February 16, 2016

VIA Electronic Mail
C. Daniel Hassell, Deputy Secretary for Tax Policy
Department of Revenue
Commonwealth of Pennsylvania
1133 Strawberry Square
Harrisburg PA 17128

Dear Deputy Secretary Hassell,

On behalf of the Pennsylvania Institute of Certified Public Accountants (PICPA), thank you for the opportunity to review and provide comments on the Department of Revenue’s draft Information Notice Corporation Taxes 2016-1 (Notice) on the Add-Back provisions under Act 52 of 2013, 72 P.S. §7401(3)1.(t).

Overall, while the Notice in some respects appears to be consistent with §7401(3)1.(t), we have several issues with the Department’s interpretation as noted in our comments presented below. More importantly, the issuance of a Notice certainly would be a good initial step in providing guidance but the significance of this issue needs to be addressed soon in a draft regulation subject to the IRRC review process.

The following are specific questions and issues we identified. References noted are those reflected on the draft Notice.

1. In various footnotes throughout the Notice, the Department cites either other States’ statutory authority or other non-authoritative sources in its interpretation and application of the Add-Back provisions including references to Alabama, Connecticut, and Georgia statutes and regulations as well as the MTC’s model statute requiring the Add-Back of certain intangible and interest expenses. See footnote numbers 8, 12, 14, 15, 17, 18, 20, 21, 22, 24, and 25. The sources cited in these footnotes are not authoritative in interpreting Pennsylvania tax statutes and the Department should not be using them as authority in interpreting and applying the Add-Back provisions but instead should provide guidance that strictly interprets Pennsylvania’s Add-Back provisions. Furthermore, the Alabama, Connecticut, and Georgia statutes and regulations are broader than Pennsylvania’s...
include the “direct or indirect” language found in these three States’ statutes and regulations or in the MTC’s Model Statute. The language of, and the General Assembly’s intent behind the Pennsylvania legislation was to the Delaware Holding Company loophole and the Notice exceeds this scope.

2. The Pennsylvania legislature enacted a fairly generic add-back provision that is similar to, but not as expansive as, some provisions in various other states. For example, some other states’ legislatures have gone further to address things such as management fees, acquisition-related costs and general interest expense, whereas Pennsylvania’s statute does not. Further, the credit and exception mechanisms included in Act 52 are generally broader than those in many other states and do not include some of the more specific threshold requirements (such as effective rate matching requirement) found in certain other states. It is reasonable to expect that the new law creates additional compliance requirements, and perhaps results in the disallowance of certain deductions, for those taxpayers who specifically engage in related party transactions involving specific types of intangibles, including intercompany financing costs related to such intangible costs. But the examples in the Department’s Notice would appear to greatly expand the breadth of the add-back provisions to potentially encompass ANY type of transaction (e.g., purchases of goods, purchases of services, management fees, and interest on loans paid to unrelated banks) whenever there is some underlying intangible expense or cost occurred by any affiliated entity in the taxpayer’s group to another affiliated entity. This arguably means that taxpayers and tax preparers would need to parse through EVERY expense incurred and consider all manners of potential indirect relationships on a group-wide basis (ignoring the separate entity concept) in order to evaluate costs incurred by any other related entities in order to fully disclose such transactions, then assemble extensive documentation in support of a claim for credit or exemption. This venture is beyond the intent of the statute and would ultimately place a substantial burden on taxpayers and tax professionals to analyze, disclose and defend legitimate transactions that were never intended to be covered. If the Department has particular concerns about intercompany arrangements beyond the items specifically included in the add-back definitions, it may use whatever other powers it has to investigate those items on audit, but the add-back provisions should not be expanded beyond the reach of the fundamental statutory requirements, and the Department should not seek to create a compliance burden that eclipses that of neighboring states.

3. **Section II. A. Applicable Intangible Assets** – The Notice states the Add-Back also applies to “other similar expenses or costs” including costs or expense deductions incurred with respect to franchise rights, know-how, trade secrets, goodwill, and contract rights, none of these terms which are defined as “intangible expenses or cost” under 72 P.S. §7401(8) nor does the Notice define these terms.
The Department needs to provide definitions for these five terms it refers to as “other similar expenses or costs” and instances and/or examples where associated costs or expense deductions are subject to the Add-Back provisions. In addition, the inclusion of franchise rights, goodwill and contract rights are not “other similar expenses and costs,” that the legislation was intended to address. The intent of the legislation was to close the Delaware Holding Company loophole. In general, the intangible assets that Delaware Holding Companies hold include patents, trade names, trademarks, etc., and do not include franchise rights, goodwill and contract rights.

4. **Section II. B. 2. Direct or Indirect Intangible Expense or Cost** – The add back of indirect intangible costs or expenses is inconsistent with the statutory language of, and the legislative intent behind the statute. The statutory language only disallows a deduction for an intangible expense or cost … paid, accrued or incurred directly or indirectly in connection with one or more transactions with an affiliated entity. The statute does not expressly disallow a deduction for an intangible expense or cost incurred … in connection with one or more direct and indirect transactions with an affiliated entity. In addition, the statutory definition of “intangible cost or expense” does not include “royalties, licenses or fees [directly or indirectly] paid for the acquisition … [of intangible assets].” Under rules of statutory construction, it is questionable whether a taxpayer is required to add back indirect intangible costs and expenses, e.g., amortization and embedded intangible costs.

Furthermore, since the purchase of a tangible product from another party, regardless of whether such party is affiliated, does not usually involve the transfer of any legal rights in an intangible asset to the purchaser (or use by the purchaser), the Add-Back should not apply unless such an intangible asset transfer or use actually occurs. Therefore, Example 1 in the Notice is inconsistent with the statutory language because it incorrectly concludes Corporation A’s deductions for payments to Corporation B for product purchases are subject to the Add-Back to the extent the amount charged for the products purchased includes costs or fees for Corporation B’ use of Corporation C’s trademarks despite the fact there was no transfer of trademark rights to Corporation A. In this Example, only Corporation B’s deductions for use of Corporation’s C’s trademarks should be subject to the Add-Back provisions. The Notice’s conclusion in Example 2 would also be inconsistent with the statutory language if there was no transfer of intangible rights to Corporation A as a result of Corporation A’s purchases of management fees from Corporation B.

5. **Section II.C. Interest Expense** - The Notice creates a presumption that an interest paid to an affiliated entity is related to an intangible property transaction, if the PA Corporate Taxpayer has incurred intangible expenses or costs with respect to the same or any other affiliated entity in the same tax year. The final
version of the Notice should provide guidance for rebutting this presumption. Example 4 suggests that if a PA Corporate Taxpayer obtains a loan from a third-party bank to pay an affiliate for an intangible asset, the taxpayer should Add-Back the interest paid on that loan. Such an inclusion of any third party interest within the scope of the Add-Back is inappropriate and inconsistent with the statute (i.e. 72 Pa. Stat. Ann. § 7401(3)(1)(t) only disallows interest that is directly related to an intangible expense or cost).

6. **Section II** - There needs to be more examples throughout Section II of situations that are or are not subject to the Add-Back provisions.

7. **Section III.A. – Add-Back Exceptions Principal Purpose and Arm’s Length Exception** - The statute provides that the principal purpose of the transaction may not be the avoidance of CNI Tax. However, the Information Notice broadly provides that the principal purpose of the transaction may not be tax avoidance. The avoidance of CNIT is presumed for transactions between or among affiliated entities that generate intangible expenses or deductions that did not change the overall economic position of the PA Corporate Taxpayer and its affiliated entities (other than tax effects) in a meaningful way. Arguably, the principal purpose requirement should be met if the principal purpose of the transaction is the avoidance of some other state tax. The Notice should also provide some specific examples of the substantiation requirements in support of expense deductions in satisfying both the principal purpose and arm’s length requirements (i.e. transfer pricing studies conducted in accordance with the Internal Revenue Code § 482).

8. **Section III.B.2. – Foreign Treaty Exception – Substantiation Requirements for Claiming the Foreign Treaty Exception** – The Notice lists six substantiation requirements for claiming the foreign treaty exception. None of these requirements are listed in the Pennsylvania statutes but the requirements are similar to those listed in the Georgia statutes cited in footnotes 20 and 21. The first four requirements are somewhat innocuous and general but the last two requirements mandate taxpayers to provide (1) a description of the business purpose of the transactions between the PA corporate taxpayer and the affiliated entity and (2) documentation that all of the terms of the transactions with affiliated entities are arm’s-length rates and terms. The Pennsylvania statutes don’t incorporate these requirements so taxpayers shouldn’t have to comply with them, specifically the last two requirements.

9. **Section IV. C – Application of the Credit Mechanism – Taxes Paid to Combined Reporting States** – The first sentence states that “The Add-Back Credit does not apply to state income taxes paid in combined reporting states. This sentence is inconsistent with the statutory language and is also incorrect because it is possible to calculate the credit for each combined group member individually using each member’s “pro-forma, separate-company” tax return.
We appreciate the opportunity to review and comment on the proposal. Please do not hesitate to contact Peter Calcara at 717.232.1821 or pcalcara@picpa.org with questions or if we can be of further assistance to you in this matter.

Sincerely,

Timothy Billow, CPA, MS
Chair, PICPA Forms Subcommittee

Peter N. Calcara, CAE
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Pennsylvania Institute of Certified Public Accountants