

Pennsylvania Tax

APRIL 2003

Governor Proposes "Closing Corporate Net Income Tax Loopholes"

SUMMARY

On March 25, 2003, Pennsylvania's Governor Ed Rendell introduced a "Plan for a New Pennsylvania," consisting of proposals to increase state expenditures for education, economic development and local government property tax relief by approximately \$3.9 billion. According to Governor Rendell, this plan will promote economic development and increase educational funding in a drive to "restore our economy and create the jobs and business growth that sustain the communities." To fund these initiatives, in addition to authorizing the installation of slot machines at horse racing tracks and to increase state borrowing by \$2 billion, the Governor also proposed some significant changes in the taxation structure of the Commonwealth. Specifically, Governor Rendell has proposed increasing personal income tax from 2.8% to 3.75%, effective July 1, 2003 and "closing corporate net income tax loopholes."

The Governor's corporate tax proposals focus on two perceived "loopholes" in the corporate net income tax structure. First, Governor Rendell proposes restricting the deductibility of related-party intangible and interest expenses. He also proposes requiring pass-through entities to withhold tax on income paid to non-resident owners. The amount of revenue to be received by the Commonwealth as a result of these changes is estimated to be \$106 million in fiscal year 2003-2004 and \$111 million in fiscal years 2004-2005 and 2005-2006. In addition, Governor Rendell proposed the creation of a Business Tax Reform Commission to evaluate the desirability of decreasing the corporate net

income tax rate and "restructuring" and "broadening" the tax base subject to corporate taxation. The goal of the Commission will be to explore the desirability of financing corporate net income tax rate reductions through the use of a revenue neutral initiative.

Governor Rendell has released the draft legislation for these amendments. It is anticipated that any such legislation will be met with fierce debate in the General Assembly and intense lobbying by affected businesses. As a result, and depending on the effectiveness of the advocacy efforts on both sides of this issue, the ultimate law could be quite different from that which is currently proposed.

RELATED-PARTY TRANSACTIONS

Proposed changes to corporate taxation of related-party transactions are intended to focus upon the treatment of out-of-state holding companies. According to Governor Rendell, as a tax avoidance tactic, many companies establish holding companies in one of four states not imposing corporate net income taxes, namely Nevada, Texas, Washington and Wyoming and allocate intangible personal property to these states pursuant to the Uniform Division of Income for Tax Purposes Act. Moreover, many corporations establish holding companies in Delaware, which generally does not impose corporate income tax on a holding company's items of income from intangible property. In addition, because Pennsylvania requires separate reporting for all corporations, and prohibits the use of consolidated returns, substantial intercorporate management fees are

also paid to states in which headquarters or holding company activities occur.

Generally, Governor Rendell proposes to eliminate these so-called “loopholes” by disallowing a corporation’s deduction for royalties and interest paid to a holding company if the principal purpose of the transaction is the avoidance of Pennsylvania tax. Specifically, the legislation proposes amending section 401(3)1 of the Tax Reform Code to disallow such deductions “unless the Corporation proves by *clear and cogent evidence* that the transaction or transactions giving rise to the expenses and costs did not have as a principal purpose the avoidance of any tax due...”

Clear and cogent evidence must consist of proof that the transactions were conducted at arm’s-length and that they were for a “substantial business purpose” and had “economic substance.” In addition, the taxpayer must provide proof that the taxpayer reported the income derived from the transaction. Notably, Pennsylvania would not consider reporting on a consolidated return that offset or eliminated the income as sufficient proof.

The consideration of Governor Rendell’s proposals may also lead the General Assembly to consider alternative approaches to similar problems taken by other states, such as Connecticut, New Jersey and Ohio. Connecticut, for example, generally disallows a corporation’s deduction for interest and intangible expenses paid to a related entity unless it can establish “by clear and convincing evidence that the adjustments are unreasonable.” Conn. Gen. Stat. § 12-218c. New Jersey imposes a similar standard for certain related-party transactions. NJ Stat. § 54:10A-4.4. Ohio established a rebuttable presumption that a transaction with a related entity should be disregarded for Ohio corporate tax purposes. Ohio Rev. Code § 5733.042. This presumption may be rebutted by evidence to the contrary.

The implementation of evidentiary requirements of the type proposed by Governor Rendell, and as utilized in Connecticut, New Jersey and Ohio, may necessitate some fundamental changes to Pennsylvania’s corporate tax settlement and appeals process. The Corporation Tax Bureau of the Department of Revenue will need to

develop standards and procedures for evaluating the sufficiency of evidentiary submissions. In addition, changes may be necessary to appeal procedures utilized by the Department of Revenue’s Board of Appeals and the Board of Finance and Revenue, both of which are currently ill-equipped to conduct evidentiary hearings that afford appropriate due-process protections to taxpayers.

NET OPERATING LOSS CARRYOVER ADJUSTMENTS

Governor Rendell has also proposed to reduce loss carryovers to the extent the carryovers were generated in prior years through the use of prospectively impermissible related-party transactions. Interestingly, NOL adjustments will not be accomplished by the resettlement of prior years’ tax returns, but instead will apparently expand the scope of documentation required to support tax returns in future years to involve a *de facto* reviews of loss determinations made in prior years. Requirements of this type may stretch the resources and capabilities of Pennsylvania’s settlement and appeals process to the breaking point and will undoubtedly create substantial delays and uncertainty regarding corporate tax obligations.

AUTHORITY FOR DISCRETIONARY ADJUSTMENTS TO INCOME AND DEDUCTIONS

One of the most important changes made to Pennsylvania’s corporate tax policies in the last twenty years was the elimination of discretionary determinations of capital stock and franchise tax liabilities by the Department of Revenue and the substitution of a relatively clear and readily understood fixed formula for the calculation of tax liabilities. Prior to the adoption of a fixed formula to determine capital stock and franchise tax liabilities, Pennsylvania enjoyed the reputation of having a tax system that was virtually impossible to understand and which was subject to inherent abuse and favoritism. Unfortunately, the Governor’s tax proposals suggest that the Commonwealth may move “back to the future” by granting the Department of Revenue discretionary authority to “adjust items of income or deductions so as to make a fair and equitable determination of taxable income.” The Department of Revenue could apply this

authority in a number of situations to readjust items of income between related party entities (for example, a profit-making Pennsylvania corporation that pays significant management fees to a related Pennsylvania entity with a net loss deduction or foreign corporation). Governor Rendell's proposal to grant the Department of Revenue discretionary authority to make equitable adjustments to tax liabilities is modeled on § 482 of the Internal Revenue Code and could be used in a manner beneficial to taxpayers to correct inequities. Unfortunately, granting the Department broad authority of this type may create difficult challenges for taxpayers and the Department.

REQUIRED TAXATION OF INCOME PASSED THROUGH TO OUT-OF-STATE SHAREHOLDERS/OWNERS

Governor Rendell expects to raise an additional \$5.5 million in revenue for fiscal year 2003-04 and \$11 million in the 2004-2005 fiscal year by mandating that pass-through entities taxed as partnerships to withhold tax on distributions made to out-of-state partners. These pass-through entities must make a return on behalf of non-filing corporate partners' share of income and expenses and withhold and pay taxes on those partners' shares at the prevailing tax rate.

In his narrative on the plan, the Governor has noted with favor provisions of West Virginia law that require a pass-through entity to withhold tax equal to four percent of the source income in West Virginia prior to making distributions to all nonresident shareholders or owners, whether individuals or corporations unless the recipients of distributions stipulate that they will be liable for corporate taxes in West Virginia. W. Va. Code § 11-21-71a. A similar withholding requirement is also imposed by Ohio in which a withholding tax is imposed on all investors at that year's corporate tax rate. Ohio Rev. Code § 5733.41.

CONCLUSION

The proposed legislation, if implemented, may substantially complicate tax reporting requirements and result in additional tax litigation. The Governor's proposals may also make Pennsylvania a decidedly less attractive location for various types of businesses, especially high-technology businesses holding substantial portfolios of intangible intellectual property assets. The Governor's proposals will also offset some of the currently attractive features of the Pennsylvania corporate tax structure that offset the state's comparatively high corporate net income tax and capital stock and franchise tax rates.

JACQUELINE JACKSON-DEGARCIA **PETER A. GLEASON**
jjacksondegarcia@kl.com *pgleason@kl.com*
717.231.5877 717.231.2892

RAYMOND P. PEPE **W. HENRY SNYDER**
rpepe@kl.com *hsnyder@kl.com*
717.231.5988 412.355.6720

FOR FURTHER INFORMATION, please contact one of the following K&L lawyers:

State Taxation

Harrisburg	Raymond P. Pepe	rpepe@kl.com	717.231.5988
	Jacqueline Jackson-DeGarcia	jjacksondegarcia	717.231.5877
Pittsburgh	W. Henry Snyder	hsnyder@kl.com	412.355.6720
	Ronald T. Aulbach	raulbach@kl.com	412.355.6249

Government Affairs

Harrisburg	Peter A. Gleason	pgleason@kl.com	717.231.2892
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75 State Street
Boston, Massachusetts 02109
617.261.3100 PHONE
617.261.3175 FAX

2828 North Harwood Street
Suite 1800
Dallas, Texas 75201
214.939.4900 PHONE
214.939.4949 FAX

Payne Shoemaker Building
240 North Third Street
Harrisburg, Pennsylvania 17101
717.231.4500 PHONE
717.231.4501 FAX

10100 Santa Monica Boulevard
Seventh Floor
Los Angeles, California 90067
310.552.5000 PHONE
310.552.5001 FAX

Miami Center - 20th Floor
201 South Biscayne Boulevard
Miami, Florida 33131
305.539.3300 PHONE
305.358.7095 FAX

The Legal Center
One Riverfront Plaza, Seventh Floor
Newark, New Jersey 07102
973.848.4000 PHONE
973.848.4001 FAX

599 Lexington Avenue
New York, New York 10022
212.536.3900 PHONE
212.536.3901 FAX

Henry W. Oliver Building
535 Smithfield Street
Pittsburgh, Pennsylvania 15222
412.355.6500 PHONE
412.355.6501 FAX

Four Embarcadero Center, 10th Floor
San Francisco, California 94111
415.249.1000 PHONE
415.249.1001 FAX

1800 Massachusetts Avenue, N.W.
Second Floor
Washington, DC 20036
202.778.9000 PHONE
202.778.9100 FAX

www.kl.com



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