Alert
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Tax Alert
News Concerning Recent Developments in Tax Law

COZEN O'CONNOR

Pa Tax Legislation Will Make Substantial Changes

The Act of July 9, 2013, No. 52 (H.B. 465) and the Act of July 18, 2013, No. 72 (S.B. 591) will make substantial changes to Pennsylvania taxes if finally enacted. The bills were part of the budget process.

Corporate Taxes

Capital Stock – Franchise Tax

Under Act 2013-52, the Capital Stock – Franchise Tax is extended two years until December 31, 2015. The tax had been scheduled to phase out after 2013. For 2014, the rate will be .67 mills. For 2015, the rate drops to .45 mills. The Capital Stock/Franchise Tax will now phase out as of January 1, 2016.

Corporate Net Income Tax

The definition of "taxable income" for tax years beginning after December 31, 2014, will require an addback of intangible expenses and related interest between affiliated entities. In the event that the taxpayer was engaged with an affiliated entity that was subject to tax in Pennsylvania or another jurisdiction, the taxpayer will receive a credit against tax due by taking the taxpayer's apportionment factor and multiplying it by the greater of: (1) the tax liability of the affiliated entity representing the income associated with the intangible expense or interest expense paid, accrued or incurred; or (2) the tax liability that would have been paid by the affiliate if the tax liability had not been offset by the credit. Additionally, the adjustment required for the addback will not apply where the transaction causing the deduction was negotiated at arm's length and was not done for tax avoidance.

Intangible expense 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." Interest expense includes the deduction allowed under Section 163 of the Internal Revenue Code (IRC) to the extent such deduction is related to the intangible expense or cost. An "affiliated entity" has been defined to include individual stockholders and such stockholders' partnerships, limited liability companies, estates, trusts or corporations that own in the aggregate more than 50 percent of the value of the outstanding stock of the entity. Additionally, the affiliated entity definition includes corporations or parties related to a corporation that would require attribution under Section 318 of the IRC. Finally, affiliated entities include the "component members" as defined in Section 1563 of the IRC or people whom there is attribution of stock ownership.

The attribution of sales to Pennsylvania for sales factor purposes will change significantly. If real estate is located both inside and outside Pennsylvania, the gain or loss on the sale is attributable to Pennsylvania based upon the percentage of original cost of the real property located within Pennsylvania. If the customer first obtained possession of the tangible personal property in Pennsylvania, sales from the rental, lease or license of such tangible personal property are considered Pennsylvania sales. If the tangible personal property is taken out of state, the taxpayer may use a reasonably determined estimate of the usage in Pennsylvania to ascertain the extent of the sales here. Finally, and most importantly, sales of services will be apportioned to Pennsylvania if the services are delivered in Pennsylvania, *i.e.*, market-based sourcing. If the service is delivered both to a location inside and outside the state, the sale is assigned to Pennsylvania based upon the percentage of total value of the service delivered here. If the percentage cannot be ascertained, the service is deemed to be delivered to the customer's billing address. The "cost of performance" analysis that has been the law in Pennsylvania for decades has been repealed. The apportionment

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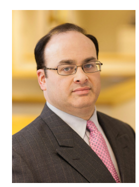

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provisions are effective for tax years beginning after December 31, 2013.

Act 2013-52 provides a special apportionment for satellite television providers, also effective after December 31, 2013. All business income is apportioned to Pennsylvania by multiplying the income by a fraction based upon the value of equipment owned or rented and located in Pennsylvania to the value of total equipment owned or rented and used by the taxpayer everywhere in generating, processing or transmitting satellite television services whether or not such equipment is affixed to real estate. The values used in the calculation are the costs of the equipment less depreciation per the books and records of the owner. All nonbusiness income is allocated like other nonbusiness income under Article IV of the code.

Act 2013-52 increases the net operating loss (NOL) deduction for tax years beginning after December 31, 2013 from the greater of $3 million or 20 percent of taxable income to the greater of $4 million or 25 percent of taxable income. For tax years beginning after December 31, 2014 the amounts are raised to the greater of $5 million or 30 percent of taxable income.

Act 2013-52 provides a new non-filer penalty for corporations of $500 plus 1 percent for every dollar of tax determined to be due in excess of $25,000. This provision is effective for tax years beginning after December 31, 2013.

Corporate Loans Tax

Act 2013-72 will repeal the Corporate Loans Tax, effective in 2014.

Board of Finance and Revenue Reform

Under Act 2013-52, the Board of Finance and Revenue will be reformed effective April 1, 2014. The board will consist of three members, two nominated by the governor and approved by the Senate and the state treasurer or his designee. Each member will have one vote in deciding cases; two members will constitute a quorum. The state treasurer or his designee will be the chairman. Each member must also be a full-time employee of the board. The two members appointed by the governor shall serve staggered four and six-year terms. Thereafter, each member appointed by the governor shall serve six-year terms. Each member of the board must be a citizen of the United States, a resident of Pennsylvania, a licensed attorney or certified public accountant in good standing, and have at least 10 years of experience in a position requiring substantial knowledge of Pennsylvania tax law.

The taxpayer and the Department of Revenue will each be represented in any tax appeal. Attorneys and accountants or other representatives can represent the taxpayer before the board so long as the representation does not constitute the unauthorized practice of law as administered by the Pennsylvania Supreme Court. The taxpayer and the department will be entitled to present written and oral evidence before the board and the other party will be provided the opportunity to comment on any submitted evidence to the board as well as providing written and oral argument to support their positions. The members or staff of the board shall not participate in any ex parte communications with the taxpayer or the department or their representatives regarding the merits of any case before the board. Any information or documentation provided by one party to the board shall also serve copies on the other party. The board is allowed to establish procedures to facilitate the compromise settlement of issues on appeal, which shall be agreed to by both parties. Finally, the board must render decisions within six months of filing an appeal before the board. The deadline can be extended by an additional six months if requested by either party.

Personal Income Tax

Act 2013-52 contains several amendments to the Personal Income Tax (PIT) regarding the reporting and taxation of income from pass-through entities and estates and trusts. Section 306.1 will provide that the classification or character of a partnership item must be determined solely at the partnership level, with the only avenue for adjustment at the partner level being an adjustment made by the department. Thus, a partner is precluded from changing the classification or character of a partnership item, even if the partner or the partner’s accountant determines that the partnership’s classification or character is erroneous.

New Sections 306.2 and 307.8(F) will be added to provide that partnerships and S corporations will be liable for the PIT due, excluding any interest, penalties or additions, on any reportable income of more than $1 million that is not reported by the entity, if: (1) the S corporation has 11 or more shareholders, (2) the partnership has 11 or more partners that are natural persons, (3) the partnership has at least one partner that is a corporation, limited liability company, partnership or trust, or (4) the S corporation or partnership elects to be subject to these new sections. Publicly traded partnerships are specifically excluded. Any notice of assessment will be issued to the partnership or S corporation; the department will not assess the partners and shareholders for the PIT due on the underreporting income, although the partners and shareholders are not relieved of their liability for PIT on the underreported income. Any deficiency assessed against a partnership or S corporation shall be appealable only by the partnership or S corporation and the assessment as finally determined after the exhaustion of appeals will be binding on the partners and shareholders. The partnership or S corporation must provide to its partners or shareholders within 90 days of the assessment becoming final an amended statement of the partners' or shareholders' pro rata share of the underreported income. Each partner or shareholder is allowed a credit for their share of the PIT assessed against and paid by the partnership or S corporation, which credit is allowable in the tax year in which the underreported income was required to be reported. These new sections fail to address how or whether a partner or shareholder may obtain a refund of any of the PIT paid by the partnership or S corporation on the underreported income if the partner or shareholder files an amended PIT return for the year of underreporting, and due to the partner's or shareholder's personal tax situation, owes PIT on the underreported income in an amount less than that paid by the partnership or S corporation – for example, where the partner or shareholder had unused losses in the tax year at issue which could now be used to offset the underreported income from the partnership or S corporation. This is of particular concern where the assessment against the partnership or S corporation is finalized more than three years after the filing of the partners' or shareholders' PIT returns. It is not clear how the assessment of PIT against a partnership will be recouped where the partnership agreement does not allow a chargeback to the partners. Further, although both sections provide that nothing shall require one partner or shareholder to be liable for the payment of the PIT liability of another partner or shareholder, they do not address how this will be applied if the ownership of the partnership or S corporation in the tax year for which the underreporting occurred is different than the ownership in the year in which the assessment against the partnership or S corporation becomes final.

Section 324 will be amended to provide that an estate or trust with income from sources within Pennsylvania is required to withhold PIT on that portion attributable to its nonresident beneficiaries.

Section 335(c) will be amended to require any estate or trust that has a Pennsylvania resident beneficiary to file a return with Pennsylvania, to provide to the Department of Revenue a copy of the estate or trust's federal income tax return, and to issue Schedules RK-1 and NRK-1s to the beneficiaries, regardless of whether or not the estate or trust has any income from sources within Pennsylvania or any connection with Pennsylvania that allows the commonwealth to require such reporting by the estate or trust under the U.S. Constitution. The enforceability of these provisions is doubtful in light of the Commonwealth Court's recent decision in *Robert L. McNeil Jr. Trust for Nancy M. McNeil, et al. v Commonwealth*, 651 F.R. 2010 (Commw. Ct. May 24, 2013).

Section 303(a)(2) will be amended to provide that in calculating net profits from the operation of a business, a taxpayer is now permitted a deduction for startup expenditures properly deducted for federal purposes pursuant to Section 195(b)(1)(A). Section 314 has been amended to limit the credit available to residents for taxes paid on income subject to tax in both Pennsylvania and other taxing jurisdictions to those taxes paid to another state, the District of Columbia, Puerto Rico, or any territory or possession of the United States; previously, a taxpayer was permitted to take a credit on his or her PIT return for taxes paid to foreign countries on income also taxed by Pennsylvania. Section 335(g) will be added to require that every estate, trust, partnership and S corporation maintain at the end of the entity's taxable year an accurate list of the names, addresses and tax identification numbers of their beneficiaries, partners and shareholders, as well as a list of the beneficiaries, partners and shareholders that were admitted or withdrew during the tax year and the date of admittance or withdrawal. Failure to keep such records will result in the estate, trust, partnership or S corporation, along with its general partner, tax matters partner, corporate officers or trustees, being responsible for any PIT due with respect to the entity. Finally, new Section 352.2 will be added to provide that any of the following is a summary offense punishable by penalties ranging from $300 to $1,500 and jail time ranging from five to 30 days for each offense: (1) failing to pay employer withholding tax, interest or penalties within 90 days after the due date absent a timely appeal of such liabilities or a duly authorized payment plan; (2) underpaying employer withholding tax, interest or penalties within 90 days after the due date absent a timely appeal of such liabilities or a duly authorized payment plan; and (3) failing to file an employer withholding tax return within 90 days of its due date.

All of the PIT additions and amendments, with the exception of Section 352.2, are effective for tax years beginning after December 31, 2013. Section 352.2 is effective immediately.

Sales and Use Tax

Relatively modest, largely administrative changes will be made to the Sales and Use Tax. An exclusion will be added for the sale or use of aircraft parts and related items. The call center credit, which was largely unused, will be repealed. A taxpayer whose license to collect Sales Tax has been revoked must appeal within 30 days of the revocation. An obsolete provision authorizing certain local receivers to collect Use Tax will be repealed. If federal legislation is passed regarding the obligation of remote sellers to collect Use Tax, the secretary of revenue is required to publish a notice so stating and the Independent Fiscal Office together with the Department of Revenue is required to file a report with legislative leaders regarding implementing any such legislation. A temporary increase in the Sales Tax imposed in Philadelphia is made permanent, with proceeds earmarked for the Philadelphia School District.

Realty Transfer Tax

Act 2013-52 amends various definitions in the Realty Transfer Tax (RTT) that affect the imposition of tax on an acquired company. Under prior laws, an “acquired company” was defined as a real estate company that within a three-year period experienced a 90 percent or more change in its ownership interests. A “real estate company” was defined as a corporation or association which is primarily engaged in the business of holding, selling or leasing real estate 90 percent or more of the ownership interest in which is held by 35 or fewer persons and that either: (1) derives 60 percent or more of its annual gross receipts from the ownership or disposition of real estate; or (2) holds real estate, the value of which comprises 90 percent or more of its entire tangible asset holdings. Real estate was defined as real estate located in Pennsylvania. Act 2013-52 expands the definition of a real estate company to include certain upper-tier entities that own direct or indirect interests in an entity that owns real estate. Specifically, a real estate company now includes a corporation or association, 90 percent or more of the ownership interests that are held by 35 or fewer persons, that owns as 90 percent or more of the fair market value of its assets a direct or indirect interest in a real estate company. Further, Act 2013-52 changes the definition of real estate to include real estate everywhere, not just Pennsylvania real estate, in determining if a company is a real estate company. Further, Act 2013-52 will amend the rules for when a real estate company becomes an acquired company by providing that the transfer of an ownership interest in a real estate company will be considered to occur within three years of another transfer if, during the three-year period, the transferring party provides the transferee with a legally binding commitment or option, enforceable at a future date, to execute the transfer. Each of these amendments is effective January 1, 2014.

A new exemption from RTT is added for: (1) transfers for no or nominal consideration from the commonwealth and its instrumentalities, agencies and political subdivisions to a volunteer emergency medical services agency, volunteer fire company or volunteer rescue company, and (2) transfers between two or more volunteer emergency medical services agencies, volunteer fire companies or volunteer rescue companies. The exemption is retroactive to transfers occurring on or after November 1, 2011.

Bank Shares Tax

Act 2013-52 makes a comprehensive reform to the Bank Shares Tax effective for the calendar year beginning January 1, 2014. The definition of an “institution” on which the Bank Shares Tax is imposed has been amended to include out-of-state banks doing business in Pennsylvania. A definition of “doing business” in Pennsylvania has been added that provides that an institution will be subject to tax if it generates receipts apportioned to Pennsylvania in excess of $100,000 and meets any of the following: (1) has an office or branch in Pennsylvania; (2) has one or more employees, representatives, independent contractors or agents conducting activities on the institutions behalf within Pennsylvania; (3) has any person, including its employee, representative, independent contractor or agent or an employee, representative, independent contractor or agent of an affiliated entity, directly or indirectly soliciting business in Pennsylvania on its behalf though person-to-person contact, mail, telephone or other electronic means or through the use of advertising published, produced or distributed in Pennsylvania; (4) owns, leases or uses real or personal property in Pennsylvania to conduct business activities; (5) holds a security interest, mortgage or lien in real or personal property located in Pennsylvania; (6) a basis exists to apportion the institution’s receipts to Pennsylvania under the sourcing rules contained in the Bank Shares Tax apportionment provisions; or (7) has a physical presence in Pennsylvania for a period of more than one day during the tax year or otherwise conducts an activity sufficient to create nexus with Pennsylvania under the U.S. Constitution. Act 2013-52 also removes the six-year moving average valuation calculation and replaces it with a one-year valuation formula; adjusts the rate and base of taxation from 1.25 percent of total equity capital to 0.89 percent of total bank equity capital; and changes the method of apportionment from a three-factor formula using payroll, deposits and receipts to a single-factor formula based solely on receipts for which detailed sourcing rules have been added.

Wagering Tax

Act 2013-52 enacts a Non-Licensed Corporation Pari-Mutuel Wagering Tax as Article XVI-B of the Tax Reform Code. The tax is designed to reach wagering by out-of-state non-licensed corporations.

Credits and Incentives

Act 2013-52 adds an article to provide for city revitalization and improvement zones. A city of the third class with a population of at least 30,000 may establish a contracting authority to designate a zone. A contracting authority is a municipal corporation that can designate a zone and construct a structure or a complex to be used for commercial, sports, exhibition, hospitality, conference and certain other purposes. Two initial zones may be approved and after 2015 two additional zones can be approved per calendar year. A pilot zone may be approved for a smaller municipality. The contracting authority may borrow money for the project. Certain state and local tax revenues paid or collected by businesses in the zone can be used to amortize bonds, subject to baseline and dollar limitations. The article restricts the legislature from making certain changes that will undermine the ability to repay bonds.

Act 2013-52 adds an article that provides for a local telecommunications broadband investment tax credit in the amount of 5 percent of the purchase price of qualified broadband equipment. The total credit in any one year may not exceed $5 million.

Act 2013-52 adds Article XVIII-F to provide for an Innovate in PA Tax Credit. Insurance companies may purchase tax credits against their Insurance Premiums Tax. The proceeds from the purchases will be transferred to the Ben Franklin Technology Development Authority, the Ben Franklin Technology Partners and regional biotechnology research centers. The goal of the program is to provide funding between about $131,000,000 and $147,000,000.

The neighborhood improvement zones legislation is transferred into Article XIX-B. The program will provide funding for a development or complex of residential, commercial, exhibition, hospitality, conference and certain other uses that can include professional sports arenas. The program is available to a city of the third class with a population of 106,000.

Act 2013-52 establishes the Keystone Special Development Zone Program, to provide for credits for qualified employers employing persons in an industrial area described in the Land Recycling and Environmental Remediation Standards Act for which the Department of Environmental Protection executed a special industrial area consent order and agreement.

Technical changes are made to the Film Production Tax Credit, including changes to tax credit carryover provisions.

A provision is added to the Educational Improvement Scholarship Credit to grandfather an applicant who received a credit if in a later year the school district is removed from the list of low-achieving schools.

The Coal Waste Removal and Ultra Clean Fuels Tax Credit will be repealed. The credit was never used.

Inheritance Tax

A transfer of a "qualified family-owned business" interest to one or more qualified transferees is now exempt from inheritance tax if the qualified business: (1) continues to be owned by a qualified transferee for a minimum of seven years after the decedent's death; and (2) is reported on a timely filed inheritance tax return. For purposes of the Act, the qualified family-owned business is either: (A) a sole-proprietorship in a trade or business with 50 or fewer full-time equivalent employees, owning assets less than $5 million and having been in existence for five years prior to the decedent's date of death; (B) an interest in an entity carrying on a trade or business with 50 or fewer full-time employees, owning assets less than $5 million, with the entity being wholly owned by the decedent or by members of his family meeting the definition of a qualified transferee, not engaging in the business of investment management of the assets owned by the business and having been in existence for five years prior to the decedent's date of death. The Act defines "qualified transferee" as the decedent's spouse, lineal decedents, siblings and lineal decedents of such siblings, or ancestors and the ancestor's siblings.

If within the first seven years after the decedent's death the qualified family-owned business is no longer owned by a qualified transferee, the transfer will be subject to the inheritance tax in the amount that would have been paid but for the exempt transfer. Act 2013-52 also requires that annually for the first seven years after the decedent's death, each owner of the qualified family-owned business certifies to the department that he or she is a qualified transferee as defined under Act 2013-52. This provision is effective for estates of decedents who die on or after July 1, 2013.

Section 2112 of Article XXI of the code related to the exemption for poverty transfers between spouses is repealed. Since the inheritance tax no longer imposes tax on transfers between spouses, this provision was obsolete.

To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact: Joseph C. Bright at jbright@cozen.com or 215.665.2053, Cheryl A. Upham at cupham@cozen.com or 215.665.4193, or Dan A. Schulder at dschulder@cozen.com or 717.703.5905.

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