

Newsletters, PA Tax News

## PA TAX LAW NEWS

January 2011

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### **PA Budget Watch**

#### **CURRENT BUDGET ON TRACK BUT FY2011-12 PRESENTS STERN CHALLENGES**

by *James L. Fritz*

As we begin the second half of Pennsylvania's 2010-11 fiscal year, state revenues seem to be turning the corner - December General Fund revenues exceeded estimate by \$176.9 million (8.4%). However, projections of a large structural deficit for 2011-12 continue to call into question whether incoming Governor Corbett will be able to deliver on his 'no tax increase' pledge for the next fiscal year and whether he will be able to implement a number of campaign promises to reduce taxes over the longer haul. Pennsylvania taxpayers should pay close attention as the new Governor and General Assembly target program cuts and consider revenue enhancements for the 2011-12 budget.

Following are some key fiscal 2010-11 revenue statistics, through December 31st, as announced in a Governor's Office press release:

	YTD Variance from Estimate	
	\$ (millions)	%
<b>General Fund</b>	<b>+191.2</b>	<b>+1.7%</b>
- Sales Tax	+102.8	+2.5%
- Personal Income Tax	+16.6	+0.4%
- Corporate Taxes	+91.4	+7.9%
- Realty Transfer Tax	-32.8	-18.0%
- "Other" Taxes	+1.2	+0.2%
- Non-Tax Revenue	+7.0	+2.2%
<b>Motor License Fund</b>	<b>+163.3</b>	<b>+14.4%</b>

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In the out-going Rendell Administration's mid-year budget briefing delivered before Christmas, Governor Rendell and his Secretary of the budget, Mary Soderberg, projected a fiscal 2010-11 General Fund shortfall of \$63 million. This took into account: (a) a \$280 million shortfall in federal stimulus appropriations; (b) \$200 million savings from the Governor's spending freeze; (c) an additional \$65 million needed for "safety net" programs; and (d) the Legislature's failure to enact a natural gas severance tax that could have yielded approximately \$70 million. However, the better-than-expected December results may erase the Projected \$63 million shortfall.

While the 2010-11 fiscal year seems relatively under control, the news for 2011-12 presents stern challenges. The current budget was balanced, in part, with \$2.6 billion in federal stimulus funds and \$750 million in one-time revenues - funds that will not be available for the 2011-12 budget. In addition, the Commonwealth faces higher costs for pensions, medical assistance and other programs. Although economic growth hopefully will help offset those large shortfalls, out-going Governor Rendell and many other officials have projected at least a \$3-4 billion gap to be closed in order to balance the 2011-12 budget.

The fiscal 2011-12 gap constitutes more than 10% of annual General Fund expenditures. Much of the General Fund represents programs which would be difficult to cut, including PreK-12 Education (35.4% of Fund), Corrections (6.7%) and Debt Service (3.5%). The Fund also includes Medical Assistance/Long Term Living (20.8%), other DPW Human Services programs (16.4%) and the ubiquitous "All Other" (10.2%). Incoming Governor Corbett reportedly is looking for substantial savings by cutting waste, abuse and fraud in welfare programs but, while we wish the new administration well in their efforts, it is difficult to believe that this will be sufficient to close the 2011-12 gap.

At the same time, the incoming governor has indicated that he is dead-set against enacting a natural gas severance tax and has pledged not to increase existing taxes. Furthermore, during the recent gubernatorial election, the incoming governor pledged to:

- Complete the phase-out of the Capital Stock and Franchise Tax by 2014.
- Reduce the Corporate Net Income Tax rate from 9.99% to 6.99% over six years.

- Phase-out the Net Operating Loss Cap over a nine-year period.
- Phase-out Pennsylvania's Inheritance Tax over a 15-year period.
- Phase-in Single Sales Factor apportionment for the Corporate Net Income Tax during 2013 and 2014.
- Enhance Research and Development incentives.

Obviously, the upcoming Pennsylvania budget cycle presents a classic confrontation between those supporting what they view as necessary government programs and the new Governor and his political allies seeking to hold the line, or reduce, taxes and "live within our means."

Some combination of cost cutting and revenue enhancement through "fees" and other non-tax alternatives (e.g. selling the state liquor stores) seems the most likely result. However, Pennsylvania taxpayers should pay close attention as they may be significantly impacted by this next budget - whether it includes "taxes" or not.

### **MARCELLUS SHALE TAX ISSUES AND OPPORTUNITIES**

by *Randy L. Varner*

As we reported in a previous edition of this newsletter, Act 46 of 2010, more commonly known as Pennsylvania's 2010-2011 budget bill, contained a commitment by the General Assembly to pass a natural gas severance tax by October 1, 2010, with an effective date of no later than January 1, 2011. Despite much posturing and negotiating, the Democrats and Republicans were not able to come to an agreement on the final form of a severance tax. Therefore, we find ourselves in the midst of an administration transition, in which incoming Governor Corbett has pledged not to enact any new taxes or tax increases. At this point the likelihood the enactment of a severance tax seems remote. Still, there are rumblings from the Democratic leadership in the House that the severance tax may not be totally dead.

One of the main sticking points with the negotiations of last summer and fall was where the revenue from a severance tax would go. Each of the several competing bills and ideas sliced the revenue pie up in a different way, with the General Fund often being the main beneficiary. We understand that the current Democratic leadership is prepared to alter the content in what was last session's H.B. 1489 and introduce a new bill that would devote all of the revenue to: (1) paying for local costs stemming from drilling; (2) providing environmental safeguards; and (3) infrastructure. The new proposal would be a volume-based tax, set at .30 per thousand cubic feet of gas extracted (MCF). H.B. 1489 would have imposed tax at .35/MCF. Even with these changes, any severance tax proposal faces a huge and likely insurmountable hurdle—at least in the short term—given Governor-elect Corbett's no new taxes pledge.

The severance tax isn't the only tax issue on the table with respect to Marcellus Shale. Last session's H.B. 10 would have subjected oil and gas interests to real estate property taxation. Currently, oil and gas interests are not subject to property taxation under the Pennsylvania Supreme Court's holding in *Independent Oil & Gas Association v. Board of Assessment of Fayette County*, 572 Pa. 240, 814 A.2d 180 (2002) ("*IOGA*"). Prior to the Supreme Court's decision in *IOGA*, many counties assessed such oil and gas interests as part of the property tax base. In *IOGA*, however, the Court determined that the assessment statutes do not provide for the taxation of oil and gas interests because they are not "lands" or any physical improvement "permanently affixed" to the ground. *Id.* H.B. 10 specifically would have included "rights held pursuant to a lease or other agreement" regarding natural gas and oil as being subject to taxation as real estate. Given the views of some legislators with respect to the impact of drilling on local governments, reintroduction of a bill similar to H.B. 10 is likely.

The Marcellus Shale has created a boom in economic activity over large portions of Pennsylvania. Excavators, engineers, transportation companies and the hospitality industry are reaping the benefits of the extraction of natural gas. Those involved in the Marcellus Shale industry should make sure they are taking full advantage of the tax exemptions available to them and understand the implications of their activities with respect to Pennsylvania taxes. For instance, those who contract with drilling companies to erect extraction equipment or prepare drilling sites, may qualify for the sales and use tax manufacturing exemption. Out of state companies who send employees or contractors into Pennsylvania for work in the industry, should understand that they will likely have nexus with Pennsylvania for corporate net income and foreign franchise taxes, and may incur additional obligations with respect to local earned income and business privilege taxes.

Along the same lines, those property owners who have royalty rights as a result of the leasing of land for drilling, may find themselves with personal income tax issues or the need for estate planning services. If you have any questions with respect to the Pennsylvania tax consequences of Marcellus Shale activities, please feel free to contact any member of the [McNees SALT Group](#).

### ***PA Tax Tips*** ***PA OFFERS MANY PRODUCTION-BASED EXEMPTIONS***

by *James L. Fritz*

Production-based tax exemptions have saved Pennsylvania businesses billions of dollars. These exemptions are known by various names, including "manufacturing," "processing," "printing," "mining," "R&D," "agriculture" and "industrial establishment." The taxes to which these exemptions apply are the Sales & Use Tax, the Capital Stock and Franchise Taxes, local Business Privilege Taxes and local Real Estate Taxes. The same term may have a different meaning for different taxes. The taxes have very different rules for exemption. To assist you in ascertaining whether your company is taking full advantage of these exemptions, this article will provide a broad overview of the available exemptions and future articles in this newsletter will discuss various aspects of the exemptions in more detail.

#### **Sales & Use Tax - A Plethora of Exemptions**

Pennsylvania's Sales and Use Tax offers a long list of exclusions and exemptions to companies engaged in production activities. Under the statutory category of "manufacture" the Legislature has excluded the direct and predominant use of various services and tangible personal property (including machinery, equipment and supplies) in:

- Manufacturing
- Fabricating
- Compounding
- Processing
- "Other operations" changing the form, composition or character of tangible personal property

"Manufacture" explicitly includes but is not limited to:

- Publishing Books, Newspapers, Magazines and other periodicals
- Printing
- Refining, Blasting, Exploring, Mining, or Quarrying or otherwise extracting natural resources, minerals and mineral aggregates



- Building, Rebuilding, Repairing, etc. of large vessels
- Conducting R&D
- Remanufacturing motor vehicle parts
- Remanufacturing aircraft, armored vehicles, etc.
- Remanufacturing locomotive parts

The following production activities also provide a basis for exclusion:

- Farming, Dairying or otherwise engaging in Agriculture, Horticulture or Floriculture
- Producing, delivering or rendering of a Public Utility Service
- Constructing, Reconstructing, Remodeling, Repairing or Maintaining Public Utility Facilities

In addition, the Legislature has established a sales and use tax exclusion category called "Processing," which includes a number of somewhat narrowly proscribed activities, many of which were added after tax auditors challenged their qualification under "manufacturing" or other more broadly-defined exclusions:

1. Filtering or heating Honey and packaging for wholesale distribution
2. Cooking, Baking or Freezing of Fruits, Vegetables, Mushrooms, Fish, Seafood, Meats, Poultry or Bakery Products and packaging for wholesale distribution
3. Cleaning, Cutting, Coring, Peeling or Chopping and treating, Fruits or Vegetables and sealing for wholesale distribution.
4. Scouring, Carbonizing, Cording, Combing, Throwing, Twisting or Winding Fibers
5. Spinning, Bleaching, Dyeing, Printing or Finishing of Yarns or Fabrics
6. Electroplating, Galvanizing, Enameling, Anodizing, Coloring, Finishing, Impregnating or Heat Treating of Metals or Plastics
7. Blanking, Shearing, Leveling, Slitting or Burning of Metals for sale to a manufacturer or processor
8. Rolling, Drawing or Extruding Ferrous and Non-ferrous Metals
9. Fabrication of Ornamental or Structural Metal (other than at construction site)
10. Preparation of Animal Feed or Poultry Feed for sale
11. Production, Processing and Bottling Non-alcoholic beverages for wholesale distribution
12. Operating a Saw Mill or Planing Mill
13. Milling Flour or Meal from Grains
14. Aging, Stripping, Conditioning, Crushing and Blending Tobacco
15. Slaughtering and Dressing of Animals for sale as meat
16. Preparing Meat Products for wholesale distribution
17. Processing of Use Lubricating Oils
18. Broadcasting of Radio and Television
19. Cooking or Baking of Bread, Pastries, Cakes, Cookies, Muffins or Donuts for sale (except at restaurant)
20. Cleaning and Roasting, and Blending, Grinding or packaging for sale of Coffee or the Production of Coffee Extract
21. Preparing Dry or Liquid Fertilizer for Sale
22. Producing, Processing and Packaging of Ice for wholesale distribution

### 23. Producing Mobile Telecommunication Services

#### **Franchise Tax - A Shorter List**

Although the Capital Stock Tax and the Franchise Tax are being phased-out, some companies still pay large amounts of tax. However, companies engaged in "manufacturing, processing, research or development" may lawfully avoid all or a significant proportion of the tax.

As under the Sales and Use Tax, the General Assembly also has statutorily established a "Processing" category including many activities. With some slight variations, these include the activities listed as numbers 1-17 and 20-22 under the above discussion of the Sales and Use Tax "processing" exclusion. In addition, for Capital Stock Tax and Franchise Tax purposes, "Processing" has been defined to include:

- Publishing of books, newspapers, magazines or other periodicals
- Blending, rectification, distillation or other production of alcohol or alcoholic liquors
- Salvaging, recycling or reclaiming of used materials to be recycled into a manufacturing process
- Development or substantial modification of computer software for sales to unrelated persons
- Refining, blasting, exploring, mining and quarrying or otherwise extracting limestone, sand, gravel or slag
- Cleaning, crushing, grinding, pulverizing, sizing or screening of limestone

#### **Local Business Privilege Taxes - Manufacturing, etc.**

The Local Tax Enabling Act provides broad taxing authority to municipalities and school districts outside of Philadelphia. However, the Act also provides fairly broad production-based exclusions limiting local business privilege and mercantile taxes levied on gross receipts.

Tax may not be collected on receipts from:

- Goods and articles manufactured in the political subdivision
- By-products of manufacture
- Minerals, timber and other natural resources produced in the political subdivision
- Farm products produced in the political subdivision
- Preparation or processing of minerals, timber, natural resources or farm products for use or market
- "Any privilege, act or transaction related to" the business of manufacturing, or to the production, preparation or processing of minerals, timber, natural resources or farm products

These exemptions may be claimed only by manufacturers, producers and farmers with respect to their own products. The Act also exempts receipts from:

- Any privilege, act or transaction relating to the processing of manufacturing by-products
- Transportation, loading, unloading or dumping or storage of goods, articles, products or by-products listed above

### **Real Property Tax - Industrial Establishments**

In Pennsylvania, *ad valorem* taxes are levied on real property by counties, school districts and municipalities. Exemptions, however, are governed by state law. These include:

- "Machinery, tools, appliances and other equipment" contained in any "mill, mine, manufactory or industrial establishment"
- Farm silos used for processing or storage of animal feed
- Farm grain bins or corn cribs used for processing or storage of animal feed
- Structures and containments used predominantly for processing and storage of animal waste
- Composting facilities incidental to farm operation
- Wind turbine generators and related appliances and equipment (including towers and foundations)

### **Not on the Exemption List?**

If you did not see an exemption category that applies to your business, but you think your business is just as worthy of exemption as many of the enumerated categories, what do you do? First, you should make sure your business really doesn't qualify for an existing exemption. The exemption terminology is not always straightforward and the interpretation of it is not always intuitive - we can assist you with these issues.

Second, if your company really does not qualify you may want to consider seeking a statutory amendment to exempt your type of activity. Again, we can advise you on the issues and hurdles one faces in seeking such exemptions. We have assisted a number of taxpayers in such efforts.

### **Qualify But Haven't Been Claiming Exemption?**

If you think your business might qualify for exemption but hasn't been claiming exemption, a refund claim may be in order. We can assist you in verifying your entitlement to exemption and can help you to document and file your refund claim.

## **LEGISLATIVE COMMITTEE ISSUES STUDY OF PENNSYLVANIA PROPERTY TAX ASSESSMENT SYSTEM**

by Randy L. Varner

After the Pennsylvania Supreme Court struck down Allegheny County's application of a "base year" property tax assessment system as unconstitutional in *Clifton v. Allegheny County*, 969 A.2d 1197 (Pa. 2009), the General Assembly responded by enacting House Resolution 334 of 2009, which required the Legislative Budget and Finance Committee ("Committee") to conduct a study of Pennsylvania's property tax assessment system and issue a report. The Committee now has completed its study and has released a 222-page report on Pennsylvania's property tax assessment system (the full report can be found at <http://lbfc.legis.state.pa.us>). While much of the report sets forth the obvious (e.g. that real property taxes are an important source of revenue for counties, municipalities and school districts), several interesting tidbits were presented. Among these are:

- 22 counties in the Commonwealth have not conducted an on-site inspection of all properties since at least the mid-1980s, and in fact, some counties have not conducted a countywide reassessment within the last 20 years (examples are Washington, Beaver, Crawford, Forest, Warren, Blair and Huntingdon);
- There are 5.89 million parcels in Pennsylvania;

- Countywide reassessments cost the counties about \$50 a parcel;
- Currently, based on the most recent tax revenues, only 12 of the 67 counties could actually generate additional revenues in the year following a reassessment in an amount that would cover the cost of the reassessment;
- Evidence suggests that conducting a countywide reassessment does not ensure that measures and standards related to level of assessment, uniformity and equity will be met;
- Issues arise when housing prices increase more rapidly than other economic indicators (i.e. household income), resulting in property tax burdens becoming a higher percentage of household expenses;

The report also presents several recommendations to improve the current system. These include the following recommendations:

- every county assessor should be certified, and be aware of the Pennsylvania Constitution's Uniformity Clause and its relevance to property tax valuation;
- the assessment laws should be consolidated;
- counties should be provided with the tools to assure quality of reassessments through (1) the development of uniform standards for reassessment contracting; (2) the creation of a state revolving loan program for counties with uniformity problems but without the financial resources to conduct a reassessment;
- counties should be required to publicly disclose key elements of the valuation and assessment methods in use;
- current county performance measures should be improved; and
- a self-evaluation tool should be developed to help counties determine when a reassessment is warranted.

Finally, the report offered the following options for major changes to the current system.

- Allow the state to become involved by establishing a state agency to value and assess all property, like the system in Maryland.
- Require school districts and other local governments to help counties fund reassessments, as is currently done in Ohio and West Virginia;
- Designate a portion of the state's realty transfer tax share as grants to counties to conduct reassessments;
- Amend the state constitution to allow for the following reforms:
  - provide caps on individual property tax increases following reassessment;
  - permit property (i.e. residential and commercial) to be treated as separate classes;
  - provide for partial reassessment or selective reassessment of areas of a county or classes of property;
  - provide for an "acquisition value" system of property valuation where a property's sales price would become the new base-year value.

We will continue to monitor any action by the General Assembly in the property tax arena. We do not foresee any drastic changes to the current system, although the recommendations set forth above with respect to helping counties finance reassessments and implement quality control measures, are likely to generate some support in the General Assembly. In any event, property owners should continue to remain vigilant about examining and evaluating their assessments yearly to make sure they are not carrying a higher tax burden than is appropriate. If you have any questions with respect to your



property assessment, please feel free to contact Randy Varner, [rvarner@mwn.com](mailto:rvarner@mwn.com), or any member of the McNees SALT team.

### **PA Sales & Use Tax Notes**

#### **PEO'S ADMINISTRATIVE SERVICE FEE NOT TAXABLE AS "HELP SUPPLY" SERVICE**

*by Sharon R. Paxton and James L. Fritz*

In *All Staffing, Inc. v. Commonwealth*, 325 F.R. 2006 (December 2, 2010), the Commonwealth Court upheld an earlier panel decision, ruling that administrative services performed by All Staffing, Inc., a professional employer organization ("PEO"), were not subject to Pennsylvania's sales tax as "help supply services."

All Staffing is a PEO, an entity that provides certain human resources-related services ("PEO Services") to clients by placing the clients' employees on its payroll. Although the clients retain control and direction over the day-to-day activities of the employees and make all hiring, firing, wage setting, disciplinary and other personnel decisions, All Staffing performs various PEO Services for its clients, including data processing services, human resources assistance, safety and risk management assistance, and maintenance of workers' and unemployment compensation accounts. The Commonwealth contended that, because All Staffing places all of a client's employees on its payroll, its business activities fall within the definition of "help supply services," and fees charged for the PEO Services are subject to sales tax. All Staffing argued that the sales tax statute imposes tax on a vendor's provision of "help" to its customers, and that it does not provide "help" (i.e., personnel) to any of its clients. The Commonwealth Court agreed with All Staffing's position that the PEO Services are not subject to sales tax because All Staffing does not supply new or additional workers to its clients.

The Commonwealth filed a Notice of Appeal to the Pennsylvania Supreme Court on December 30, 2010.

Following are notes of other recent Pennsylvania sales & use tax developments.

#### **Natural Gas Extraction**

The Department of Revenue has issued a ruling applying sales and use tax law to natural gas extraction activities. Equipment predominantly used directly in performance of fracturing services is exempt from tax under the mining exclusion. Materials (gases, sand, cement, etc.) predominantly used directly in fracturing services also are exempt. Fracturing services are not subject to tax as these services are directly used in mining. Equipment brought in for use in Pennsylvania qualifies for the isolated sales exemption as long as the sales are infrequent and nonrecurring. Vehicles and trailers registered under the International Registration Plan ("IRP") are subject to tax to the extent that they are required to be registered under 75 Pa. C.S. §§ 101-9909 (the "Vehicle Code"). *Ruling No. SUT-10-003, September 15, 2010.*

#### **Taxability of Web-Based Services**

Web-based services are not taxable if access to the software is solely through the Internet and the server or data center is not located in Pennsylvania. This rule applies to web-based services that enable subscribers to have remote computer access, attend and participate in meetings online, attend online webinars and provide attended or unattended technical computer support to their employees and external customers. If, however, a subscriber's access is evidenced by a "license to use" computer software applications, such charges are taxable when the software is hosted on a server in Pennsylvania. *Ruling No. SUT-10-005, issued November 8, 2010.*

### **Mere Use of Assets Does Not Create Bulk Sale Liability**

On November 17, 2010, the Pennsylvania Supreme Court affirmed, without opinion, the Commonwealth Court's June 6, 2009 decision in *Pizzutti, Inc. v. Commonwealth*. In that case, the court ruled that a taxpayer who merely using the assets of another taxpayer who was delinquent in the payment of sales tax did not trigger bulk sale liability. The Department of Revenue had taken the position that any "transfer" of assets, including a gift, can trigger bulk sale liability (responsibility for unpaid taxes of the transferor) under Section 1403 of the Fiscal Code. The Commonwealth Court disagreed, noting that Section 1403 authorizes the Department to pursue only the "purchaser" of assets for a bulk sale liability. The Court rejected the Department's argument that the term "purchaser" signifies any "recipient" of assets and held that the plain language of Section 1403 imposes a bulk sale liability for unpaid taxes of a seller or transferor only where the new owner of the transferred assets has acquired them by payment of consideration.

### **Local Hotel Occupancy Tax Inapplicable to State Employees**

Commonwealth employees are not subject to hotel occupancy taxes imposed by local govern-ments. Since the enabling statutes authorizing local jurisdictions to impose an occupancy tax do not contain an express authorization to tax the Commonwealth, the doctrine of Sovereign Immunity applies and local governments have no authority to collect hotel occupancy tax from Commonwealth employees while on official business. *Ruling No. SUT-10-004, issued October 20, 2010.*

### **PA Personal Income Tax Notes**

#### **PROHIBITION OF LOSS CARRYOVERS BY S CORPORATION SHAREHOLDERS CONSTITUTIONAL**

by Sharon R. Paxton and James L. Fritz

On November 18, 2010, a three-judge panel of the Commonwealth Court ruled, in *DelGaizo et al. v. Commonwealth*, Nos. 558 F.R. 2008 and 37 F.R. 2009, that Section 307.10(b) of the Tax Reform Code, 72 P.S. § 7307.10(b), does not violate the Uniformity Clause of the Pennsylvania Constitution. The taxpayers contended that Section 307.10(b) results in the non-uniform treatment of corporate shareholders because it prohibits the carryover of losses by shareholders of Pennsylvania S corporations while the carryover of losses by Pennsylvania C corporations is permitted under the Tax Reform Code.

The taxpayers argued that the statutory prohibition against the carryover of losses by shareholders of S corporations results in the taxation of nonexistent profits and that, since the payment of tax on non-existent profits is a burden only on S corporation shareholders, the statute violates the Uniformity Clause. In rejecting the taxpayers' arguments, the Court noted that there are legitimate distinctions between Pennsylvania S corporations and Pennsylvania C corporations and that S corporation shareholders cannot have the benefits of the S election (e.g., lower income tax rate) without the burdens. The Court also pointed out that the taxpayers had voluntarily chosen S corporation status for the corporation in which they have an ownership interest. The taxpayers filed Exceptions to the Court's panel decision on December 10, 2010.

Following are notes of other Personal Income Tax developments.

### **IRS Adjustments Provide Basis to Assess PA Tax**

The Commonwealth Court has refused to strike assessments of Pennsylvania Personal Income Tax that were based on information from the IRS concerning adjustments to the taxpayer's federal returns. The additions to income determined by the IRS were not reported on the PA returns. State tax had been withheld for which no income had been reported to the

state by the taxpayer. The taxpayer failed to offer any evidence to rebut the IRS adjustments or to explain why state tax had been withheld in error. *Basile v. Commonwealth, Nos. 258, 259, 260 F.R. 2006 (September 20, 2010)*.

### **Innocent Spouse Relief**

The Department of Revenue has adopted a regulation discussing procedures for electing, and the criteria to qualify for, Innocent Spouse Relief. The qualifying circumstances include when a joint return has under-reported tax, the understated income is attributable to the non-electing spouse and the electing spouse did not know or have reason to know of the understatement. *61 Pa. Code § 119.30, adopted Pa. Bulletin Vol. 40, p. 2361 (December 11, 2010)*.

### **PA Corporate Tax Notes**

#### **COMPUTATION OF INSURANCE RETALIATORY CHARGES**

*by Sharon R. Paxton and James L. Fritz*

In *Selective Way Insurance Co. v. Commonwealth*, No. 429 F.R. 2008 (November 30, 2010), the Commonwealth Court overruled Exceptions filed by the Commonwealth to its decision that the Pennsylvania Department of Revenue was required to apply the New Jersey premium cap (capping the amount of taxable premiums at 12.5% of worldwide premiums) when calculating the amount, if any, of Pennsylvania retaliatory charges to be paid by a New Jersey insurance company doing business in Pennsylvania. The Court determined that calculation of the retaliatory charge requires more than simply a comparison of New Jersey and Pennsylvania premiums tax rates. The Department must determine what amount of tax would be paid to New Jersey by a Pennsylvania insurance company doing the same amount of business in New Jersey that the New Jersey insurance company has done in Pennsylvania. By ignoring the New Jersey premium cap, the Department assessed a retaliatory charge on Selective Way "based on a fictional, much higher New Jersey premium tax than what a similarly-situated Pennsylvania company would actually pay in New Jersey."

Following are notes of other Pennsylvania corporate tax developments:

### **Gross Premiums Tax - Credit for Guaranty Association Assessments**

In *Allstate Life Insurance Co. v. Commonwealth*, 89 F.R. 1997 (October 15, 2010), a majority of the Commonwealth Court overruled Exceptions filed by the Commonwealth to its March 25, 2010 decision holding that the credit for guaranty association assessments must be computed separately for each assessment class and not on a consolidated basis for all types of covered policies. The Court also interpreted the "proportionate part factor" used to determine the proportion allowed to be credited for assessments in the annuity class to include annuity considerations in both the numerator and the denominator. Three judges dissented on the basis that, among other things, the legislative history did not support the granting of a tax credit for annuity assessments.

### **Calculation of Final Year KOZ Credit**

Tax benefits for Keystone Opportunity Zones, Keystone Opportunity Expansion Zones and Keystone Opportunity Improvement Zones began to expire in 2010. The effective date for expiration of benefits will be December 31st of the year in which they expire. Taxpayers with a tax year end of December 31st will be entitled to credit for the entire year. Taxpayers with a tax year ending on a date other than December 31st will be entitled to a credit based on activity in the subzone or expansion subzone from the beginning of their tax year to December 31st. Corporate Tax Bulletin No. 2010-01, August 25, 2010.

### **Restricted Tax Credits**

The Department of Revenue has reissued its bulletin regarding the application of restricted credits and the prerequisites for sale of tax credits. The bulletin applies to the following credits: R&D, Film Production, Neighborhood Assistance, Resource Enhancement and Protection, KIZ and AEP. All restricted credits are the first credits applied to an account. The bulletin provides many more guidelines and several Q&A's. *Corp Tax Bulletin 2008-02, reissued October 20, 2010.*

### **PA Property Tax Notes**

#### **MERE CONVEYANCE NOT JUSTIFICATION FOR REASSESSMENT**

*by Timothy J. Horstmann*

The Commonwealth Court has ruled that a reassessment issued following the purchase of a newly constructed home in a development constituted an impermissible "spot reassessment," in violation of the Fourth to Eighth Class County Assessment Law and the Uniformity Clause of the Pennsylvania Constitution. The County had originally valued the property, along with other properties in the development, at half the actual value, so as to reduce the tax burden of the developer. Upon the sale of each parcel in the development, the County would reassess at what it believed to be the actual value. As there was no division of the parcel or other change to affect the value of the land, there was no authority for reassessment. *Blazek v. Washington County Board of Assessment Appeals*, No. 16 C.D. 2010 (December 22, 2010) (see also *Brunetti v. Washington County Board of Assessment Appeals*, No. 15 C.D. 2010).

### **Charitable Exemption Effective Date**

The Pennsylvania Supreme Court has declined to hear an appeal from a decision of the Commonwealth Court, affirming a decision of the Court of Common Pleas determining that the effective date of tax-exempt status is the date upon which the property is acquired, and not the date of assessment. *In Re: Appeal of Jubilee Ministries International*, No. 438 WAL 2010.

### **Uniformity Remedy**

A taxpayer was not entitled to a reduction in his property's assessment that set the assessment at the base year value. The taxpayer had successfully shown that the current assessment violated the Uniformity Clause of the Pennsylvania Constitution, because other similar properties were assessed at values substantially less. Nevertheless, the requested relief - a reassessment at the base year valuation - would only exacerbate the lack of Uniformity in assessed values in the district. The proper remedy afforded to the taxpayer was a reduction in the assessed value of the property to conform to the common level existing in the district. *Smith v. Carbon County Board of Assessment Appeals*, No. 1205 C.D. 2009 (December 7, 2010).

### **Alternative Energy & Gas Drilling in Clean and Green**

Act 88 of 2010 amends the Pennsylvania Farmland and Forest Land Assessment Act of 1974 to permit property owners to develop alternative energy systems on tracts of land with preferential assessments under the Act. The property owner must utilize a majority of the energy produced on the tract, and must otherwise continue to meet the requirements for a preferential assessment under the Act. Act 88 also provides property owners with the ability to lease or otherwise devote such tracts for exploration and removal of gas and oil. While the land actually used for exploration and removal shall be subject to roll back taxes, subsurface collection and transmission lines are exempt. Act No. 88 of 2010, S.B. 298 (effective December 27, 2010).



### **Charter School Exemptions**

Act 104 provides that school property owned by charter schools shall be exempt from real property tax. The exemption applies to school property of charter schools, cyber charter schools, and associated nonprofit foundations. Additionally, school property owned by other nonprofit entities and leased at or below fair market value to a charter school or cyber charter school shall also be exempt. Finally, Act 104 declares that any agreement entered into before December 31, 2009, by a charter school or similar entity to make payments in lieu of taxes, shall be null and void. *Act No. 104 of 2010, H.B. 101* (effective January 17, 2011).

### **Wind Energy in Clean and Green**

Act 109 also amends the Pennsylvania Farmland and Forest Land Assessment Act of 1974, this time to permit property owners to construct wind power generation systems on tracts of land entitled to preferential assessment. While the portion of the tract used for the wind power generation system will be subject to roll back taxes, the remainder of the tract shall retain the preferential assessment, provided it continues to meet the requirements of the Act. *Act No. 109 of 2010, H.B. 1394* (effective November 23, 2010).

### **RETAILERS TO COLLECT 911 FEE ON PREPAID CELL PHONE SERVICE**

by James L. Fritz

Under Act 118 of 2010, signed by Governor Rendell on November 23rd, vendors of prepaid cellular phone service will have to begin collecting a "prepaid Wireless E-911 Surcharge," effective July 1, 2011. The surcharge is established at "\$1 per retail transaction" and will be adjusted if and when the standard wireless E-911 surcharge is changed.

The seller must collect the new surcharge from the consumer "for each retail transaction occurring in this Commonwealth." The surcharge must either be separately-stated on the invoice or otherwise disclosed to the consumer. Transactions not occurring at a Pennsylvania business location of the seller will be sourced on the basis of applicable sales and use tax rules. The surcharge will not be included in calculating sales tax or any other state or local tax. Vendors will be required to remit the collected surcharges to the Pennsylvania Department of Revenue on the same schedule as sales and use taxes. Assessment, audit, appeal, collection and enforcement procedures also are adopted from the sales and use tax statute.

During the first 180 days after the effective date of the Prepaid Wireless E-911 surcharge, a seller may retain 35% of collections as compensation for direct start-up costs. Subsequently, sellers will be entitled to retain "up to 3% ... for administrative purposes."

Sellers of prepaid cellular service should watch for further guidance to be issued by the Department of Revenue.

### **LOCAL TAX DEVELOPMENTS**

by James L. Fritz and *Timothy J. Horstmann*

#### **"All Power Is Inherent in the People," BUT**

In a recent case most interesting for its discussion of political powers "inherent in the people," the Commonwealth Court has upheld an *en banc* Lebanon County Court of Common Pleas decision invalidating the tax referendum requirement in the

City of Lebanon's Home Rule Charter. The City had filed an action to invalidate the Charter provisions requiring a public referendum on any real estate tax increase of more than two mills. The Commonwealth Court agreed with the court below that the provision violated 53 Pa. C.S. § 2962(b) which "states that in home rule municipalities, the 'governing body shall not be subject to any limitation on the rates of taxation imposed upon residents.'"

The court rejected a taxpayer argument that the decision below violated Article I, Section 2 of the Pennsylvania Constitution, which provides:

### **Political Powers**

#### **Section 2**

All power is inherent in the people, and all free governments are founded on their authority and instituted for their peace, safety and happiness. For the advancement of these ends they have at all times an inalienable and indefeasible right to alter, reform or abolish their government in such manner as they may think proper.

The court noted that this provision:

has never been applied to Home Rule Charters, or municipal government generally. Article I, Section 2 has been applied only in the context of statewide governmental questions, such as the procedure for amending the Pennsylvania Constitution. See, e.g., *Com. v. Tharp*, 562 Pa. 231, 754 A.2d 1251 (2000). Even more fundamentally, a constitutional provision granting rights to "the people" does not eviscerate the laws setting forth the procedures by which the citizens may exercise those rights. The people act through the laws passed by their representatives in the General Assembly as well as through local enactments, and under our existing structure of government, a local municipality simply may not override affirmative State law.

In re: City of Lebanon Home Rule Charter, Dkt. No. 364 C.D. 2010, 9/1/2010.

Following are notes of other PA local tax developments.

### **Distinction Between Earned & Unearned Income Constitutional**

The Earned Income Tax law's classification of earned income as taxable and unearned income as not taxable does not violate the Uniformity Clause of the Pennsylvania Constitution. This distinction is based upon a reasonable classification of those taxpayers engaged in performing services, and those taxpayers merely receiving income from passive activities, such as the ownership of property, and such a classification does not violate the Uniformity Clause. *Boguslavsky v. North Pocono School District*, No. 1139 C.D. 2010 (December 16, 2010).

### **Other PA Tax Notes**

#### **2011 Interest Rate**

For 2011, the interest rate for underpayments of PA taxes is 3%. The same rate will be paid on Personal Income Tax refunds. Refunds of other taxes will accrue interest at 1%. *Pa. Bulletin Vol. 40, December 25, 2010.*

#### **2011 PURTA Surcharge Rate**

The Public Utility Realty Tax surcharge rate for 2011 is 1.6 mills. *Pa. Bulletin Vol. 40, p. 2419.*

### **2011 Fuel Tax Rates**

For 2011 the Pennsylvania tax rate for aviation gasoline is increased to 5.5¢ per gallon; jet fuel is increased to 1.7¢ per gallon. The 2011 rate for the Oil Company Franchise Tax remains at 19.2¢ per gallon on "liquid fuels" (gasoline) and 26.1¢ per gallon on "fuels" (diesel). Per gallon rates for alternative fuels: Ethanol (20.8¢), Methanol (15.4¢), Propane/LPG (22.8¢), E-85 (21.9¢), M-85 (17.8¢), CNG (7.9¢), LNG (18.2¢). Electricity as a fuel is taxed at 0.93¢ per kwtt. *Pa. Bulletin Vol. 40, p. 2377.*

### **Inheritance Tax - Annuity Not Exempt As Life Insurance**

An investment product characterized as an "annuity" by the provider was not exempt from Inheritance Tax as life insurance when it allowed for regular payments to the annuitant and did not involve any element of risk on the part of the provider. The terms of the investment product provided for an initial lump sum premium deposit, and a guaranteed effective interest rate. The purchaser had an unlimited right to withdraw income after the first 30 days and to withdraw up to 15% of the total value of the annuity annually without penalty. Although the purchaser died without receiving any distributions, the policy was more akin to an annuity than to life insurance because the purchaser possessed the right to receive payments of principal and income up to the maximum amounts provided for in the agreement. *Ruling No. INH-10-002, issued July 15, 2010.*

### **Realty Transfer Tax - Purchase of Leasehold and Underlying Property**

Tax applies to the entire purchase price where the purchaser is buying real estate subject to a short-term master lease and option to buy held by a related entity, and is simultaneously buying out the lessee. The purchaser may not exclude the purchase price allocated to the master lease and related option to buy. Because of the relationship between the lessor and lessee, the purchase is viewed as a single transaction. *Ruling No. RTT-10-003 (November 10, 2010).*

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