

# *Pennsylvania – House passes bill proposing income tax rate reduction, intangible expense addback, and market-based sourcing*

May 10, 2013

## *In brief*

On May 6, 2013, the Pennsylvania House of Representatives passed [H.B. 440](#), which would make several significant changes to the state's Corporate Net Income (CNI) tax. The changes include: (1) phasing in a 10-year rate reduction from the 9.9% current rate to a 6.99% rate; (2) adopting an addback for intangible expenses paid to an affiliate; (3) implementing market-based sourcing for the sale of services; and (4) increasing the cap on the net loss deduction. Pennsylvania taxpayers should be aware of the potential support that the bill has with the governor and with the state Senate.

## *In detail*

### **Corporate net income tax rate reduction**

Current law provides that the CNI tax rate is 9.99%. H.B. 440 would provide an annual rate reduction, beginning with a 9.89% rate for the tax year beginning on or after January 1, 2015 and ending with a 6.99% tax rate for tax years beginning on or after January 1, 2025.

### **Intangible expense addback**

For taxable years beginning after 2014, taxpayers would not be allowed to deduct affiliated entity intangible expenses, including interest expenses relating to intangibles. An 'affiliated entity' has several meanings, including an entity

that is either 50% owned by or has a 50% ownership in the taxpayer.

The following exceptions would apply:

- **Subject to tax.** The taxpayer would receive a pro rata credit to the extent that the affiliated entity was subject to a tax that includes the expense in its tax base.
- **Business purpose.** The expense disallowance would not apply to a transaction that was directly related to a valid business purpose. A valid business purpose is a purpose that alone or in combination with other

purposes constitutes the primary motivation for a business activity or transaction. The purpose cannot be the avoidance or reduction of taxation. A transaction done at arm's length shall be presumed to be directly related to a valid business purpose.

- **Treaty.** The expense disallowance would not apply when the affiliated entity is domiciled in a foreign nation that has in force a comprehensive income tax treaty with the US with certain provisions.

- **Conduit.** The expense disallowance would generally not apply when the affiliated entity directly or indirectly paid the expense amount to a person who is not an affiliated entity.

### **Market-based sourcing for services**

Under current law, sales, other than sales of tangible personal property, are sourced based on costs of performance.

Under H.B. 440, effective for tax years beginning after 2013, services would generally be sourced to Pennsylvania if delivered to a location in the state. If the delivery location is both within and without the state, then the sale of a service would be sourced to Pennsylvania “based upon the percentage of total value of the service delivered to a [Pennsylvania] location.”

If the customer is not an individual, and the state of assignment cannot be determined, then the service is deemed to be delivered to the location where the services were ordered, and

deemed delivered to the customer’s billing address if the order location cannot be determined. If the customer is an individual, the service is deemed to be delivered at the customer’s billing address.

Under H.B. 440, costs of performance would continue to be the sourcing method for sales other than tangible property and services.

### **Phased increase in net loss deduction**

Under current law, the CNI tax provides for a net loss deduction that is capped at the greater of: (1) \$3 million; (2) 20% of taxable income; or (3) the amount of net losses that may be carried over to the taxable year.

H.B. 440 would provide that, for taxable years beginning after 2013, the net loss deduction is capped at: (1) \$4 million; (2) 25% of taxable income; or (3) the amount of net losses that may be carried over to the taxable year.

For taxable years beginning after 2014, H.B. 440 would provide that the net loss deduction is capped at: (1) \$5 million; (2) 30% of taxable income; or

(3) the amount of net losses that may be carried over to the taxable year.

### **The takeaway**

H.B. 440 certainly bears watching as it is considered by the Senate. H.B. 440 closely mirrors [H.B. 2150](#), which passed the House with bipartisan support last year and failed to make it out of the Senate. However, H.B. 440 contains a number of provisions that the governor proposed in his budget address, so the bill could garner support in the Senate and possibly the support of the governor.

One element of the addback that Pennsylvania taxpayers should be aware of is the provision allowing for an exception based on an arm’s length transaction. If an affiliated expense transaction is done at an arm’s length, the transaction is presumed to be directly related to a valid business purpose and, therefore, would qualify for the exemption. It will be interesting to see if there are any proposed changes to this language as it is considered by the Senate.

### **Let’s talk**

For more information regarding Pennsylvania H.B. 440, please contact:

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