PICPA
Pennsylvania Institute of CPAs

June 20, 2024

Via electronic mail: mariamil@pa.gov
Maria L. Miller
Office of Chief Counsel
Department of Revenue
Dept. 281061
Harrisburg, PA 17128-1061

Re: Comments on Proposed Regulation #15-462, Business and Nonbusiness Income

Dear Ms. Miller,

On behalf of the Pennsylvania Institute of Certified Public Accountants' (PICPA) State Taxation Steering Committee, we greatly appreciate the opportunity to provide comments to the Independent Regulatory Review Commission (IRRC) on the proposed business/nonbusiness income regulations. The PICPA is a professional CPA association of about 20,000 members working to improve the profession and serve the public interest in Pennsylvania. Founded in 1897, the PICPA is the second-oldest CPA organization in the United States, as well as one of the largest. Membership includes practitioners in public accounting, education, government, and industry.

Overview

In reviewing the proposed regulations, our major concerns are that certain provisions are inconsistent with Pennsylvania's corporate net income tax (CNIT) statute and case law and that the proposed regulations need to provide additional guidance in certain other areas.

Business Income vs. Apportionable Income – Certain provisions of the *Multistate Tax Commission Model General Allocation and Apportionment Regulations* (MTC regulations) incorporated into the proposed regulation do not account for the differences between the definition of "business income" in the CNIT statute and case law and the definition of "apportionable income" in the MTC regulations.

The proposed regulations incorporate many of the allocable/apportionable income provisions in the MTC regulations. The Department of Revenue's (DOR's) reliance on MTC regulations appears to be a change in its view of MTC guidance, possibly resulting from Pennsylvania joining the MTC Joint Audit Program. Adding to this supposition is the comment contained in the proposed regulation's preamble: "To promote consistent treatment with other states, the majority of the proposed language for this regulation mirrors the rules of the MTC on 'Apportionable and Nonapportionable Income.'"

The DOR's efforts to promote state uniformity through the adoption of MTC regulations are commendable, but the proposed regulation fails to take into consideration very important differences between the definition of "business income" in Pennsylvania's CNIT statute and "apportionable income" in the MTC regulations. Incorporating provisions of the MTC regulations without taking into account those differences violates the General Assembly's authorization of the DOR "to prescribe, adopt, promulgate, and enforce rules and regulations, not inconsistent with this article, relating to any matter or thing pertaining to the administration and enforcement of the provisions of this article, and the collection of taxes, penalties, and interest imposed by this article." (72 P.S. Section 7408.) For example, the proposed regulation incorporates the MTC "functional test" in two of the examples, but they are not consistent with the CNIT functional test for determining business income.

Undermining Judicial Precedents – The proposed regulation would impermissibly reverse the judicially created multiform business/unrelated asset doctrine through administrative action. Only the General Assembly or the courts have the authority to reverse this judicially created doctrine.

The multiform business/unrelated asset doctrine is effectively a unitary business test that the Pennsylvania courts adopted "to avoid an unconstitutional application of an otherwise constitutional state statute to an out of state corporation." (*Commonwealth v. Sterling*, 40 Pa. D. and C.2d 669, 674 (C.P. 1966)) The constitutional theory of multiformity provides that a state may not tax value earned outside its borders unless there is "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." (*Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45, 74 S. Ct. 535, 98 L. Ed. 744 (1954)." *RB Alden Corp. v. Commonwealth*, 142 A. 3d 169,177 (Pa. Commw. Ct. 2016))

In *Commonwealth v. ACF Industries Inc.* (441 Pa. 129 (1970)) the Supreme Court of Pennsylvania adopted a three-factor test for purposes of determining whether multiform business/unrelated asset treatment is appropriate. The relevant factors to consider are as follows:

> First, … some or all the business operations outside Pennsylvania are independent of and do not contribute to the business within the state.
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> Second, … we must focus on the relationship between the Pennsylvania activity and the outside one, not the common relationships between these and the central corporate structure. Only if the impact of the latter in the operating units or activities is so pervasive as to negate any claim that they function independently from each other do we deny exclusion in this context.
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> Third, … a truly divisionalized business, conducting disparate activities with each division internally integrated with respect to manufacturing and selling, may be in a position to make a valid claim for exclusion.
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> *(ACF Industries*, 441 Pa. at 142 -- 143.)

The multiform business/unrelated asset doctrine focuses on the operational relationship between the business or the asset to determine whether income constitutes business income from a unitary business. Under this doctrine, there must be an operational connection between income earned and a corporate taxpayer's business activities within the Commonwealth. Although a taxpayer may engage in a unitary business, the income of that unitary business still must have a connection with the Commonwealth of Pennsylvania to constitute apportionable business income.

In the preamble, the DOR erroneously states that the multiform business/unrelated asset doctrine is no longer viable after the amendment of the definitions of "business income" and "nonbusiness income" in 2001. The DOR dismisses that the Supreme Court of Pennsylvania has affirmed the viability of the multiform business/unrelated asset doctrine after the CNIT law change in 2001 that added to the definition of business income "all income which is apportionable under the Constitution of the United States." In fact, Commonwealth Court refused the DOR's request to declare the multiform business/unrelated asset doctrine no longer viable.

In *RB Alden Corp. v. Commonwealth* (142 A. 3d 169,172 (Pa. Commw. Ct. 2016) (n. 9)), the court states:

> The Commonwealth argues that the multiformity or unrelated assets doctrines are antiquated and no longer apply as they were developed out of 1930-40s era Pennsylvania case law attempting to apply the Due Process and Commerce Clauses of the United States Constitution to the Pennsylvania foreign franchise tax. The Commonwealth maintains that *ACF Industries'* holding as it relates to the multiformity or unrelated assets doctrines is

> inapplicable in this case because *ACF Industries* was decided before the Code was enacted and, instead, it interpreted a 1965 amendment to a 1935 statute, which has long been repealed. The Commonwealth argues that although some of the *ACF Industries'* era analysis may be similar, it does not control the interpretation of the current Pennsylvania definition of business and nonbusiness income adopted by our legislature. Although the Commonwealth is correct in that *ACF Industries* analyzed a statute that is not relevant to this case and that it was decided before the Code was even enacted, this Court, in *Glatfelter I* and the Supreme Court in *Glatfelter II*, used *ACF Industries* in determining whether the multiformity or unrelated assets doctrines apply, even after the definition of "business income" was amended in 2001.
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> *See also, Glatfelter Pulpwood Co. v. Commonwealth*, 19 A.3d 572 (Pa. Commw. Ct. 2011), aff'd, 619 Pa. 243, 61 A.3d 993 (2013).

Although the Pennsylvania courts refer to U.S. Supreme Court decisions in determining whether income is apportionable business income, the Pennsylvania courts have not rejected the multiform business/unrelated asset doctrine for purposes of determining what income is apportionable under their interpretation of the U.S. Constitution.

Until the General Assembly or the courts reject the multiform business/unrelated asset business doctrine, the doctrine is still valid law. Unfortunately, the proposed regulation does not address this doctrine and how it relates to "business income." Arguably, income that is not taxable under the multiform business/unrelated asset doctrine also would not be "apportionable under the Constitution of the United States."

The multiform business/unrelated asset doctrine was born out of constitutional principles. However, the analysis that the Pennsylvania courts have applied for determining what constitutes a multiform business or unrelated asset is not exactly the same as the analysis that the U.S. Supreme Court has applied to the court's apportionable income cases. The Pennsylvania courts have placed more weight on certain factors, and less weight on other factors. In addition, the Pennsylvania courts have addressed the issue of when certain divisions within a corporation are engaging in separate businesses. The proposed regulation needs to address this difference. The reference to "as applied by the United States Supreme Court" in the definition of "trade or business" in 61 Pa. Code Section 153.24a(a) would impermissibly disregard the Pennsylvania court multiform business/unrelated asset decisions.

Additional Considerations that the Regulations Need to Address

- Specific rules and procedures as to what documentation a corporate taxpayer needs to provide with its tax report to support a claim for nonbusiness income. Under its current policy, the DOR summarily denies nonbusiness income treatment on desk review/audit and at the Board of Appeals. The statutory definition of "business income" includes "all income which is apportionable under the Constitution of the United States." (72 P.S. Sectoin 7401(3)2.(a)(1)(A)) Currently, neither the Board of Appeals nor the Board of Finance and Revenue have the authority to address constitutional issues. Technically, neither administrative appeals board will have the authority to address business/nonbusiness income cases. Almost every business/nonbusiness income case ends up in Commonwealth Court unless it is otherwise compromised at the administrative appeal levels. The DOR's policy is inconsistent with good tax policy and its own mission statement to "fairly, efficiently, and accurately administer the tax laws."
- The final regulation must provide formal procedures for obtaining nonbusiness income treatment at the time a tax report is filed. Currently, a corporate taxpayer claiming nonbusiness income is required to complete and file a REV-934 and provide the information requested on the form. Even if a taxpayer complies with the requirements, the DOR denies nonbusiness income treatment. The final regulation shall

prohibit the DOR from summarily denying nonbusiness income treatment if a corporate taxpayer provides the information requested on the REV-934. If a taxpayer provides the requested documentation, the DOR must provide a detailed explanation for denying nonbusiness income treatment.

- Guidance for determining when the income from a partnership constitutes business income to a corporate partner. Instances when a corporate partner's distributive share of partnership income and gain/loss on the sale of an interest in a partnership constitute business/nonbusiness income.

  The regulations provide:

  > Income arising from transactions and activity in the regular course of the taxpayer's trade or business constitutes business income. The determination of whether a corporate partner's distributive share of partnership income is business income depends upon whether the income arose in the regular course of the taxpayer's trade or business, determined in accordance with Section 153.24 (reserved). The taxpayer's trade or business shall include activities performed in partnership. (61 Pa. Code § 153.29(c)(1))

  However, the regulations do not provide any additional guidance on how to determine under what circumstances a corporate partner and a partnership are engaging in a unitary business. Historically, the DOR has treated all income that a corporate partner receives from a pass-through entity as business income. In most instances, a corporate partner contesting the business income classification of income from a partnership has to go to Commonwealth Court for relief. Many states have addressed this issue either by statute or regulations. Addressing this issue in the proposed regulation will promote the fair, efficient, and accurate administration of the tax laws.

The PICPA strongly recommends that IRRC reject the proposed regulation in its current form. In addition, it is important that the DOR commit to following any regulations that are adopted. Otherwise, the DOR's effort will not promote the efficient administration of the CNIT statute.

Specific Comments

The DOR's incorporation of certain provisions of the MTC regulations into proposed business/nonbusiness regulations is not consistent with the CNIT statute, regulations, and case law.

- The definition of "trade or business" in the proposed regulations would impermissibly include all transactions and activity of a unitary business, including those with no connection with Pennsylvania (61 Pa. Code Section 153.24a(a)). The proposed regulation defines "trade or business" to include "all transactions and activity that are included in the unitary business of the taxpayer under the unitary business principle as applied by the U.S. Supreme Court." This definition differs from the definition of that term in the model MTC regulations. The MTC regulations define "trade or business" as "the unitary business of the taxpayer, part of which is conducted within [this state]."

The proposed definition of "trade or business" effectively reverses the judicially adopted multiform business/unrelated business doctrines that the Pennsylvania Supreme Court and Commonwealth Court held to be viable after the 2001 law change in *Glatfelter Pulpwood Co. v. Commonwealth* (19 A.3d 572 (Pa. Commw. Ct. 2011), aff'd, 619 Pa. 243, 61 A.3d 993 (2013)) and *RB Alden Corp. v. Commonwealth* (142 A. 3d 169, 172 (Pa. Commw. Ct. 2017) (n. 9)). The DOR cannot repeal through regulation the multiform business/unrelated asset doctrines that the Pennsylvania courts continue to uphold. For uniformity purposes, the proposed regulation should substitute the phrase "under the unitary business principle as applied by the U.S. Supreme Court" with the MTC language, "part of which is conducted within [this state]."

- Transactional test (61 Pa. Code Section 153.24a(c)): Reading Subsection (c)(1) together with the proposed definition of "trade or business" in 61 Pa. Code Section 153.24a(a) would result in the taxation of all transactions of a unitary business "in the regular course of the taxpayer's trade or business," whether that particular business or transaction has any connection with the Commonwealth. This provision would impermissibly repeal the multiform business/unrelated asset doctrine and, more importantly, violate the U.S. Constitution, which requires a connection between the income-producing activity and the Commonwealth. As the court stated in *Glatfelter Pulpwood Co. v. Commonwealth (61 A.3d 993, 1008 (Pa. 2013),* "Under both the Due Process and the Commerce Clauses of the [United States] Constitution, a state may not, when imposing an income-based tax, tax value earned outside its borders." (*Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 164, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983); see also *Allfirst Bank v. Commonwealth*, 593 Pa. 631, 933 A.2d 75, 77 n. 4 (2007), "[U]nder the Commerce and Due Process Clauses of the U.S. Constitution, states may only impose taxes on value attributable to in-state business activity.")

To satisfy the transactional test and give rise to business income, the transaction must occur in connection with a corporate taxpayer's unitary business being conducted in Pennsylvania.

In subsection (c)(2), the DOR incorporates the language of the MTC regulations with the exception of the phrasing, "However, even if a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer's mere financial betterment rather than for operations of the trade or business, such activities do not satisfy the transactional test." This provision should be added to provide corporate taxpayers with more guidance as to when investment activities constitute business income.

- Functional test (61 Pa. Code Section 153.24(a)(d)): Two examples in the proposed regulation that incorporate MTC regulations impermissibly use the "related to" standard, although the CNIT statute still requires that the "the acquisition, the management, or the disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations."
    - Section 153.24a.(d)(4) - Example 1: The conclusion that the income from the sale of five stores that were never integrated into the taxpayer's trade or business constituted business income "because the property's acquisition was *related* to the taxpayer's trade or business" does not reflect the CNIT functional test. Under the CNIT functional test, the income would not be business income because the property's acquisition of the five stores was not *"an integral part of"* the taxpayer's regular trade or business. In addition, the example would not constitute business income under *Allied-Signal Inc. v. Director, Division of Taxation* (504 U.S. 768 (1992)).
    - Section 153.24a.(d)(4)(ii): The provision providing that income from infrequent sales is business income if the property is or was *related* to the taxpayer's trade or business is inconsistent with the CNIT statute that requires that the property be an *integral* part of the taxpayer's trade or business. Reading subsection (d), including certain examples, together with the proposed definition of "trade or business" in 61 Pa. Code Section 153.24a(a) would result in the taxation of all transactions of a unitary business "in the regular course of the taxpayer's trade or business," whether that particular business or transaction has any connection with the Commonwealth. This provision would attempt to impermissibly repeal the multiform business/unrelated asset doctrines and violate the U.S. Constitution. To satisfy the functional test and give rise to business income, the transaction must occur in connection with a corporate taxpayer's unitary business being conducted in Pennsylvania. In fact, the multiform business/unrelated assets doctrine must be incorporated into the proposed regulations to make it clear that these concepts are still viable in Pennsylvania.
- 61 Pa. Code Section 153.24a(f)(4) (Commonly controlled group of entities): In determining a commonly controlled group of entities, the different treatment of general and limited partners is inconsistent with the

provisions of 72 P.S. Section 7402.2. In addition, the provisions do not address certain entities formed as business trusts, e.g., RICs and REITs, that are not treated as corporations for CNIT purposes.

- 61 Pa. Code Section 153.24a(g)(3) (Interest): The DOR should incorporate Example (vi) in the MTC regulations to provide additional guidance as to what interest income constitutes nonbusiness income.
- 61 Pa. Code Section 153.24a(g)(4) (Dividends): The DOR should incorporate the MTC regulations addressing the business/nonbusiness income treatment of dividends. In certain instances, corporate taxpayers are required to include dividends in their tax base.
- 61 Pa. Code Section 153.24a(g)(5) (Patents and Copyright Royalties): This provision is not based upon the functional test as embodied in the CNIT definition of "business income" in 72 P.S. Section 7401(3)2.(a)(1)(A). The royalties would not constitute business income if the patents have no connection with the taxpayer's trade or business in the Commonwealth, e.g., if the patents only are used to manufacture products only used in foreign countries. In addition, under the multiform business/unrelated asset doctrine, the royalties received in Example 1 may constitute nonbusiness income, if the underlying patents have no connection with the taxpayer's trade or business in Pennsylvania.
- 61 Pa. Code Section 153.24a(h)(2) (State-to-State Consistency): This does not account for the instance that not all state and local jurisdictions adopt the same definitions or "business income" and "nonbusiness income" or interpretations of those terms. The proposed reporting requirements are burdensome, and treatment in other states may not have any impact on how items of income are classified for CNIT purposes.
- Other Item (Treatment of Corporate Partners): The DOR's recognition of the unitary business concept presents the perfect opportunity to address the corporate partner issue. The regulations should contain provisions addressing the instances when a corporate partner would be permitted to treat its distributive share of income from a nonunitary partnership as allocable nonbusiness income. Previous drafts of proposed corporate partner legislation could serve as the basis for regulatory guidance.

Thank you for the opportunity to review and provide comments on the proposed business/nonbusiness income regulations. As always, the PICPA welcomes the opportunity to meet with you to discuss our comments in more detail.

Sincerely,

Peter N. Calcara, CAE
Vice President, Government Relations

cc: Independent Regulatory Review Commission