Pennsylvania Supreme Court Agrees With DOR in Apportionment Case

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By Andrea Muse

An in-state company properly used the Department of Revenue's interpretation that out-of-state sales are apportioned according to where the benefit is received, the Pennsylvania Supreme Court has held.

The Pennsylvania Supreme Court ruled February 22 in *Synthes USA HQ Inc. v. Commonwealth* that an in-state taxpayer was entitled to a corporate net income tax refund under the DOR's "long-standing" interpretation of the tax provision as apportioning sales of services based on where the benefit is received instead of the cost-of-performance method.

The court concluded that the state attorney general was permitted to take a position inconsistent with the DOR's, but the court rejected the attorney general's interpretation.

Richard Pomp, a professor of law at the University of Connecticut, told *Tax Notes* February 22 that the cost-of-performance method is an origin-based rule that looks to the source of the income-generating activities, and the method was clearly the statutory approach during the audit years, stating that the decision converts the law into a market-based statute. He added that Pennsylvania changed its law to a market-based approach in 2014 and did not make the change retroactive.

"An executive branch agency like a tax department is charged with executing the law, not supplanting it with what they think a better approach should be," Pomp said, adding that this raises a severe separation of powers issue and that the attorney general "was right for trying to have the will of the legislature respected and implemented."

Richard M. Botwright, co-chair of Stevens & Lee's state and local tax group, told *Tax Notes* that the court's holding is pretty clear that the attorney general has two clients — the commonwealth and the DOR — and could take a contrary position to the DOR and advance that contrary position while representing the commonwealth. But he added that the attorney general is required to notify the DOR that it is taking a contrary position.

Botwright said the court's decision effectively strikes the words "cost of performance" from Pennsylvania's statute by interpreting the provision to apportion services based on the "benefit received" method.

Botwright added that the decision sources services using the same method used to source tangible personal property "despite those provisions using completely different language," and ignores that the statute was changed in 2014 to reflect the benefit-received method.

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"If the statute already had that rule, it would have been unnecessary to make that change," Botwright contended, adding that the dissent's analysis of the provision was correct.

DOR Communications Director Jeffrey Johnson told *Tax Notes* in a February 22 email that the agency was still reviewing the decision. The attorney general's office declined to comment.

Synthes, which is based in Pennsylvania, provided management, research, and development services to its out-of-state affiliates. On its 2011 Pennsylvania return, it apportioned its out-of-state sales of services based on where it incurred the costs of performing those services when calculating its sales factor.

In 2014 Synthes filed for a refund of $2 million for 2011 based on the DOR's interpretation of the provision that out-of-state sales of services are apportioned according to where the benefit is received.

Before January 1, 2014, 72 P.S. section 7401(3)2.(a)(17) stated that sales of services occur in Pennsylvania if the income-producing activity is performed in the state or the income-producing activity is performed both in and outside the state but more of the activity is performed in Pennsylvania than in any other state, based on the costs of performance.

The DOR denied the refund after determining that the company had failed to produce sufficient evidence to support its claim. The Board of Finance and Revenue agreed with the DOR, and Synthes appealed to the Pennsylvania Commonwealth Court, eventually presenting enough evidence to support its refund claim.

But the attorney general argued on behalf of the state that the DOR's interpretation of the apportionment provisions before January 1, 2014, was wrong and Synthes was not entitled to apportion its sales of services based on where the benefit is received.

The commonwealth court allowed the DOR to intervene in the case and ultimately upheld the DOR's interpretation of the apportionment provision in a July 2020 decision, noting "with dismay the Attorney General's assertion in this case of a legal position directly adverse to that of its client, the Department."

The attorney general appealed the decision to the Pennsylvania Supreme Court, which heard oral arguments in March 2022.

Majority Opinion

The court held that the attorney general had standing in the appeal, rejecting the DOR's argument that the attorney general was not a party at the Board of Appeals or Board of Finance and Revenue proceedings and was not aggrieved by the commonwealth court's order directing the DOR to issue a refund to Synthes.

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The supreme court noted that the Commonwealth Attorneys Act (CAA) explicitly sets out provisions to allow supersession and intervention while the attorney general continues to represent the commonwealth.

Adding that the attorney general "is not merely the Department's law firm," the court stated that the attorney general is the chief law officer for the commonwealth as a whole, accountable directly to the Pennsylvania voters and independent of the governor and executive agencies.

The court also concluded that the state was aggrieved by the commonwealth court's order, which ordered a refund of tax revenues, and had standing to appeal the decision.

But the supreme court also noted that the attorney general's office is staffed by lawyers bound by the Pennsylvania Rules of Professional Conduct who are required to follow rules regarding conflicts of interest.

While taking no position on whether the attorney general gave adequate notice to the DOR that it was taking a contrary position, the court stated that the attorney general "was ethically bound to advise the Department of its conflicting interpretation" and that under the CAA the DOR could have then requested to be represented by the general counsel, who is tasked with providing legal advice and representation to the governor.

Apportionment Provision

Finding that the critical terms of the apportionment provision are not defined by the General Assembly, the supreme court concluded that "colorable arguments can be made that the 'income-producing activity' occurs either where the taxpayer produces the service or where the customer receives the service."

The court noted that while other states have done so, Pennsylvania has not adopted the Multistate Tax Commission's regulations related to the apportionment provision, which defines "income-producing activity" and "costs of performance" in terms of the taxpayer's production activity instead of the consumer's market-based activity.

Adding that some states have adopted overtly market-based approaches, the court concluded that the relevance of other states' interpretations of their apportionment provisions for sales of services was diminished, considering the reduced uniformity in the statutory language and adopted regulations.

The court concluded that the provision should be read in the context of the other apportionment provisions, noting that the activity relevant to the sales factor is the in-state consumer's purchase of the good, service, or product.

Stating that the sales factor encompasses both the provision for sales of tangible personal property and the provision for sales of services, the court determined that "it would be incongruous to apply

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diametrically opposed sourcing methods" to the sales factor's component parts by using destination sourcing for tangible personal property and origin sourcing for services.

The court found the DOR's interpretation of the provision the most compelling because it "locates the sales of services to where the service is fulfilled and the income finally produced, which is at the customer's location, in conformity with" the treatment of sales of tangible personal property.

The court also observed "that application of this method has the added benefit of providing continuity for taxpayers as the Department's consistent application of destination sourcing for similarly situated taxpayers prior to 2014 will continue for taxpayers in 2014 and after."

Concurrence and Dissent

In a concurring and dissenting opinion, Justice Kevin M. Dougherty joined in the majority's decision that the attorney general was permitted to take a position that is inconsistent with the DOR's interpretation of the statute, but argued for the former's interpretation of the apportionment provision for sales of services.

Dougherty contended that the plain language of the provision, the contrasting language in the apportionment provision for sales of tangible personal property, and the decisions of other state courts interpreting similar provisions support construing the provision as adopting a cost-of-performance method.

Dougherty noted that the provision uses the term "costs of performance" — though he also acknowledged that it is not defined in the law — while the provision for sales of tangible personal property "expressly embraces the benefit received method tying taxation to receipt by the customer."

Adding that the seller bears the costs of performance, with the customer typically paying a price that is above the costs for the seller's performance of the service, Dougherty argued that the "term clearly calls for a seller-based sourcing methodology."

Dougherty noted that Synthes argued that applying the cost-of-performance method in this case would violate the uniformity clause of the state constitution, given the DOR's long-standing policy of requiring taxpayers to use the benefit-received method, but he contended that "Synthes does not have a constitutional right to the continuation of the Department's past errors in misconstruing" the provision.

Chief Justice Debra Todd asserted in a separate concurring opinion that regarding whether the attorney general may assert a position contrary to that of a government agency, the majority should have limited its discussion to the CAA instead of also looking to the state's rules of professional conduct.

She argued that the ethical implications of the attorney general's representation were outside the scope of the appeal, were not meaningfully briefed by the parties, and did not need to be addressed to resolve the case.

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The taxpayer in *Synthes USA HQ Inc. v. Commonwealth* (No. 11 MAP 2021) was represented by Brent Beissel and Frank Gallo of Reed Smith LLP.

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