

Comments of the Independent Regulatory Review Commission



Department of Revenue Regulation #15-462 (IRRC #3402)

Business Income and Nonbusiness Income

July 24, 2024

We submit for your consideration the following comments on the proposed rulemaking published in the May 25, 2024 *Pennsylvania Bulletin*. Our comments are based on criteria in Section 5.2 of the Regulatory Review Act (RRA)(71 P.S. § 745.5b). Section 5.1(a) of the RRA (71 P.S. § 745.5a(a)) directs the Department of Revenue (Department) to respond to all comments received from us or any other source.

1. Whether the agency has the authority to promulgate the regulation; Whether the regulation conforms to the intention of the General Assembly in the enactment of the statute upon which the regulation is based; Implementation procedures.

The Preamble to this proposal states the following:

The purpose of this proposed rulemaking is to add § 153.24a regarding business income and nonbusiness income due to legislative changes and the further development of the unitary business principle of the United States Constitution in case law.

We have two concerns related to the criteria cited above. First, Senator Scott Hutchinson, Chairman of the Senate Finance Committee, and Representative Keith Greiner, Minority Chairman of the House Finance Committee, have submitted comments in opposition to the rulemaking. Both legislators believe the proposal is inconsistent with statutes upon which it is based. In his comments, Senator Hutchinson stated, “For example, the allocable/apportionable income provisions contained in this proposal differ from and are inconsistent with the definition of ‘business income’ found in Pennsylvania’s Corporate Net Income Tax statute, a clear administrative overreach and undermining of the General Assembly’s exclusive legislative power.” Representative Greiner’s comments stated, “I believe that this proposal goes far beyond the department’s statutory authority and attempts to give the department powers that allow it to assess business taxes in a manner consistent with combined reporting methodologies, something that has never been authorized by the General Assembly.” The legislators also believe the proposal is contradictory to longstanding legal precedent and doctrine adopted by the Pennsylvania Supreme Court.

In order to determine if a regulation conforms to the intention of the General Assembly in the enactment of a statute upon which it is based, this Commission is guided by Section 5.2(a) of the RRA. It states, in part, the following: “In making its determination, the commission shall

consider written comments submitted by the committees and current members of the General Assembly, pertinent opinions of Pennsylvania’s courts and formal opinions of the Attorney General.”

In light of these comments, we ask the Department to address the concerns raised by the legislators and to explain if the “legislative changes and the further development of the unitary business principle of the United States Constitution in case law” change the manner in which the corporate net income tax (CNIT) is imposed.

Second, the Department states in the Preamble that the majority of the proposed language for this regulation mirrors the *Model General Allocation and Apportionment Regulations (Model)* of the Multistate Tax Commission. It explains this approach has been taken to promote consistent treatment with other states. We believe that consistency of tax rules between states will benefit Pennsylvania-based taxpayers operating in multiple jurisdictions. However, as illustrated below, the verbatim use of language from the *Model* is problematic because that language deviates from the standards established by the *Pennsylvania Code and Bulletin Style Manual*.

The proposal contains numerous provisions from the *Model* that could be described as informative rather than regulatory. Regulations establish binding norms between the regulated community and the governmental agency imposing the regulation. Informative or illustrative language should not be included in a regulation. Two examples of informative provisions are quoted below:

From § 153.24a(c)(4):

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, rents, royalties, gains, income derived from accounts receivable, operating income, non-operating income, and the like, is of no aid in determining whether income is business or nonbusiness income.

From § 153.24a(e)(2)(i):

A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980): functional integration, centralization of management and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. Facts suggesting the presence of the previously mentioned factors should be analyzed in combination for their cumulative effect and not in isolation. A particular business operation may be suggestive of one or more of the previously mentioned factors.

In addition, the proposal contains 23 examples that provide guidance on whether a business activity generates business income or nonbusiness income. Below is a sampling of such examples:

From § 153.24a(f):

(f) *Examples of business income and nonbusiness income.* The examples used in these regulations are illustrative only and are limited to the facts they contain.

(1) *Rents from real and tangible personal property.*

Example 1: The taxpayer operates a multistate car rental business. The income from car rentals is business income.

Example 2: The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

We acknowledge that the regulated community could benefit from the informative and illustrative language included in this proposal. However, we question if this unique type of regulatory language is consistent with the intent of the General Assembly when it granted the Department general rulemaking authority under Part V of the Tax Reform Code of 1971 (72 P.S. § 7408(a)). If the Department believes the information and examples contained in the regulation are needed to assist with the implementation of it and compliance by those subject to CNIT, we suggest that those provisions be deleted from the rulemaking and placed in a policy statement or guidance document that is easily accessible to the regulated community.

2. Compliance with the provisions of the RRA or the regulations of the Commission in promulgating the regulation.

Section 5.2 of the RRA directs this Commission to determine whether a regulation is in the public interest. The Regulatory Analysis Form (RAF) and Preamble submitted with this proposal do not provide sufficient information to determine if the rulemaking is in the public interest. Specifically, we ask the Department to provide additional information for the following sections of the RAF:

- RAF #12 – This section of the RAF asks how the regulation compares to other states and how it will affect Pennsylvania’s ability to compete with other states. What states impose a CNIT? Of those states, which ones have adopted or incorporated the Multistate Tax Commission’s *Model*, as this proposed rulemaking does?
- RAF #19 and #23 – These sections of the RAF relate to the fiscal impact the rulemaking will have on the regulated community. Members of the regulated community and Representative Greiner disagree with the Department’s contention that the rulemaking will not have a fiscal impact. They point to pending cases before the Board of Finance and Revenue and the Commonwealth Court that will be impacted by this rulemaking. We ask the Department to quantify the impact this rulemaking could have on those pending cases.

3. Section 153.24a. Business and nonbusiness income. – Possible conflict with statutes.

The Department states in the RAF and Preamble that this proposal clarifies existing law. A major concern of the regulated community is that the proposal does more than that. They believe it changes the way business income will be taxed for CNIT purposes, deviates from Pennsylvania tax law and conflicts with established judicial precedence. The Pennsylvania Institute of Certified Public Accountants submitted a comment stating that the proposal 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.”

Comments submitted by the regulated community point to specific provisions of this section to illustrate that the rulemaking does more than clarify existing law. Listed below are examples of their concerns:

- The proposal does not account for differences between the definition of “business income” in the statute and the definition of “apportionable income” in the *Model*.
- The transactional test of Subsection (b), the functional test of Subsection (c) and the definition of “trade or business” found in Subsection (h) would result in the taxation of all transactions of a unitary business, “whether that particular business or transaction has any connection with the Commonwealth.”
- Subsection (b) and Subsection (c) would impermissibly repeal the multiform business/unrelated assets doctrine.
- The language of Subsection (d), relating to unitary business principle, and Subsection (e), relating to principles for determining the existence of a unitary business, contravenes the separate reporting requirements of the CNIT law by giving the Department the authority to impose mandatory combined reporting.
- The Department lacks the statutory authority to require the disclosures of Subsection (g), relating to consistency and uniformity in reporting, and the additional disclosures and reporting requirements are not needed and will have a fiscal impact.
- The proposal should not conclude that the judicial principles of “multiformity” and “unrelated assets” are no longer applicable.

A review of these concerns, and those raised by Senator Hutchinson and Representative Greiner, reveals a difference of opinion of what this proposal is intended to do and what it will do. We ask the Department to review all the concerns of the stakeholders and to explain in the Preamble to the final-form regulation why the rulemaking is consistent with the Tax Reform Code and the relevant judicial precedents cited by the stakeholders. In addition, we suggest that the Department convene a meeting of the stakeholders to reach consensus on the best way to incorporate the *Model* into the Department’s regulations while at the same time ensuring that the regulations are consistent with Pennsylvania tax law and judicial precedent.

4. Clarity.

The *Model* includes provisions related to the treatment of dividends. This proposal does not include similar provisions. A commentator has suggested that the clarity of the proposal would be improved if it included language that addressed the treatment of dividends.

Section 2.11(a) of the *Pennsylvania Code and Bulletin Style Manual* states definitions should be placed near the beginning of a chapter. The definitions section for this regulation, Subsection (h), is at the end of the chapter. To be consistent with the *Pennsylvania Code and Bulletin Style Manual*, we suggest the definitions for this rulemaking be moved to the beginning of the chapter.