the Department does not seem to be seeking out Delaware holding company

arrangements, but will essentially disallow inter-company expenses under a sham-transaction theory if it becomes aware of situations where there is little to no substance to a Pennsylvania taxpayer's Delaware affiliate. Act 52, however, codified the Department's existing guidance on sham transactions. Thus, we expect the Department might start going after more Delaware holding company arrangements.

2. *Cost of Performance Cases Settled*: For receipt factor apportionment purposes, Pennsylvania sources receipts from sales other than sales of tangible personal property based on cost of performance. However, at times, the Department has taken the position that market sourcing is necessary to fairly reflect the taxpayer's business activity in the state. Some taxpayers have also taken this position on their returns or in refund claims. Recently a few costs of performance cases have settled in Pennsylvania. Taxpayers that were assessed by the Department using a market-based approach received a significant settlement percentage. Taxpayers that took the market sourcing position themselves also received meaningful relief at settlement. The new market-sourcing statute, which has plenty of room for interpretation as written, continues to source sales of intangibles under the UDITPA income-producing-activity rule. Thus, the Department may continue to interpret this provision using a market-based approach where beneficial to the commonwealth.

SALES AND USE TAXES

Legislative Developments

Remote Seller Nexus: Act 52 added a requirement triggered off of federal remote-seller nexus legislation: If federal remote seller nexus legislation is enacted, a committee comprised of the Department of Revenue and the Independent Fiscal Office must provide proposed draft legislation and other plans for implementing the federal law, as well as an estimate of the revenue impact to the commonwealth. In doing so, Act 52 all but confirmed that Pennsylvania does not currently have authority to impose nexus on remote sellers.

Despite the lack of authority, the Department issued a Tax Bulletin in 2011 stating that the activities of remote sellers could create sales tax nexus with Pennsylvania. Based on that Tax Bulletin, the Department has been contacting remote sellers asserting nexus and requiring registration. Act 52 confirms that remote sellers that do not own property or engage in nexus-creating activities in Pennsylvania still have no obligation to collect and remit Pennsylvania sales tax under existing Pennsylvania law.

Judicial Developments

MRI Machines Not Within Manufacturing Exemption Because They Are Used By Physicians. The Commonwealth Court recently rejected a medical practice's argument that its purchases

of MRI and CT machines are not subject to sales and use tax because the machines are used in manufacturing. The taxpayer relied on two previous Pennsylvania Supreme Court decisions that separately held that the use of cameras by a portrait photographer constituted manufacturing, and that MRI machines are "nothing more than cameras."

The court noted that, under the literal statutory definition of manufacturing, "virtually any business which saves data or images to a computer and then downloads them to some media—electronic or hard copy—for its own use or that of a client, could *arguably* qualify" for the manufacturing exemption. The court viewed this as an absurd result that "the General Assembly could not have intended," and searched for a limiting principle on manufacturing.

The court turned to the regulations on learned professionals and medical equipment. Property used by learned professionals is taxable, as is most medical equipment. The court reasoned that since the MRIs are used by physicians (a type of learned professional) and are medical equipment, both of which are specified as taxable, they do not fall within the manufacturing exemption.

This decision confirms the normally broad scope of the manufacturing exemption. As the court acknowledged, the statutory and regulatory definitions of manufacturing are extremely broad and would reach almost all computer equipment. If the equipment is not used by a learned professional or in another enumerated taxable use, it should be within the manufacturing exemption under this case's reasoning. *Tristan Associates v. Commonwealth*, 639 F.R. 2010 (August 19, 2013).

Administrative Developments

1. *Updated list of Taxable/Exempt Property*: The Department of Revenue has published the updated List of Taxable and Exempt Property. The revised list records the following property that is now subject to sales and use tax: canned computer software and licenses to use canned software, regardless of the method of delivery or access, helmets, fencing, sushi, flavored water (including vitamin drinks), beads and materials used in jewelry-making, sheds (unless the purchaser has a building permit), ballet shoes, chewing tobacco (all types), cigars (all types), and tobacco (all types). The following items are exempt from tax: headwear for everyday wear, beer sold in six-packs (unless sold by a distributor), whole and ground coffee beans, milk, lice shampoo, flags of the United States and the Commonwealth of Pennsylvania (all other flags are taxable), and toe sneakers. Notice of Taxable and Exempt Property, Pa. Bull. Doc. No. 12-2503, Pa. Bull. Vol. 42, No. 53, December 22, 2012.

2. *Tax Transfer to Electricity Generation Supplier*: The Department of Revenue has issued a ruling stating that a taxpayer's remittance of the entire amount (less any applicable discount)

billed and collected on behalf of an Electrical Generation Supplier (EGS) to the EGS fully satisfies the taxpayer's sales tax obligations with respect to such charges. Once the taxpayer proves to the Department that the amounts have been remitted to the EGS, no further assessments with respect to those charges will be made. This guidance seemingly conflicts with Pa. Stat. Ann. 72 § 7225, which provides that collected sales tax transferred to another party is still a liability of the collecting party. However, the Natural Gas Choice and Competition Act overrides the provisions of Pa. Stat. Ann. 72 § 7225. Therefore, the taxpayer's liability for the sales tax collected on behalf of an EGS terminates on the transfer of the full amount of sales tax collected to the appropriate EGS. Letter Ruling No. SUT-12-002 (November 28, 2012).

Trends/Outlook for 2013/2014

Treatment of Cloud Computing: Through a letter ruling, the Department of Revenue changed its taxation of accessing pre-written software on servers—cloud computing—from location of server to location of end-user. Letter Ruling No. SUT-12-001 (May 31, 2012).

The taxpayer in the ruling used cloud computing in two ways. First, the taxpayer purchased and installed software on remote servers that was accessed by its employees through the cloud. The employees were not charged for using the software. Second, the taxpayer installed software on remote servers and charged customers a fee to access the software.

The Department determined that, as a result of recent case law and advances in technology, a fee paid for accessing otherwise taxable software housed on a server is subject to sales and use tax when the user is located in Pennsylvania. The Department’s conclusion centered on the observation that a user accessing remote software exercises power and control over the software. Similarly, the letter ruling states that if the software is located on a server in Pennsylvania, but all end-users are outside of the commonwealth, no tax is due.

If the billing address for the software is a Pennsylvania address, all users are presumed to be located in the Commonwealth. To rebut this presumption, the taxpayer must identify the percentage of users in Pennsylvania by completing an exemption certificate.

The Department continues to modify its proof requirements for taxpayers seeking to establish end-users located outside the commonwealth. Additionally, the Department recently asserted that all unassigned licenses will be considered Pennsylvania receipts. The Department’s treatment will likely continue to evolve as various appeals make their way through the administrative process and into Commonwealth Court.

PROPERTY TAXES

Legislative Developments

1. *Library Tax Authorized*: Act 210, effective November 1, 2012, authorizes a municipality's voters to determine whether to impose an annual special library tax on all taxable property of the municipality to establish, maintain, and aid a local library. If imposed, the library tax remains in effect until another vote is taken to change it. Municipal officials can increase the rate without voter approval. The library tax is levied and collected in the same manner as other municipal taxes and is in addition to all other taxes, unless the tax is incorporated into the general levy. The tax must be levied and collected at the annual rate of not less than 11/2 mills annually on taxable property in the municipality. The following is exempt from the tax: (1) a building owned and occupied by a local library; (2) the land on which a local library stands; and (3) land that is immediately and necessarily appurtenant to a local library. The locality must meet certain requirements in its relationship to the library in order for the tax to be imposed.

2. *Agricultural Use Definitions Amended*: Act 190, effective October 24, 2012, amends the definition of land dedicated to agricultural use and when the roll-back of taxes is required. "Agricultural commodity" has been expanded to include agricultural, apicultural, horticultural, floricultural, silvicultural, viticultural and dairy products, as well as pasture, livestock, poultry, poultry products, products commonly raised on a farm for human consumption or commercial transport, and compost. "Compost" is now defined as material resulting from the biological digestion of dead animals, animal waste, or other biodegradable materials at least 50 percent by volume of which is comprised of products commonly produced on farms. Landowners with the agricultural preferential assessment will not be subject to roll-back taxes on the entire tract of land if they use up to two acres of land to sell agriculturally related products or activities. Roll-back taxes do not apply to the land used for the commercial sale of products or activities if the commercial sales take place on no more than one-half of an acre, and if at least 50 percent of the products are produced on the tract, and no new utilities or buildings are required.

Judicial Developments

1. *Eligibility for Purely Public Charity Exemption*: Pittsburgh alleges that the largest employer in the city, University of Pittsburgh Medical Center ("UPMC"), does not qualify for exemption as a purely public charity under the constitutional *HUP* test. If UPMC is not a purely public charity, it will be subject to the city's real estate and payroll taxes. UPMC removed the case to federal court, but the federal court remanded back to state court for lack of federal

jurisdiction. UPMC argues that the city is unlawfully targeting it because of its size and international presence, and that the city should have raised this issue through an assessment rather than judicial action. No. GD 13-005115, *City of Pittsburgh v. University of Pittsburgh Medical Center* (pending, Court of Common Pleas of Allegheny County); Civil Action No. 13-565, 2013 WL 4010990 (W.D. Pa. August 6, 2013).

2. *Deficient Recordkeeping Insufficient Basis for Valuation Appeal*: The Commonwealth Court denied the taxpayer's appeal of the valuation of real property. The taxpayer challenged the valuation of two parcels of real property containing subsurface coal deposits, contending that Schuylkill County failed to maintain proper mapping records of the parcels as required by law. The court found that all of the information required by law, including record cards, maps and aerial photographs, had been maintained by the county. The court went further to say that even if the recordkeeping was deficient, invalidating the challenged assessments is not permitted. *BET Lehigh Real Estate, LLC v. Schuylkill Cty. Bd. of Assessment Appeals*, 1385 C.D. 2012 (April 10, 2013).

3. *Selective Appeal*: The Commonwealth Court held that the trial court was in error in finding that a school district that engaged a private firm to review assessments of apartment buildings violated the taxpayer's right to uniformity where the firm appealed only two properties on the list of under-assessed properties, both belonging to the taxpayer. The taxpayer's only claim was that the school district's choice to appeal only the assessments of the taxpayer's properties was arbitrary and capricious. However, Pa. Cons. Stat. Ann. 53 § 8855 places no constraints or restrictions on a taxing district's right to appeal an assessment if aggrieved. In addition, the Pennsylvania Supreme Court has recognized that the U.S. Constitution does not require equalization across all potential sub-classifications of real property. The Commonwealth Court previously upheld the right of a school district to adopt a narrow classification of properties evaluated for appeal based on considerations, such as financial and economic thresholds, and that such classifications do not amount to deliberate, purposeful, discrimination as a matter of law. *Weissenberger v. Chester Cty. Bd. of Assessment Appeal*, No. 157 C.D. 2012 (March 8, 2013).

4. *Golf Course Exempt as Common Facility*: The Commonwealth Court held that a planned residential development's golf course is exempt as a "common or controlled facility" under Pa. Cons. Stat. Ann. 68 § 5105(b)(1). The golf course parcels meet the Uniformed Planned Community Act's (UPCA) definition of "common facilities" because the parcels are within a planned community and owned by unit owners' association. The court found the trust that owns the golf course and other common facilities performs the essential protective functions

of an owners' association as to the community's “common facilities” or “controlled facilities” for purposes of the UPCA, even though the Trust Agreement was recorded more than 12 years before the enactment of the UPCA, and the provisions of the UPCA concerning the organization of the unit owners' association are not retroactive. The Pennsylvania Supreme Court's decision in *Saw Creek Community Association, Inc. v. County of Pike*, 866 A.2d 260 (2005) controlled the decision. The court held that the definition of “common facilities” in Pa. Cons. Stat. Ann. 68 § 5103 requires that a property meet just two requirements: (1) that it is within the planned community; and (2) that it is owned or leased by or leased to the homeowners' association. *Pinecrest Lake Community Trust v. Monroe Cty. Bd. of Assessment Appeals*, No. 865 C.D. 2012 (February 19, 2013).

5. *Illegal Spot Assessment*: The Commonwealth Court overturned an attempt to reassess a two-acre tract of land with a barn because it was an illegal “spot assessment.” The county issued a reassessment notice because “the sale of land and the assessment of a home site not assessed previously.” The “sale of land” given as a reason for the reassessment was the sale of an adjoining tract of land by the taxpayer. As part of the reassessment, the county also added the value of a home site even though the land had no home site on it. The trial court agreed that none of the four statutory criteria for a reassessment applied to the taxpayers’ property, but ruled that the reassessment was proper and necessary in order to comply with the Uniformity Clause. The Commonwealth Court rejected the reasoning of the trial court, recognizing that reassessments are only authorized in specific situations provided by statute, and that none of those situations were present in the taxpayer’s case. Therefore, the reassessment was an illegal spot assessment. The court held that a county cannot assign a home site value when no home site existed because real estate taxes are not hypothetical, but are based on the actual value of the property. *Krohn v. Snyder County Board of Assessment Appeals*, Nos. 116 and 117 C.D. 2012 (January 23, 2013).

Administrative Developments

Philadelphia Common Level Ratio: On April 14, 2012, the State Tax Equalization Board held that the third data set for the Common Level Ratio for Philadelphia for 2010 (CLR) is not valid. The board held that in setting the CLR, the STEB may only consider the “assessed valuations” that are set “for county tax purposes,” and may not adjust the formula that is uniformly used across the state to calculate the CLR. The proper revised Philadelphia CLR for 2010 is 25.5 percent.

OTHER TAXES

Personal Income Tax

Judicial Developments

Resident Trusts Post-McNeil. On May 24, the Commonwealth Court reversed the Board of Finance and Revenue and held that the imposition of tax on a Delaware trust with no Pennsylvania income or assets in the tax year violated the Commerce Clause, even though the settlor was a Pennsylvania resident at the time the trust was created. The commonwealth did not appeal the decision.

While it's unclear how far the Department will apply the decision, so far, it is applying it to trusts with the same facts. Thus, the settlor's residency at the time of the trust's formation is no longer a sufficient basis for taxation.

Bank Shares Tax

Legislative Developments

Act 52 Includes Changes to Bank Shares Tax. The changes under Act 52 include:

Broadens Tax Base: Under Act 52, the Bank Shares Tax applies to every institution doing business in the commonwealth.

Receipts Factor: Starting in 2014, the Bank Shares Tax is apportioned using only the receipts factor. That is, taxpayers will now disregard the payroll and deposits factors.

Rate Change: Act 52 adjusts the Bank Shares Tax rate to be .89 percent of the book value of total bank equity capital.

Market Sourcing: Like the Corporate Net Income Tax, the Bank Shares Tax, under Act 52, moves to market sourcing of the receipts factor.

Real Estate Transfer Tax

Legislative Developments

Act 85 Amends Realty Transfer Tax Definitions: On July 2, 2012, the governor signed into law Act 85, which makes a number of changes to the realty transfer tax definitions under § 8101-C, including:

Association: now includes a general partnership, a limited partnership, and a limited liability partnership….

"Family Farm Business" replaced "family farm corporation" and adds the requirement that at least 75 percent of the company's assets are devoted to the business of agriculture.

Administrative Developments

Transfers of Oil and Gas Interests: The Department of Revenue issued guidance on the division and transfer of oil and gas interests for real estate tax purposes. The Department states that oil and natural gas interests are derived from ownership of, or rights to, subsurface minerals of the mineral rights estate. Royalties are a right to a share of the mineral production or income from the mineral production. The royalty payment is considered personal property, whether in cash or in-kind. Oil and gas in place are considered real estate, but once the oil or gas is physically severed from the land, it becomes personal property. Informational Notice Realty Transfer Tax and Personal Income Tax 2012-04 (October 10, 2012).

Gross Receipts Tax

Judicial Developments

Limit on Telecom Gross Receipts Tax: Several taxpayers are challenging the Department of Revenue's broad interpretation of the telecommunications gross receipts tax in cases pending in Commonwealth Court. Verizon, the taxpayer in the lead case, argued that *Bell Telephone* was wrongly decided by the Pennsylvania Supreme Court in 1943.

In July, the court issued its decision, concluding that the Department's interpretation went too far. Specifically, the court concluded that receipts from non-recurring service charges are not subject to gross receipts tax, but receipts from private line and directory assistance charges are taxable.

The gross receipts tax is imposed on receipts from "telephone messages transmitted" (traditional telephone messages) and receipts from "mobile telecommunications service messages" (cell phone messages). The *Verizon* case involved the portion of the statute imposing tax on traditional telephone messages, so the controversy centered around the meaning of the phrase "telephone messages transmitted." Specifically, the issue was whether three distinct types of receipts are subject to tax: receipts from certain non-recurring service charges, directory assistance charges, and flat-rate charges for private lines.

The statutory language at issue—"telephone messages transmitted"—has been around since 1929. And in in the 1943 case of *Commonwealth v. Bell Telephone Company of Pennsylvania*, the Pennsylvania Supreme Court interpreted this language very broadly. Verizon argued that *Bell Telephone* was wrongly decided. Alternatively, Verizon argued that

the receipts at issue are not taxable even under the *Bell Telephone* framework. The Commonwealth Court did not revisit the *Bell Telephone* decision itself. Instead, the court analyzed Verizon's receipts under the framework established by *Bell Telephone*.

Both parties filed appeals to the Pennsylvania Supreme Court.

Local Taxes

Legislative Developments

Philadelphia Community Development Corporation Contributions Credit: Philadelphia has amended its city code (Chapter 19-2600 "Business Income and Receipts Taxes") to increase the number of businesses that may obtain a credit against business income and receipts taxes upon contributing to certain community development corporations engaged in neighborhood economic development activities in the city. The ordinance increases the number of businesses from 35 to 40 beginning with tax year 2013. Phila. Ord. 130012, eff. starting with tax year 2013.

Judicial Developments

Business Privilege Tax on Activities Outside Jurisdiction: The Pennsylvania Commonwealth Court found that the trial court erred in finding that a local business privilege tax applied to *all* sales made by salesmen who sometimes used an office located in the township, because the ordinance imposing the tax specifically limited its application to sales made within the territorial limits of the township.

The trial court relied on *Gilberti v. City of Pittsburgh*, 511 A.2d 1321 (Pa. 1986), in which the state Supreme Court used a "base of operations" test to determine that the city could apply business privilege tax to activities outside the city limits where the office located in the city provides a place from which to solicit business, accept communications, conduct meetings, store supplies, and perform office work.

The Commonwealth Court, however, noted that the ordinance at issue in *Gilberti* was inapplicable because the ordinance did not limit the reach of the tax to business transactions within the territorial limits of the municipality as was the case here. The Commonwealth Court instead found the analysis of *V.L. Rendina, Inc. v. City of Harrisburg,* 938 A.2d 988 (Pa. 2007), where the Supreme Court held that some logical connection between the activities that are the subject of a business privilege tax and the municipality itself is needed where the ordinance had specific language limiting the tax to transactions within the municipality. Because the township failed to demonstrate a logical nexus between the activities it sought to tax and the municipality as required under *Rendina*, the tax did not apply to sales made by

the salesmen in question. *Giles & Ransome, Inc. v. Whitehall Twp.*, No. 645 C.D. 2012, (February 11, 2013).

Credit Against Earned Income Tax: The Commonwealth Court held that it is not unlawful to apply the earned income tax (EIT) credit provided under section 317 of the Local Tax Enabling Act (LTEA), generally applied to offset Philadelphia EIT, to EIT imposed by a school district or other political subdivision for income earned outside Philadelphia.

County tax collection committees argued that interpreting the EIT credit as a "super credit" that applies to offset Philadelphia EIT and EIT imposed by school districts and political subdivisions outside Philadelphia violates the Equal Protection Clause of the Pennsylvania Constitution by treating similarly situated taxpayers differently and contrary to other credits provided under the LTEA. Rather, the county argued that the credit should be apportioned.

In ruling against the county, the Commonwealth Court noted that it held in favor of a "super credit" previously in a 1981 case, and the legislature had ample time to amend the law to expressly provide for apportionment of the credit if it so intended. The court also noted that a taxpayer who earns income both inside and outside of Philadelphia is not similarly situated to another taxpayer whose income is earned totally outside of Philadelphia and taxed at a lower rate. *Berks County Collection Committee, et al. v. Pa. Dept. of Community and Economic Development*, No. 378 M.D. 2012 (January 7, 2013).

Local Business Privilege "Flat Tax" Unconstitutional: The Pennsylvania Supreme Court reversed a 2010 decision of the Commonwealth Court and held that a business privilege "flat tax" ordinance violated the Local Tax Reform Act ("LTRA"). The tax was limited to businesses with gross receipts in excess of $1 million. The Supreme Court held that the tax ordinance imposed a tax "on gross receipts or part thereof," even though the ordinance imposed a fixed tax not based on a percentage of receipts. The Supreme Court determined that the LTRA's prohibition against new taxes "on" gross receipts or a part thereof is not limited to taxes "measured by" gross receipts or otherwise restricted in its meaning to percentage-based taxes. The disputed ordinance violated the LTRA because it effectively imposed a tax on that portion of a business's gross receipts in excess of $1 million. The court did not invalidate all flat taxes containing an exemption based on a threshold level of gross receipts. Instead, the court hinted that a "very modest" gross receipts threshold might pass constitutional muster. *Shelly Funeral Home, Inc. v. Warrington Township*, 30 MAP 2010 (December 18, 2012).

Administrative Developments

Philadelphia Sustainable Business Credit Regulation: The Philadelphia Department of Revenue has issued Business Income and Receipts Tax Regulation 505, effective March 11,

2013, to assist in administration of the sustainable business tax credit against Philadelphia business income and receipts tax. The regulation provides definitions, information on filing applications, addresses eligibility requirements and the amount of the credit. The regulations provide that businesses must apply for certification as a sustainable business on a form specified by the Mayor's office of Sustainability, and all annual certifications will be granted on a first-come, first-served basis. Eligible businesses will receive a tax credit equal to $4,000 for tax years 2012 through 2017.

Trends/Outlook for 2013/2014

"Elimination Tax": House Bill 1189, which passed the House October 2, would allow school districts to replace property taxes with an earned income or Business Privilege Tax/ Mercantile Tax (called an "Elimination Tax"). Before passing the House, the bill defeated a much debated amendment (that would have allowed the district to replace it with a personal income tax or broadened sales tax).

Base of Operations Requirement. The House introduced House Bill 1513, which, similar to bills proposed in prior sessions, would limit the imposition of a local BPT or gross receipts tax to taxpayers that have a "base of operations" in that taxing jurisdiction. The bill would also limit the tax to a taxpayer who conducts transactions within the jurisdiction for 15 or more days a year. In addition, gross receipts that are taxed in another jurisdiction may be excluded from tax.

This legislation is reacting to the 2007 PA Supreme Court decision (*Rendina, Inc. v. Harrisburg and the Harrisburg School District*) where the court reversed its previous position that a municipality cannot tax an entity that lacks a permanent base of operation within its borders.

This bill was considered for the first time in the House September 30. Given that this bill is similar to bills introduced in prior sessions, it would seem unlikely to pass. However, the bill's importance would grow if HB 1189 (discussed above) gains momentum.

ADDITIONAL NOTES OF INTEREST

1. *Overhaul of the Board of Finance and Revenue.* Act 52 revamped the Board of Finance and Revenue, which is currently the second and final level of administrative review in a Pennsylvania tax appeal before going to Commonwealth Court.

   Starting April 2014, the board will go from a six-member board comprised of representatives of various Departments (including the Department of Revenue) to a three-member

independent board. Two of the new board members will be appointed by the governor (and confirmed by the Senate), and the third member will be the treasurer or the treasurer's designee. All board members are required to have at least 10 years of Pennsylvania tax law experience and be either a CPA or an attorney.

This new board is expected to bring about many changes. Like the Board of Appeals, the Board of Finance and Revenue will now have statutory compromise authority. Giving taxpayers a second opportunity to settle an appeal before going to court is expected to allow the attorney general's office to focus more resources on litigation. Additionally, all Board of Finance and Revenue decisions will be published (after redacting confidential information) and accessible on the Internet.

In addition to the new composition of the board itself, Act 52 brings about a number of other important changes that are designed to promote greater transparency in the process. Under the new independent Board of Finance and Revenue, the Department's role will be greatly altered:

- The Department may be represented at proceedings before the board
- Taxpayers will receive a copy of anything the Department submits, and have a chance to comment on the Department's submission
- Ex parte communications with the board will no longer be allowed

The Department's new role as a true "party" to an appeal—instead of as a member of the board—makes this a more judicial-like forum. Since this may give taxpayers a truly independent review of a legal issue before going to court, taxpayers (and taxpayer representatives) should pay greater attention to presenting a case to the new board than they may have become used to with the old Board of Finance and Revenue.

2. *Collection Procedure and Bank Attachment*: The Department of Revenue has released updated guidelines for the collection of tax and the use of administrative bank attachment for certain tax liabilities. Collection procedures include the issuance of a notice of assessment, followed by a dunning notice (provided no appeal is filed), and contact from the Delinquent Tax Call Center if the taxpayer should still fail to respond. If all these efforts fail, a taxpayer's sales tax license may be revoked (delinquencies for unremitted sales tax), administrative bank attachment, and referral to a collection agency or the Attorney General. Administrative bank attachment only applies to: business entities; individuals operating as a sole proprietor; shareholders, members or partners of a pass-through entities; or corporate officers or other responsible individuals who have property subject to tax liens exceeding $1,000. The Department may only use administrative bank attachment where the tax liability has been

assessed; the taxpayer's right to appeal has expired (or the tax liability has been sustained through the appeals process); the taxpayer has defaulted on a duly executed deferred payment plan or declined to execute a deferred payment plan; a lien has been filed; and the taxpayer has been advised of all potential enforcement actions, including administrative bank attachment. The notice also explains the rights and remedies available to taxpayers. Informational Notice Miscellaneous Tax 2013-01 (January 2, 2013).

3. *Board Compromise Authority*: Without any statutory action, the Pennsylvania Department of Revenue's Board of Appeals decided it had the authority to compromise tax appeals, effective immediately. *See* Miscellaneous Tax Bulletin 2011-02, issued November 16, 2011. The board's authority was later codified by Act 85, signed into law July 2, 2012. A compromise will only be considered when it illustrates doubt regarding liability or promotes effective tax administration."

   As part of Act 52, the new Board of Finance and Revenue, effective April 1, 2013, has compromise authority as well. A compromise at the Board of Finance and Revenue will need the approval of the taxpayer and the Department. This gives a taxpayer a second chance to settle before court.

   Previously, a challenge to a tax assessment or refund claim could not be compromised until Commonwealth Court. However, the compromise of cases at the administrative level is now possible. Following a taxpayer's submission of the Request for Compromise form, an informal conference will be held. If both parties are able to reach a tentative settlement, that settlement will then be submitted for approval. The extensiveness of this approval process varies widely based on the amount at issue.

   Cases that have been resolved through a compromise cannot be reopened. That is, a taxpayer waives its right to: (1) appeal the compromise order, (2) claim any refund of money paid pursuant to the compromise order, and (3) file any petition or appeal that raises the same issues for the tax period(s) and liability(ies) addressed in the compromise order.

   So far, the Board of Appeals has been compromising cases; however, it seems taxpayers are not receiving the same settlements as they might receive at Commonwealth Court.

4. *Enhanced Enforcement and Audit Guidance*: The Department of Revenue is enhancing its enforcement efforts by increasing the number of audits as well as the scrutiny applied to refund claims in an effort to improve collections. Additionally, auditors have been told they may grant penalty relief in order to reduce the number of claims filed at the Board of Appeals.

5. *When to File an Amended Return*: Taxpayers should carefully consider whether they should file an amended return, or if some other course of action is more appropriate, because an amended return will not be considered by the Department unless the taxpayer consents in writing to a one-year, statute-of-limitations extension. Further, the Department has taken the position that its acceptance of changes in an amended return is discretionary, and that the amended return will not preserve the taxpayer's refund rights. In December 2011, the Department indicated that no refund claim is filed with the Board of Appeals but an amended return requesting a refund is filed within the refund claim statute of limitations, the Board "should" grant jurisdiction based, if properly documentation. However, jurisdiction is not required, so, if a taxpayer thinks it is entitled to a reduction in its tax, the taxpayer generally would want to file a petition for refund instead of filing an amended return. Pa. Reg. 151, adopted June 19, 2010.

6. *Possible Change to the Uniformity Clause of the Pennsylvania Constitution*: Subcommittees have been formed to review specific provisions of the Pennsylvania constitution to determine whether those provisions need to be "modernized." One of the provisions being studied is the uniformity clause, which provides that "all taxes shall be uniform, upon the same class of subjects…" within the same taxing jurisdiction. Because of this uniformity provision, Pennsylvania cannot impose a graduated income tax rate, cannot tax residential and commercial property at different rates, and also cannot issue "spot assessments," but instead must reassess all property in a county instead of singling specific property out for reassessment. There is some concern that "modernization" of the uniformity clause may undo these taxpayer-friendly protections.

7. *"Pay-to-play" at the Board of Appeals?* The Department has taken the position that the only issues that can be addressed by the appeal boards in a corporate net income or franchise tax assessment appeal are ones directly related to the adjustments made by the Department in its assessment. (In the past, a Pennsylvania taxpayer could raise any issue in an appeal of a "settlement," i.e., assessment.) This position can create a problem when a taxpayer agrees with the Department's adjustment, but disagrees with the overall tax assessed because other issues would reduce the amount of tax liability. Now, for a taxpayer to request an adjustment to its tax liability, the taxpayer must first pay the assessment, and then file a refund claim raising those issues that are not directly related to the assessment. Thus, taxpayers should consider preserving issues on their tax returns, even if those issues have no tax effect. Pennsylvania Department of Revenue Misc. Bulletin 2008-01 (May 2, 2008).

   Additionally, the Department has started to automatically dismiss refund petitions where an amount remains unpaid on the taxpayer's account for the tax year at issue.

8. *Payment of Assessment Opens Appeal Period.* In the case of amounts paid as the result of an assessment, determination or settlement, a petition for refund must be filed within six months of the actual payment of tax. Previously, a taxpayer was required to file within six months of the mailing date of the notice. This new provision applies to petitions filed after July 1, 2012.

BIOGRAPHIES

Lee A. Zoeller
Reed Smith LLP
2500 One Liberty Place
1650 Market St.
Philadelphia, PA 19103
Phone: 215-851-8850
lzoeller@reedsmith.com

Lee is the Practice Group Leader of Reed Smith's State Tax Group. He works closely with clients to determine the best course of action – from strategy development through litigation – to resolve the taxpayer's issues. In addition to representing clients in state tax appeals, Lee provides multi-state advice to corporations on various state income, franchise and sales tax issues – and works with these corporations to implement any resulting tax-saving strategies.

Frank J. Gallo
Reed Smith LLP
2500 One Liberty Place
1650 Market St.
Philadelphia, PA 19103
Phone: 215-851-8860
fgallo@reedsmith.com

Frank is a partner in Reed Smith's State Tax Group. He focuses his practice on state tax planning and controversy matters, concentrating on income/franchise and sales and use taxes. He advises clients in a variety of industries, with an emphasis on the pharmaceutical, financial services, and consumer product industries.

Christine M. Hanhausen
Reed Smith LLP
2500 One Liberty Place
1650 Market St.
Philadelphia, PA 19103
Phone: 215-851-8865
chanhausen@reedsmith.com

Christine is an associate in Reed Smith's State Tax Group. She handles multi-state corporate tax and sales and use tax issues, and focuses on Pennsylvania taxes. She represents clients in a wide range of industries in connection with state tax return positions, audits, administrative appeals, and litigation in various jurisdictions.