

Pennsylvania enacts intangible expense addback, market-based sourcing, and other significant tax changes

July 9, 2013

In brief

On July 9, 2013, Pennsylvania Governor Tom Corbett signed [H.B. 465](#), which makes significant changes to Pennsylvania taxes, including: adopting intangible expense addbacks, expanding the cap on the net operating loss deduction, requiring market based sourcing for services, extending the phase-out of the Capital Stock/Franchise Tax for 2 years, implementing comprehensive Bank Shares Tax reform, modifying and creating certain tax credit programs, and broadening the application of the realty transfer tax.

In detail

Intangible expense addback

For taxable years beginning after December 31, 2014, Pennsylvania requires a Corporate Net Income Tax (CNIT) addback for: (1) intangible expenses and (2) interest expenses related to an intangible that are paid, accrued, or incurred directly or indirectly in connection with one or more transactions with an affiliated entity.

For purposes of the addback, 'intangible expense' means "[r]oyalties, 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." Further, 'interest expense' means "[a] deduction allowed under [IRC Sec. 163] to the extent that such deduction is directly related to an intangible expense."

The following exceptions apply:

- **Subject to tax.** A taxpayer receives an apportioned credit to the extent that the affiliated entity was subject to a tax that includes the expense in its tax base.

- **Business purpose.** The addback does not apply to a transaction that did not have as its principal purpose the avoidance of CNIT and was done at arm's length rates and terms.
- **Treaty.** The addback does 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 addback generally does not apply when the affiliated entity directly or indirectly paid the

expense to a non-affiliated entity, with certain conditions.

Sales factor and market-based sourcing

Under current law, all sales, other than sales of tangible personal property, are sourced to Pennsylvania if: (1) the income-producing activity is in Pennsylvania; or (2) the income-producing activity is performed both inside and outside of Pennsylvania and a greater portion is performed in Pennsylvania than in any other state, based on costs of performance.

Effective for tax years beginning after December 31, 2013, the following sales are sourced to Pennsylvania:

- Sales from the sale, lease, rental or other use of real property, if the real property is located in Pennsylvania.
- Sales from the rental, lease, or licensing of tangible personal property if the customer first obtained possession of the tangible personal property in Pennsylvania. If the tangible personal property is subsequently taken out of Pennsylvania, the taxpayer may use a reasonably determined estimate of usage in Pennsylvania.
- Sales of services delivered to a location in Pennsylvania.
- Sales of services delivered to a location in and outside Pennsylvania are sourced based upon the percentage of 'total value' of the service delivered to the Pennsylvania location.

For sales of services, 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 (and not a sole proprietor), the service is deemed to be delivered at the customer's billing address.

All other sales (other than sales of tangible personal property), such as sales of intangible assets, continue to be sourced to Pennsylvania under the current law, i.e., based on income producing activity/costs of performance.

Expanded cap on utilization of net operating loss deductions

Since 2010, the CNIT net loss deduction has generally been limited to the greater of 20% of taxable income or \$3 million. The new legislation expands the cap as follows:

- For taxable years beginning after December 31, 2013, the net loss deduction is the greater of 25% of taxable income or \$4 million.
- For taxable years beginning after December 31, 2014, the net loss deduction is the greater of 30% of taxable income or \$5 million.

Extension of the Capital Stock/Franchise Tax

The Capital Stock/Franchise Tax is imposed at a rate of 0.89 mills for the 2013 tax year and is scheduled to expire after 2013. H.B. 465 extends the scheduled phase-out of the tax as follows:

- For taxable years beginning January 1, 2014 to December 31, 2014, the rate of tax is 0.67 mills.
- For taxable years beginning January 1, 2015 to December 31, 2015, the rate of tax is 0.45 mills.

The tax is scheduled to expire for taxable years beginning after December 31, 2015.

Satellite television service apportionment

Effective for tax years beginning after December 31, 2013, all business income of satellite television service providers shall be apportioned to Pennsylvania based on a fraction, the numerator of which is the value of Pennsylvania equipment owned or rented by the taxpayer or owned by an entity that is included with the taxpayer in a controlled group, as defined in IRC Sec. 267(f), and used by the taxpayer in generating, processing or transmitting satellite television services, and the denominator of which is the value of all such equipment located everywhere.

Bank Shares Tax reform

H.B. 465 establishes comprehensive Bank Shares Tax reform. The following changes become effective for the calendar year beginning January 1, 2014, and each calendar year thereafter:

- The rate of the Bank Shares Tax is reduced from 1.25% to 0.89%.
- The tax base changes from total equity capital to bank equity capital.
- The six-year moving average valuation formula is replaced with a one-year valuation formula.
- Currently, the tax is apportioned based on an evenly-weighted three factor apportionment formula, consisting of payroll, receipts and deposits. The new legislation eliminates the payroll and deposits factors, thereby apportioning the tax base using only the receipts factor.
- Receipts factor sourcing requirements are expanded and

generally follow a market-based approach.

- Specific nexus standards are established with respect to out-of-state institutions. An institution is considered to be 'doing business' in Pennsylvania if it generates gross receipts apportioned to Pennsylvania (in accordance with the new sourcing provisions) in excess of \$100,000 and meets any of the established criteria with regard to physical presence.
- Current law requiring a special process for Bank Shares Tax appeals is repealed. Such appeals will be included in the newly reformed Board of Finance and Revenue appeals process.

We will issue a separate release regarding the Bank Shares Tax changes as a result of H.B. 465.

Realty Transfer Tax

Under current law, the Pennsylvania Realty Transfer Tax is imposed on the value of real property transferred by deed, instrument, or other writing. In addition, certain transfers of a 'real estate company' interest are subject to the tax when 90% or more of the total ownership interest in a real estate company is transferred within a three-year period. A 'real estate company' is generally defined as an entity primarily engaged in the business of holding, selling, or leasing real estate with 90% of its ownership interest held by 35 or fewer persons and which either (1) derives 60% 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% or more of the value of its entire tangible asset holdings, exclusive of tangible assets that are freely transferrable and actively traded on an established market.

Effective January 1, 2014, a 'real estate company' also includes a corporation or association that owns, as 90% or more of the fair market value of its assets, a direct or indirect interest in a real estate company.

Also effective January 1, 2014, H.B. 465 modifies the criteria for determining when 90% or more of the total ownership interest in a real estate company has been deemed to be transferred.

Sales and use tax

The Independent Fiscal Office, in conjunction with the Department of Revenue, must submit a report outlining the implementation of the Federal Marketplace Fairness Act, whereby remote sellers can be required to collect sales and use tax. The report is due within 90 days of the Department's published notice announcing enactment of the Federal legislation.

The sunset provision for the additional 1% local Philadelphia sales and use tax is eliminated.

Personal Income Tax

Effective for tax years beginning after December 31, 2013, the Personal Income Tax (PIT):

- aligns Pennsylvania with Federal rules to allow for a start-up business deduction in the year a business is established
- provides for the option to capitalize and recover allowable intangible drilling costs under IRC Sec. 263(c) over a ten year period or elect to currently expense up to one-third of the costs in the year the costs are incurred and recover the remaining costs over a ten-year period
- eliminates the PIT credit for taxes paid to foreign countries. The credit allowed for taxes paid to other states remains in effect.

Credits

- **Film Production Tax Credit.**

Applicable to tax credits awarded after June 30, 2013, the Director of the Film Office may consider additional criteria he or she deems appropriate when evaluating and approving credit applications to ensure maximum employment and benefit in Pennsylvania.

Additionally, a Film Production Tax Credit purchased or assigned in calendar year 2013 and 2014 may be carried forward and used in 2014 and 2015, respectively.

- **Job Creation Tax Credit.** The Department of Community and Economic Development may award the total amount of credit authorized for a multiple year Job Creation Tax Credit in the first year in which the new job is created and the tax credit is earned.

- **Innovate in PA Tax Credit.**

H.B. 465 establishes the new Innovate in PA Tax Credit program, which provides a new source of funding for early-stage venture capital investment. The program authorizes the sale of up to \$100 million of insurance premiums tax credits to qualified purchasers.

- **Mobile Telecommunications Broadband Investment Tax Credit.**

For tax years beginning after December 31, 2013, and ending before January 1, 2024, H.B. 465 establishes a new credit against the CNIT for providers of mobile communications services measured by 5% of the cost of investment in qualified broadband equipment located in Pennsylvania. The credit is available to all taxpayers (i.e. corporations, pass-through entities and is transferrable to owners of

pass-through entities), is capped at \$5 million per year, and will be prorated, if necessary. Further, the credit is non-refundable and may be carried forward 5 years.

- **City Revitalization and Improvement Zones (CRIZ).**

H.B. 465 establishes the CRIZ program to provide economic development and job creation in third class cities meeting certain criteria. The legislation requires guidelines necessary to implement the CRIZ program to be published by October 31, 2013.

We will issue a separate release regarding these tax credit changes.

Compliance requirements for pass-through businesses

H.B. 465 authorizes actions by the Department of Revenue to improve income tax compliance and administrative efficiency for pass-through entities such as partnerships, LLCs, and S-corporations. The bill also establishes new measures for collecting PIT from non-resident owners with Pennsylvania source income. Specifically, the legislation establishes the following, effective for taxable years beginning after December 31, 2013:

- authorizes the assessment of tax at the pass-through entity level in certain instances where income has been underreported

- requires a partnership to maintain an accurate list of partners and addresses
- requires estates and trusts to withhold Pennsylvania tax on Pennsylvania source income from non-residents
- requires non-resident estates and trusts to file Pennsylvania returns if they have Pennsylvania beneficiaries or Pennsylvania source income
- mandates the filing of Form PA-20S/PA-65 (pass-through information return) and Forms RK-1 and NRK-1 for all resident and non-resident owners.

Tax appeals reform

H.B. 465 makes substantial changes to tax appeal procedures at the Board of Finance and Revenue (Board). Under current law, only the taxpayer (or authorized representative) can present oral and documentary evidence to the Board. The Pennsylvania Department of Revenue (DOR) is represented on the Board, since one of the six Board members includes DOR counsel. The Board is also not authorized to enter into settlements with taxpayers.

Effective April 1, 2014, both the taxpayer and the DOR are entitled to present oral and documentary evidence before the Board. Additionally, the Board may order a compromise settlement with agreement of both parties. HB 465

also reorganizes the existing Board to include three full-time members: (1) two members nominated by the governor and approved by the senate; and (2) the treasurer or designee.

The takeaway

H.B. 465 represents sweeping change to Pennsylvania taxation in several areas. Pennsylvania joins the ranks of states that require related party addbacks, but only for intangible expenses and interest expenses related to intangibles. Taxpayers should carefully review the addback exceptions, particularly the calculations required for the subject to tax credit. Taxpayers engaged in selling services will have to navigate the new statutory framework for sourcing services, including identifying where services are 'delivered.' Taxpayers with Pennsylvania NOLs should re-evaluate the amount of NOLs that can be utilized through 2015 as a result of the NOL cap expansion and consider the impact of any increase in NOL utilization for valuation allowance purposes.

Taxpayers subject to the Capital Stock/Franchise Tax (CS/FT) should consider opportunities since the tax will remain in effect through 2015. Specifically, to the extent three-factor apportionment is utilized, taxpayers should consider the impact of market based sourcing since the CNIT apportionment rules also apply for purposes of the CS/FT.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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