

## **PENNSYLVANIA ENACTS BUDGET WITH SELECTIVE TAX CHANGES**

The 2005-06 Pennsylvania budget was enacted on July 7th, and Governor Ed Rendell is expected to also sign the related tax bills that were approved in an overnight session on July 6th. None of the dramatic tax proposals to shift Corporate Net Income tax burdens (*e.g.*, unitary combined reporting, denying certain inter-company deductions, removing the limitation on net operating loss deductions and changing the apportionment formula) were enacted nor was a proposal to change the tax appeal process. However, the definition of taxable compensation was amended to more closely conform to federal treatment, some tax credits were revised, selective enforcement tools were sharpened, and the scheduled reduction in the Capital Stock/Franchise tax was left intact. Additionally, some business incentive programs were modestly cut.

### **Non-Qualified Deferred Compensation Becomes More Consistent with Federal Treatment**

House Bill 176 (Printer's No. 2565) adopts the federal rules of constructive receipt for non-deductible unfunded non-qualified deferred compensation that is subject to the claims of creditors of the employer. This provision, retroactive to 2003 and any earlier years under appeal, overturns last year's decision of the Commonwealth Court in *Ignatz v. Commonwealth*, 849 A.2d 308 (Pa. Commw. 2004).

Distributions from a non-qualified deferred compensation plan attributable to elective deferrals or the income of such deferrals will be treated as taxable compensation regardless of whether they are paid before or after retirement. This provision becomes effective for this calendar year plus any earlier years under appeal.

Although H.B. 176 does not include broad definitional changes of excludable retirement income or tax withholding from early distributions that were sought by the Rendell Administration, it adopts by reference certain Internal Revenue Code (IRC) sections for the timing of income inclusion of deferred compensation. The new IRC § 409A is applicable as of the 2005 tax year and IRC § 83 and § 451 are applicable retroactively to the 2003 tax year.

### **Other Personal Income Tax Changes Conform to Federal Rules**

- Life insurance, endowment and annuity contracts: H.B. 176 clarifies that Pennsylvania will allow the tax-free exchange of life insurance, endowment or annuity contracts under IRC § 1035 (effective immediately), while recognizing income (to be classified as interest) only to the extent that payments under such contracts are includable in gross income for federal income tax purposes (effective for 2005).
- Health Savings Accounts: H.B. 107 (P.N. 2567) excludes income of Health Savings Account (HSA) as defined under IRC § 223 and amounts paid or distributed from a HSA used exclusively to pay or reimburse qualified medical expenses of the HSA beneficiary. This benefit is applicable for the 2005 tax year.

### **Certain Business Incentive Tax Credits Revised**

- Educational Improvement Tax Credits: H.B. 628 (P.N. 2564) increases the annual statewide cap by 10% to \$44 million (\$29.3 million for scholarship organizations and \$14.7 million for educational improvement organizations) and imposes annual reporting requirements on the recipient organizations. These credits, awarded on a first-come, first-served basis, may be applied against the following business taxes: corporate net income, capital stock/franchise, bank

and trust company shares, title insurance company shares, insurance premiums and mutual thrift institutions. Last year's credit appropriation of \$40 million was fully exhausted by September 8, 2004.

- Research and Development Tax Credit: H.B. 176 provides that pass-through entities may transfer all or a portion of the R&D tax credit to their owners in proportion to their shares of distributive income. The owner of a pass-through entity must claim the credit in the taxable year in which the transfer is made, and may not carry forward, sell or assign the credit. This is effective beginning in 2006.
- Film Production Tax Credit: H.B. 176 amends the tax credit that was established last year under Act 95. The changes are generally effective for 2005.

### **Realty Transfer Tax Administration and Enforcement Tools Strengthened**

H.B. 176 extends the assessment period in the case of substantial underpayment of tax with no limit if the deficiency is due to fraud or "an undisclosed, intentional disregard of rules and regulations." The state Department of Revenue regulations are specifically made applicable to the local tax and the Department is authorized to collect the local tax if authorized by the local government unit.

### **Cost of Tax Collection Reimbursable**

Effective immediately, H.B. 176 provides that for most taxes the out-of-pocket collection costs incurred by the Department of Revenue and the Office of Attorney General are reimbursable. These costs include lien filings and collection agency commissions. This new section of the Tax Reform Code is 72 P.S. § 10003.17.

### **Capital Stock/Franchise Tax Rate Reduction Intact**

The previously scheduled reduction in the capital stock/franchise tax rates was left unchanged. The current rate for the 2005 tax year is 0.599% (5.99 mills) and is set to be annually lowered by 0.1 percentage point (1 mill) until it reaches zero in 2011. The multi-year phase-out, which began with Act 23 of 2000, was interrupted and slowed down once by Act 46 of 2003.

### **Business Incentive Programs Replenished at Reduced Levels**

The enacted budget, H.B. 815 (P.N. 2568), reduced the funds up to 10% over last year for most business incentive programs administered by the Department of Community and Economic Development. However, Department Secretary Dennis Yablonsky has indicated this will not affect any projects and manufacturers will continue to receive priority.

Due to the reduced funding levels, feasible commitments should be sought and secured early in the fiscal year. For example, at the end of May most of the customized job training appropriations for 2004-05 (which were reduced by 8% for this year) had been committed.

### **Corporate Net Income Tax (CNI) Proposals Excluded**

Neither the Governor's package to shift burdens among CNI taxpayers (H.B. 1557) nor the CNI-lowering proposals that had been adopted earlier this legislative session by the House (H.B. 515, 650 and 797) were included in the tax bills that were negotiated as part of the overall budget compromise. In exchange for mandatory unitary combined reporting, the Governor had sought to lower the CNI rate, adopt a sales-only apportionment formula (with market-sourcing extended to services) and uncap the net operating loss deduction.

It is expected that these or other major CNI changes will not be seriously considered by the General Assembly until the 2006-07 budget is deliberated next spring. Medical assistance and other spending pressures are expected to again make tax reductions difficult. With 2006 being a gubernatorial election year, it is also doubtful that a Democratic Governor seeking re-election and a Republican-controlled General Assembly will find agreement on controversial business tax changes.

Now that the Rendell Administration has failed a second time to legislatively foil what it calls the "Delaware Holding Company Tax Loophole" (two years ago it proposed to generally deny deductions for interest and certain other intangible expenses paid to related parties), it is not clear whether the Department of Revenue will broadly challenge these arrangements in field audits. While the Department has selectively denied inter-company deductions based on equitable principles – with at least three appeals pending in Commonwealth Court – it acknowledges on its website that such arrangements are "not illegal" but are "a loophole in the law that allows companies to avoid paying their fair share of taxes." (*Loophole Fact Sheet*, Secretary's Spotlight, PA Department of Revenue, <http://www.revenue.state.pa.us/>).

#### **Tax Appeal Proposal Excluded**

The Governor's proposal to create a new Tax Tribunal as the trier of fact for tax appeals and change the role of the Commonwealth Court to a tax appellate body was also excluded from the tax and budget package. This is also expected to be reconsidered next year, if not before.

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