PA Budget Inching Forward

By James L. Fritz

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While Commonwealth revenue collections continue to come up short of projection for the current year (General Fund $720 million short of target through March) and it is almost universally acknowledged that pension fund shortfalls will present a major financial problem for the Commonwealth in Fiscal 2011-2012, there seems to be little interest in voting for tax increases in what is an election year for most Pennsylvania legislators.

Sales & Use Tax Expansion

On March 23rd, the Pennsylvania House, by a 107-89 vote, adopted a 2010-2011 General Fund budget similar to the Governor's February budget proposal and sent it to the Senate. This, however, did not include Governor Rendell's proposal to reduce the sales tax rate from 6% to 4%, but broaden the tax base to produce a net tax increase of more than half a billion dollars. In fact, the House also did not vote on any of the other tax increases and changes proposed by the Governor - including combined reporting of Corporate Net Income Tax, a natural gas severance tax, elimination of the sales tax vendors' allowance and expansion of tobacco taxes to cover cigars and smokeless tobacco.

At this point, most observers see little likelihood that the Governor's sales tax proposal will be adopted this year. This has been the case since the Governor's February budget address. In the Senate where Republicans are in firm control, leaders immediately called the Governor's sales and use tax proposal "dead on arrival." The Governor's sales and use tax proposal would expand the tax base to include nearly all services and eliminate 74 categories of tax exemptions. It would retain consumer exemptions for food, clothing and prescription medicines and business exclusions for manufacturing and processing machinery and equipment. The services to become subject to tax under the Governor's proposal would include:

- Accounting, auditing and bookkeeping services
- Administrative services
- Advertising, public relations & related services
- Air transportation
- All other professional and technical services
- Architectural, engineering & related services
- Consulting (scientific, environmental & technical)
- Custom computer programming, design and data processing
- Electrical, plumbing, heating & air conditioning maintenance
- Information services
- Legal services
- Transportation services
- Scientific research & development services
- Specialized design services
- Waste management and remediation
- Water and sewage services

Among the exemptions directly impacting the business community that would be eliminated are:

- Bad debts
- Catalogs and direct mail advertising materials
- Charges for returnable containers
- Common carrier equipment
- Public utility equipment and supplies
- Rail transportation equipment
- Wrapping and packaging supplies

The Governor's proposal seems to have the potential to greatly increase "tax pyramiding" - tax would be imposed on numerous business inputs, and again when the company's products are sold. In industries which are not vertically integrated and have a chain of companies providing intermediate services and products, there is a particularly great risk of imbedding multiple layers of tax in the final cost of product. Smaller companies which must purchase multiple services which they cannot produce in-house would also be particularly affected. And, as there has been no mention of an inter company exemption, additional tax would be imposed on services rendered by related companies. Even with the lower rate, it seems likely that many industries could find themselves bearing higher total tax burdens.

In proposing to lower the rate and broaden the sales and use tax base, the Democrat Governor seems to have borrowed from proposals advanced by Republican Sam Rohrer, who is now opposing Attorney General Tom Corbett for the Republican gubernatorial nomination. Although Rohrer would use additional revenues to replace school real estate taxes, Governor Rendell proposes to put the additional revenue collected in FY 2010-11 into a new "Stimulus Transition Reserve Fund," which would be tapped to replace federal stimulus funding that has shored up the 2009-10 budget and will provide Pennsylvania with approximately $2.8 billion in FY 2010-11. Only $500 million of stimulus funding will be available in FY 2011-12.

The most serious effect of the Governor's sales tax proposal may be to give legislators ideas for next year when Pennsylvania faces a huge pension funding shortfall, which it must start to pay off in FY 2011-12.

Combined Reporting; Single Sales Factor; Removing NOL Cap
Unless there is a quick sea-change from last year's budget debate, the Governor's resurrected proposal to move from separate company reporting to combined reporting for Corporate Net Income Tax purposes would also seem to have toughsledding ahead. While past proposals would have substantially reduced the rate in conjunction with combined reporting, this time the Governor has proposed only a one percent reduction, from 9.99% to 8.99%. The proposal does appear to have some support on the Governor's side of the aisle.

In conjunction with combined reporting, the Governor proposes to eliminate the use of property and payroll factors for apportionment and move to a "single sales factor." On a standalone basis, this proposal has had substantial business support, and the Commonwealth has made several increases in the weighting of the sales factor over recent years. It will be interesting to see whether the Governor's opponents will seek to sever this part of the Governor's proposal and incorporate it into the final budget on a standalone basis.

The same could be said for the Governor's proposal to lift the current cap on net operating loss carryforwards. The Governor would lift the cap prospectively and retain the current $3 million or 20% cap for prior year losses.

The Governor's budget proposals indicate that these Corporate Net Income Tax changes, taken as a whole, would generate in excess of $70 million in additional annual state revenue. Additional revenue generated in FY 2010-11 would be added to the "Stimulus Transition Reserve Fund."

Natural Gas Severance Tax
There seems to be substantial debate over the Governor's proposal for a natural gas severance tax. Many other states impose a severance tax on natural gas. With the Marcellus Shale formation underlying a large part of the Commonwealth, many see a golden opportunity to generate revenues to deal with current and future revenue shortfalls.

Cigars & Smokeless Tobacco
Pennsylvania apparently is the only state in the Union that does not tax cigars and smokeless tobacco. The Governor's budget documents claim that in public polling, 90 percent of the public supports taxing these products. Southcentral PA Tobacco farmers and their allies, however, have been successful in the past in opposing this tax.

Wither and When?
It is difficult to believe that Pennsylvania's General Assembly will vote for any general tax increase in an election year. Facing a substantial revenue shortfall in the current fiscal year and with fiscal storm clouds on the horizon, however, we would not be surprised to see some narrow "adjustments" in Pennsylvania's tax system, in conjunction with this year's budget. Will that be resolved by June 30th? Your bet is as good as ours!

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