



Feb. 24, 2020

Via Electronic Mail (dberguson@pa.gov)
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Dear Mr. Berguson:

On behalf of the Pennsylvania Institute of Certified Public Accountants' (PICPA) Committee on State Taxation, we greatly appreciate the opportunity to review and provide comments on the proposed business/nonbusiness income regulations prior to their submission to the Independent Regulatory Review Commission (IRRC). Our major concerns are that certain provisions of the proposed regulations are inconsistent with the Pennsylvania statute and case law and that the proposed regulations need to provide additional guidance in certain other areas.

A. Overview

The proposed regulations incorporate many of the allocable/apportionable income provisions in the *Multistate Tax Commission Model General Allocation and Apportionment Regulations* (MTC regulations). The Department of Revenue's (Department) reliance on the MTC regulations appear to be a change in the Department's view of MTC guidance. The Department's opposition to the court's invalidation of sales factor regulation -- 61 Pa. Code 153.26(b) in *Commonwealth v. Gilmour Mfg. Co.*, 573 Pa. 143 (2003) -- stemmed from the Department's view that the Pennsylvania General Assembly chose not to adopt the Uniform Division of Income for Tax Purposes Act (UDITPA). The Department specifically stated that it did not interpret Section 16(a) of the UDITPA in the same manner as the MTC. Moreover, Pennsylvania is not a signatory of the Multistate Tax Compact. In light of the Department's historical opposition to the MTC's interpretation of state corporate income tax rules, we wonder if the proposed regulations are, in fact, reflective of a change in Department's view of the MTC regulations. Adding to this supposition is this comment contained in the preamble of the proposed regulations: "To promote consistent treatment with other states, the majority of the proposed language for this regulation mirrors the rules of the Multi-State Tax Commission on 'Apportionable and Nonapportionable Income.'"

The Department's efforts to promote state uniformity with the adoption of the MTC regulations are commendable, but the proposed regulations fail to take into consideration the differences between the definition of "business income" in the corporate net income tax (CNIT) statute and "apportionable income" in the MTC regulations. Incorporating the provisions of MTC regulations without taking into account those differences will result in confusion because they are inconsistent with the language of the statute and longstanding case law. For example, the proposed regulations incorporate the MTC "functional test" provisions, but they are not consistent with the test embodied in the language of the

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CNIT statute. In addition, Pennsylvania has had for decades a multiform business/unrelated assets doctrine that was recently affirmed by the Commonwealth Court in *RB Alden Corp. v. Commonwealth*, 142 A. 3d 169,172 (Pa. Commw. Ct. 2016) (n. 9).

In addition to the technical flaws, the proposed regulations fail to provide guidance in two important areas:

- **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 Department 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 Pa.C.S. Section 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 Department’s policy is inconsistent with good tax policy and the Department’s mission statement to “fairly, efficiently, and accurately administer the tax laws.”
- **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 PICPA strongly recommends that the Department revise the proposed regulations prior to their submission to IRRC. In addition, it is important that the Department commit to following any regulations that are adopted. Otherwise, the Department’s effort will not promote the efficient administration of the CNIT statute.

B. Specific Comments

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

61 Pa. Code § 153.24a.

- **Definitions of “Business Activity” and “Business Income” impermissibly expand the functional test (61 Pa. Code Section 153.24a(a)).** The definitions of “business activity” and “business income” in the proposed regulations are not consistent with the statutory definition of “business income.” The statutory definition of “business income” includes “... if the acquisition, the management or disposition of the property constitutes an integral part of the taxpayer’s regular trade or business operations.” 72 Pa.C.S. Section 7401(3)2.(a)(1)(A) (emphasis added).

The proposed definitions of “business activity” and “business income” are adopted from the definition of “apportionable income” in the MTC regulations. The definition of “apportionable income” in the MTC regulations no longer requires that property “constitutes an integral part of the taxpayer’s regular trade or business.” Rather, the property need only be “related to the operation of the taxpayer’s trade or business.” The exclusion of the words “integral” and “regular” effectively broaden the functional test beyond what is incorporated into the statutory definition of “business income” and the Pennsylvania case law interpreting those provisions.

The MTC expanded the functional test in 2014 to eliminate the functional test's requirement that "the property constitutes an integral part of the taxpayer's regular trade or business operations." The functional test's "integral" requirement is contained in the CNIT definition of business income. The MTC regulation's "that the property is or was related to the operation of the taxpayer's business" language is a more relaxed standard. The broadening of the functional test through the proposed regulation is inconsistent with the express language of the CNIT statute and corresponding case law.

The fact that the definition of "business income" includes "all income which is apportionable under the Constitution of the United States" does not support equating the functional test in the CNIT statute and the MTC regulations. The history of the MTC regulations supports that they are different tests. Both the definition of "business activity" and "business income" in the proposed regulations should be amended to be consistent with the statutory functional test and the judicial application of that test in Pennsylvania.

- **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 United States Supreme Court." This definition differs from the definition of that term in the model MTC regulations. The MTC regulations define that term 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 which 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 Department cannot repeal through regulation the multiform business/unrelated asset doctrines which the Pennsylvania courts continue to uphold. The proposed regulation should substitute the phrase "under the unitary business principle as applied by the United States 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 attempt to impermissibly repeal the multiform business/unrelated asset doctrine and, more importantly, violates the U.S. Constitution. 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 Department incorporates the language of the MTC regulations with the exception of the language -- "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 more guidance as to when investment activities constitute business income.

- **Functional test (61 Pa. Code § 153.24(a)(d)).** This subsection is not consistent with the definition of “business income” in the CNIT statute from which the functional test is derived and the case law. Under the statute, the functional test requires that “the acquisition, the management or disposition of the property constitutes an integral part of the taxpayer’s regular trade or business operations.” 72 Pa.C.S. Section 7401(3)2.(a)(1)(A) (emphasis added). The proposed regulation, which adopts the MTC regulations, only requires that the property be “related to the operation of the taxpayer’s trade or business.” The proposed regulation needs to be revised to be consistent with the CNIT definition of the functional test, including the replacement of the extensively used “related to” wording.
- 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.
- **Unitary business principle (61 Pa. Code Section 153.24a(e)).** In addition, the proposed regulations touch upon meeting either transactional or functional test would be sufficient to meet the unitary business income principle. The interrelationship between the transactional/functional tests and the unitary business principle needs to be explained in more detail.
- **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 Pa.C.S. § 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)(1) and examples.** The proposed regulations treat rents from real and tangible personal property as business income “if the property with respect to which the rental income was received is or was used in the taxpayer’s trade or business and/or was depreciated, expensed” This provision is not based upon the functional test as embodied in the CNIT definition of “business income” in 72 Pa.C.S. Section 7401(3)2.(a)(1)(A). In addition, the mere use of the rental income in the taxpayer’s trade or business goes beyond a similar provision in the MTC regulations. The MTC regulations and examples do not look to the use of the rental income in determining whether the income is business income. The proposed regulations that incorporate the MTC regulations also do not refer to the use of the rental income in determining whether it is business income.

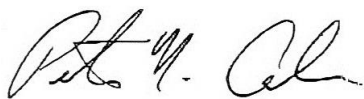
The provision also may raise constitutional issues. The use of the rental income is not necessarily indicative of whether the asset or part of the asset was operated as part of the corporate taxpayer’s unitary business. (See e.g., *Allied-Signal Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).) Under the broad definition of “trade or business” in the regulations, the treatment of rental income with no connection with a corporate taxpayer’s in-state business activities as business income may also give rise to constitutional issues. As a result, the concepts of Allied Signal and other similar cases should likewise be incorporated into the regulations.

Under the judicially created multiform business/unrelated asset doctrine, the court found that the use of proceeds is not a relevant factor in determining whether income is business income. (See e.g., *Commonwealth v. ACF Industries, Inc.*, 441 Pa. 129, 144 (1970).)

- **61 Pa. Code Section 153.24a(g)(3) (Interest).** The Department 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 Department 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 Pa.C.S. Section 7401(3)2.(a)(1)(A).
- **61 Pa. Code Section 153.24a(h)(2) (State-to-state consistency).** This provision goes far beyond the reporting requirements in the MTC regulations and does not take into account that not all state and local jurisdictions adopt the MTC regulations, or may have the same interpretations of those regulations. 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 Department’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.

Once again, 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,



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