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THIS MANUAL IS NOT AUTHORITATIVE AND MAY NEITHER BE CITED TO SUPPORT AN AUDIT POSITION NOR RELIED ON BY THE TAXPAYER.

INTRODUCTION

The primary objective of this manual is to provide instructions on the performance of a Pennsylvania corporation tax compliance audit. Instructions are based on current state tax statutes, department regulations, court cases, departmental policies, previous audits, appeal decisions, and general accounting and auditing principles.

This manual is intended as guidance to the audit staff. Auditing methods and techniques suggested in the manual may not be necessary or applicable for every audit. This manual is not authoritative and may neither be cited to support an audit position nor relied on by the taxpayer.

This manual and its auditing procedures will be continuously evolving as it is impacted by changes in tax statutes, regulations, court cases and departmental policies.

Part I - General Auditing Provisions

CHAPTER 100. DEFINITIONS.

CTM100.1. Definitions.

The following words and terms, when used in this document, have the following meanings, unless the context clearly indicates otherwise:

CNI - Corporate net income.

CS/FF- Capital stock/foreign franchise.

Department - Department of Revenue.

FF - Federal Form.

IRC - Internal Revenue Code.

NL - Net loss.

NOL - Federal net operating loss.

PA - Pennsylvania.

TRC - Tax Reform Code.

CHAPTER 101. OVERVIEW.

CTM101.1. Act 119.

Reports received after 6/30/06 but not settled by 12/31/07 are governed by Act 119.

- (1) The tax may be assessed within three years from original received date or due date whichever is later (t/c 01).
- (2) The period may be extended if the taxpayer signs Consent to Extend form.
 - (3) Basis of Assessments must be provided for any tax increases.
 - (4) Any assessments of \$300 or more must be mailed by certified mail

CTM101.2. Resettlements.

All reports settled before 1/1/08.

- (1) The resettlement period is three years from original settlement date. (t/c 04 AG date)
- (2) The settlement period was 18 months from received date. (t/c 01) Technically there should be no departmental resettlements after 12/31/2010. The Boards may have resettlement dates after this due to appeals.

CTM101.3. Auditor General's role.

- (a) For years under Act 119 assessment system, the Auditor General has four months to sign off on the determination per 72 P.S. § 7407.5(c). In case of the failure of the Department and the Department of the Auditor General to agree on a determination of tax liability ... within four months, the matter shall be submitted to the Board of Finance and Revenue for decision. If the board fails to reach a decision within three months, the determination of the department of revenue shall automatically become valid. The decision of the Board of Finance and Revenue shall be implemented by the issuance of an assessment under this article, a refund or a credit, under section 1108 of "The Fiscal Code," or other appropriate action.
- (b) For years under the settlement system, the Auditor General has sixty days to sign off on the return per 72 P.S. § 7802. Promptly upon making any settlement, (a) the Department of Revenue shall transmit the original settlement, with all of the papers appertaining thereto, to the Department of the Auditor General. (b) The Department of the Auditor General shall audit such settlement and, within sixty (60) days after the receipt thereof, express in writing its approval or disapproval thereof, and return it to the Department of Revenue. If the settlement is disapproved, the Department of the Auditor General shall state in writing the specific reasons upon which the disapproval is based. (c) If the Department of the Auditor General shall disapprove the settlement, it shall be the duty of the Department of Revenue to reconsider it, to confer with the Department of the Auditor General, and to endeavor to agree with the Department of the Auditor General upon the settlement to be made. (d) If the Department of Revenue shall revise the settlement, it shall resubmit the same to the Department of the Auditor General for approval or disapproval. (e) In the event that the Department of Revenue and the Department of the Auditor General shall fail to agree, within four months after the original submission of the settlement by the

Department of Revenue to the Department of the Auditor General, the settlement shall be submitted by the Department of Revenue to the Board of Finance and Revenue, which shall consider the objections of the Department of the Auditor General, and determine in what amount the settlement shall be made.

CHAPTER 102. PRE-AUDIT PREPARATION.

CTM102.1. Pre-audit confirmation letter.

To most efficiently and effectively prepare for the audit, all of the preaudit preparation should be performed at the same time. The audit application and confirmation letter should be open on your laptop so as to input, delete or modify information as the research is performed.

CTM102.2. Determinations needed.

- (a) What records to request for the audit.
- (b) What preliminary questions to ask.
- (c) What issues may have been granted or refused at the appeal levels in prior years.
- (d) What areas require extensive or minimal examination based on materiality of each issue. Prioritize the areas to be reviewed during the fieldwork.

CTM102.3. Subscribe to audit assignment information.

- (a) Open Audit's homepage.
- (b) Select audit information (search for existing or past audits, run reports, etc.).
 - (c) Enter assignment number.
 - (d) Select view LAN information click on link to subscribe to assignment.

- (e) Select send e-mail whenever any information changes for this assignment plus any other e-mail that may be helpful.
- (f) Other information or links will be useful for pre-audit preparation. These will be discussed further under later sections.

CTM102.4. Review intranet and mainframe for departmental data files.

- (a) Review report as filed.
- (1) Compare page 1 of the RCT 101, each of the tax reports and the ledger to determine if all are reporting the same number. If discrepancy, notify headquarters immediately so corrections can be made.
- (2) Compare the tax report as filed with the numbers entered on CTSTART in the taxpayer column. If discrepancy, notify your supervisor to correct the data.
 - (b) Review both open (CTBNO) and closed (CTBNC) ledgers.
 - (1) Determine the status of audit year and all open years.
- (i) Open years are those years that under the statute can be assessed or resettled.
- (ii) Complete status report (internal document) in the application. Indicate transaction codes in date order including date, tax amount, and penalty.
- (2) If report undetermined, check CTSTART that supervisor signed on to bundle so no one else can determine/settle report.
- (3) Must periodically check on CTBNO and CTBNC to see if any transactions occurred since last reviewed especially amended reports, RARS and appeals. If change occurs, update status.
- (4) Determine status of Pennsylvania reports of change (t/c R14). Screen print copies of CTBNO and/or CTBNC of last year showing receipt of RARS into a Word document and save as WP_#_title (e.g. WP_2_RAR).
 - (c) Review current and prior years for appeals.

- (1) The audit assignment information on the intranet will list all appeals and provide a link to the new docket system (RAPS)
 - (i) After logging in, select search.
- (ii) Enter the box number to search on taxpayer id. Other searches are available by using the drop down box.
- (iii) Review issues under appeal. Review decisions and orders for of all BOA, BFR and/or Commonwealth Court decisions. Determine what relief was granted, if relief granted on the issue or if a monetary compromise and what impact it may have on the current open years. If documents are not on RAPS copies may be ordered through mimenu.
 - (iv) Review Department policies on RAPS.
 - (A) When in search screen, click on policy search.
- (B) Then select category, then select corporation. This will bring up all policies for corporation taxes.
 - (C) To select a policy item, click on the policy id #.
- (D) Click on view next to internal document or public document to see the document for the issue.
 - (I) Internal documents are for Department use only.
- (II) Public documents are what has been placed on Revenue's internet page or placed in any of Revenue's published formats.
 - (d) Review Audit Home page for Assignments of prior audits.
 - (1) By searching on the box number you will get all corp tax audits.
 - (2) By searching on the EIN you will get all tax audits.
- (3) Briefly review prior audits to determine if there are any issues or information that may impact the current audit. Imaging of ct audits started

1/17/2004. If audit is not imaged, mimenu can be reviewed for the microfilm location of the complete audit package.

- (e) Review employer withholding system (KITS. Obtain information for:
 - (1) Audit year analysis for payroll factor.
 - (2) Current year to perform employer withholding review.
- (f) Review imaged returns for K-1s filed for partnerships, S-corporations, limited liability partnerships and limited liability companies filing as a partnership.
- (1) Obtain images using the PIT screen and enter the EIN of taxpayer on the SSN line.
 - (2) To get a copy of the partnership return, enter the partnership EIN+C.
- (3) Determine who the other members are and that all members have filed the appropriate returns.
 - (i) If delinquent years exist, question.
- (ii) Research affiliates that file with taxpayer for potential collateral audits.

CTM102.5. Create audit in audit application.

- (a) Create the audit for the corp tax assignment in the application program.
- (b) Input available information to the REV-149 form. Much of the information can be copied and pasted from the audit request, on the audit assignment information intranet page.
 - (c) Save copies of the imaged returns to the audit (C:\MS_AUDIT\MS_AUDWK).
- (1) The audit assignment information intranet page has a link to view imaged returns for this taxpayer.
- (2) Imaged return may be under several different sections, save all sections.

- (3) Name the file using the last 2 digits of the year plus the section name (e.g. 00_rct101).
- (d) Open the corp tax access file (work on files CT access files add/edit forms menu).
 - (1) Select CTSTART add/edit forms menu.
 - (2) Complete the following information on the form:
 - (i) Report status.
 - (ii) Report type.
 - (iii) Corporate activity.
 - (iv) Use single factor for CS/FF.
 - (v) Limit audit schedules to.
 - (e) Download EW information.
 - (1) Click the download button.
 - (2) Be sure to be connected to the LAN in order to download.
 - (f) Input CTSTART information.
- (1) Review CT ledger to determine if the report was (re)settled or assessed.
- (2) If a determined/settled return, always use numbers from the adjusted column (never use Auditor General column). If no number appears in the adjusted column then the submitted number has been accepted. Some settlements and all resettlements at this time are manually settled. Manual (re)settlements mailed prior to 1/1/2002 should be found on microfilm. All manual (re)settlements mailed on or after 1/1/2002 are imaged. As research and analysis is performed input information as found.

CTM102.6. Review tax report.

- (a) Compare current year to prior years to determine if there is a discrepancy in filing from prior years such as a material change in taxes paid. Under the audit assignment information for the assignment select LAN information, then select: View analysis for recent corporate tax returns for this account.
- (1) Analyze the information provided and compare from year to year to determine if any material changes occurred from year to year.
- (2) Compare the CS/FF and CNI fractions to determine if there are any differences.
- (i) If factors are the same, it would suggest the taxpayer is not a manufacturer.
- (ii) If the CS/FF numerators are lower than the CNI numerators and the denominators are the same, the taxpayer may be claiming a manufacturing, processing or other exemption.
- (iii) If the denominators and possibly the numerators are lower for CS/FF than CNI, then they may have an investment in an LLC.
 - (3) Analyze the FF1120 information for all years.
 - (i) Are all the years similarly filed?
- (ii) Did both the income and expenses proportionally increase/decrease or was there a material change in income or expenses but not both.
- (iii) Are there any material changes from the beginning to end of year balance sheet items?
 - (iv) If any discrepancies, question taxpayer as to what had occurred.
- (b) For the current audit year determine if the pro forma FF1120 was filed as would have been returned to and ascertained by the federal government if separate returns had been made to the federal government.
 - (1) Are there any federal statutory changes needed to be made?

- (2) Analyze income and expense items to determine if there are any negative items which would impact the factors?
- (3) Examine spreadsheets (if included in report), for those corporations filing consolidated returns with IRS.
- (4) If spreadsheets are not included, request the taxpayer has them available for the audit fieldwork.
- (5) Are there any intercompany transactions or any Delaware holding company deductions?
 - (6) Pennsylvania CNI tax analyze:
 - (i) Deductions and additions to income or loss.
- (ii) Apportionment factors with information filed. Complete reconcilement schedules in the audit application, as able.
 - (iii) Analyze net loss (NL).
- (A) Compare NLs claimed on report to CTSTART and resettlement information for correct NL.
- (B) Review copies of reports for those years from which NLs were carried over.
- (C) There is no statute that prevents the Department changing the NL in the year that it is carried forward. The NL can be reduced to zero. Can only change NL to taxable income if still within the statutory time to determine/resettle.
- (iv) If applicable, analyze multiformity/unrelated asset claims. Determine if claimed in prior years and granted. If granted in past was it a money compromise or granted based on facts.
- (A) Only compromises based on facts can be granted at our level if all details are available.
- (B) Facts must be exactly as they were in the original stipulation.

- (C) Do not grant new claims with similar facts. All new claims must be granted under appeal.
 - (7) Capital Stock/Franchise tax analyze:
 - (i) Fixed formula:
- (A) Review calculations for all available M-1s, M-2s and M-3s to determine if adjustments to book income are needed.
- (I) Review or obtain copy if not filed with return, Federal Form 8886 Reportable Transaction Disclosure Statement.
- (II) Pull copies of prior years and determine if any other information needed from taxpayer.
- (B) If taxpayer files a 10-K, obtain from http://www.sec.gov/index.htm/ website.
 - (I) Compare to net worth portion of fixed formula.
- (II) Review the notes to the financial statements to determine any issues that may impact the audit. Determine if there were any notes concerning tax accruals.
 - (ii) Three factor apportionment:
 - (A) If factors same as CNI no further research is needed.
- (B) Analyze validity of manufacturing/ processing / research and development activities per information submitted and obtained from research.
- (C) Determine that all pass thru entities that are treated for CS/FF tax purposes as corporations, are removed from the factors.

CTM102.7. Internet research.

(a) Using any of the search engines enter taxpayer's name to search for a web site or any other items available about the taxpayer. Also if the taxpayer has an

ultimate parent, search for the parent.

- (b) Research the Security Exchange Commission at http://www.sec.gov/index.htm to determine if taxpayer or the ultimate parent files a 10-K.
 - (c) Research http://www.reportgallery.com/ for annual reports of company.
 - (d) Research any other claims that may have been made on the tax report.
 - (e) Review tax laws, regulations, tax bulletins, etc. They can be found at:
 - (1) Department of Revenue site http://www.revenue.state.pa.us/.
 - (2) PA Regulations- http://www.pacode.com/.
 - (3) US Tax Code http://www.fourmilab.ch/ustax/ustax.html.
- (4) US Tax Regulations http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?&c=ecfr&tpl=/ecfrbrowse/Title26/26tab_02.tpl.
 - (5) Unofficial Purdon's Pennsylvania Statutes from West.
- (6) The PA corp tax laws, regulation, memorandums and bulletins are on the Audits Corp Tax homepage.

CTM102.8 Phone contact with taxpayer and/or representative.

- (a) Be aware of all deadline dates for open years when setting potential audit dates to discuss with the taxpayer.
- (b) Establish a time frame to conduct audit and schedule plant tours, based on the open year deadlines. If a taxpayer requests a delay of more than six months from the date of contact, it is required that a letter signed by a corporate officer requesting this delay be obtained by the auditor prior to this request being granted.
 - (c) If the audit fieldwork is scheduled close to the deadline date:
- (1) For years under Act 119 assessment system inform taxpayer a consent to extend must be signed by an officer of the company in order to be granted

additional time to provide information due to the deadline date. Follow Bureau procedures for completion and processing of a Consent to Extend form. See Chapter 105.

- (2) For years under the settlement system inform taxpayer no extensions of time can be granted to send additional information, due to the deadline date. Include this information in the letter to the taxpayer requesting books and records needed.
 - (d) Audit date will determine necessity of prior and subsequent years for audit.
- (e) Inform taxpayer that audits may be performed on prior or subsequent years based on findings of current year.
 - (f) Discuss objectives of audit.
- (g) Inform taxpayer of records required to perform audit. Tailor this request to the taxpayer. Do not use a generic request that covers areas that do not pertain to the taxpayer.
 - (1) Pursue obtaining electronic files for CAS audit assist
 - (i) If not available determine where sales invoices are maintained.
 - (ii) Sales invoices must be reviewed for destination sales.
- (2) If applicable, obtain detailed written description of exempt activities for all locations from taxpayer prior to audit.

CTM102.9. Confirmation letter.

The letter should include:

- (1) Date field work is to start.
- (2) Detailed list of books and records needed at the audit site. Be sure this is tailored to the taxpayer and not a generic list (e.g. do not ask for manufacturing records if taxpayer is not a manufacturer).

- (3) A list of questions that may have arose during the preaudit analysis of the assignment.
- (4) If taxpayer is claiming an exemption for CS/FF, request a detailed written description of activities of each PA location for which they are claiming an exemption. If exemption is claimed based on exempt activities outside PA, must identify each location and provide detailed written description of those activities occurring at the out of state location as well.
 - (5) Enclose a copy of:
 - (i) Taxpayer's Bill of Rights.
- (ii) Corporation Tax Computer Audit Feasibility Questionnaire and Informational Handout.
- (6) List on the index under correspondence. The engagement letter previously sent should also be included under correspondence.

CTM102.10. Miscellaneous.

- (a) Prepare out-of-state request, if necessary, using the audit application system.
- (b) Make necessary travel arrangements (airplane, hotel, rental car, etc.) using SAP.

Chapter 103. POLICIES AND GUIDELINES.

CTM103.1. Audit policies.

- (a) The Department's policy forbids Audit personnel from preparing tax documents for the taxpayer. This is a conflict of job duties. You may assist the taxpayer by answering questions.
- (b) The copy of the PA Statute (law) on the Audit's intranet site is an unauthorized version for internal use only. DO NOT GIVE COPIES TO ANYONE OUTSIDE THE DEPARTMENT.

- (c) Request for records.
- (1) Use a request for records form to document all information requested. Include a copy of all requests in the audit package under correspondence.
- (2) If the taxpayer needs to send information not available while you are at the audit site, place all requests in writing and designate a date taxpayer needs to respond by.
 - (3) If time permits allow 30 days with a 30-day extension.
 - (d) Correspondence with the taxpayer.
- (1) Date and time of all telephone conversations should be noted in the narrative.
- (2) Any written correspondence by mail or e-mail must be included in the audit application under correspondence.
 - (e) Submitting of audits to headquarters.
- (1) Audit should be received in headquarters within 120 days of the preaudit date.
 - (2) MUST BE SUBMITTED PRIOR TO 180 DAYS OF THE DEADLINE DATE.

CTM103.2. Open years.

- (a) Prior and subsequent open years **must** be reviewed for possible audit.
 - (1) A detailed analysis of all open years must be performed.
 - (2) Determine if each item on the PA and Federal return is similarly filed.
- (3) Identify any items are not similarly filed or filed in an open year but not in the current assignment.
 - (b) Mandatory procedures for all open years.

- (1) For each item changed in the original audit assignment, immediately request documentation for that item for all open years.
- (2) For any item not filed in the original audit assignment year but filed for any of the other open years, immediately request documentation for that item.

CTM103.3. Collateral audits.

- (a) An assignment must be made for each year audited. The audit application can only create schedules for one year for each assignment.
 - (b) A complete audit must be performed on the original audit assignment.
 - (c) An abbreviated audit may be performed on the collateral audits.
 - (d) An abbreviated audit narrative consists of:
 - (1) A general statement that this is a collateral audit of the year "XXXX".
 - (2) Reference to the main audit for general comments on the company.
- (3) If accepted in original audit, under each section of the narrative state that the factor, adjustment, etc. was filed similar to the main audit year and no further auditing procedures were performed except for the "....." area found to deficient in the main audit.
- (4) If the section was not filed similar to the prior year do a complete audit on this section.
- (5) If a section had a claim by the taxpayer in one year and not the other, this must be addressed in the audit narrative and a complete audit performed on this section.
 - (e) Abbreviated schedules.
- (1) If accepted in original audit, enter lump sum numbers for submitted/determined/settled and for audited columns (e.g. for factors only enter numerator and denominator). No breakdown of each line item is needed and no documentation is needed.

- (2) If the section was not filed similar to the prior year do a complete audit on this section. The schedules for these areas must be completed in full.
- (3) If a section had a claim by the taxpayer in one year and not the other, the schedules for these areas must be completed in full.

(f) Exhibits.

- (1) If accepted in original audit, no documentation needed.
- (2) If the section was not filed similar to the prior year, all documentation needed.
- (3) If a section had a claim by the taxpayer in one year and not the other, all documentation needed.

CTM103.4. Estimated assessments. (72 P.S. §7407.1(c)) (for all reports not settled by 12/31/2007)

- (a) If the taxpayer does not provide requested documentation to determine tax issues, the tax may be estimated assessed.
- (b) 72 P.S. §7403 describes a report as a form prescribed, prepared and furnished by the Department, an annual report ... Such report shall set forth: A true copy of its return to the Federal Government of the annual taxable income ... or such part or portions of said return, as the Department may designate; or If no return was filed with the Federal Government the report made to the Department shall show such information as would have been contained in a return to the Federal Government had one been made; and Such other information as the Department may require. ...
- (c) An estimated assessment will result in striking off the received date for the tax.
 - (d) Estimated assessments can not be appealed per 72 P.S. §407.1(e).
- (e) When all information is received, a new received date will be placed on the system and the three years to assess the tax will start from the new date.

- (f) Estimated assessment must be stricken off within 90 days of receiving the information to complete the return (72 P.S. § 407.1(f)).
- (1) Must have 2 written requests for records forms in audit file. Give 30 days for first request and if no response send a second request allowing 30 days.
- (2) All estimated assessments must be pre-approved by your supervisor and then Headquarters' staff prior to a post audit conference with the taxpayer.
 - (g) Audits to be resettled (for all reports settled prior to 1/1/2008):
 - (1) This is for those audits under the settlement system.
- (2) If the taxpayer can or will not provide the requested information the audit shall be resettled in the favor of the Commonwealth.

CTM103.5. Taxpayer delay.

- (a) The taxpayer may find it necessary to delay the audit for various reasons. Where it is apparent that the reasons stated by the taxpayer are authentic and not intended to interfere with the orderly conduct of an audit, the auditor may arrange for a date sometime in the future for a preaudit conference.
- (b) In the event of repeated postponements, or a postponement of over 60 days, the taxpayer must request a postponement in writing on company letterhead signed by a company officer. The taxpayer should be asked to provide the letter within two weeks. The request must include:
 - (1) The reason for the delay.
 - (2) The date when the preaudit conference can be held.
 - (3) Must be signed by a corporate officer.
 - (4) Must be included in the audit report.
- (c) If you are having problems with resolving the date for the audit, discuss with your supervisor the option of contacting the CEO, CFO or audit committee of the company.

CTM103.6. Amended reports, reports of change, and Revenue agent reports.

- (a) Determine if an amended return (T/C 11) has been filed and determined/settled.
- (b) Determine if a report of change (T/C R14) has been filed and determined/settled.
- (c) The supervisor should contact Headquarters as soon as possible to inform them of the filing of the return. A decision will then be made whether to request that the Bureau of Corporation Taxes expedite the determination/resettlement of the return or the return be pulled, put into an audit bundle, and determine/resettle by the audit supervisor.

CTM103.7. Returns received.

- (a) Auditor must indicate the date the return was received (or postmarked if mailed). If mailed attach envelope with return.
 - (b) Copies should be made for all years under audit to be included as an exhibit.
- (c) Supervisor must complete a settlement/resettlement sheet for each year under audit. A copy should be kept with the exhibited copy of the return.
- (d) All returns and settlement/resettlement sheets should be sent into Harrisburg as soon as possible to be processed through the Bureau of Corporation Taxes.

CTM103.8. General audit report guidelines.

- (a) Abbreviations may be used only if they are first spelled out with the abbreviation in parentheses.
 - (b) Use dollar signs and commas in your narrative.
- (c) References in the narrative or on the schedules are permitted for any published documents such as the law, regulations, court cases, published policy statements, Corporation tax bulletins, etc.

- (d) References to legal determinations are not permitted, as these are Attorney/Client confidential documents. When possible, provide rationale used in the conclusion of the legal determination as basis for change made and indicate it is based on current Bureau /Department policy.
- (e) Do not exhibit any information that the taxpayer has submitted with the return as filed.
- (f) If a corporation is greatly decentralized and is reporting to the corporate headquarters via tax packages, the auditors must extract specific detail on a Pennsylvania location and visit that location to verify the figures as submitted on the tax packages with original source documents on a test basis.

CTM103.9 Document labeling.

- (a) Correspondence includes all written communication between the audit office and the taxpayer. Correspondence is to be labeled with C- and an Arabic number. Correspondence should be listed in date order.
- (b) Schedules are prepared by the auditor. Schedules will be automatically number by the CT Access program.
- (c) Exhibits are the taxpayer's workpapers. Exhibits are labeled with capital letters. Use the label maker in the audit application.
- (1) Do not highlight areas of exhibits, as when copied these highlights will be dark or blacked out.
- (2) Identify numbers to be carried to the schedules. If a group of numbers are being summarized into one number, identify what numbers are compiled to make up the number carried to the schedules.
- (d) Workpapers are copies of Department of Revenue paperwork. Workpapers are labeled with roman numerals.
- (1) Workpapers with numerous pages can be broken down into sub workpapers to segregate those forms, schedules etc, which are being addressed in the audit.

(2) Any paperwork that is now on a Department image system need not be imaged.

CTM103.10. Documentation and audit trail.

- (a) In addition to the cites to the law and regulations in the narrative template headings, document all adjustments in the narrative with detailed explanations and specific references to the appropriate law, regulation, bulletin or other Department publications (in that order).
 - (b) When an adjustment is made:
 - (1) Describe the issue being adjusted.
 - (2) State how it impacts PA and everywhere.
 - (3) State reason for the adjustment.
 - (4) Identify laws & regulations that apply.
- (5) Identify taxpayer's records reviewed, copies of exhibits, and reference schedules.
 - (6) Must exhibit copy of taxpayer's records showing issue being adjusted.
- (c) If a taxpayer is in compliance and no adjustments are being made, the narrative can be shortened. However, to provide a proper audit trail, schedules must be completed and exhibits presented to show that the books and records were reviewed.

CHAPTER 105 - CONSENT TO EXTEND TIME LIMIT. (72 P.S. §7407.4)

CTM105.1 Consent to extend.

(a) A taxpayer may consent in writing before the expiration of the period (three years from received date) to extend the period. This also consents to extend the period

for record retention.

- (b) Where a taxpayer requests a delay and it is doubtful that the auditor can complete the audit by statutory deadlines the auditor must request the taxpayer complete a consent to extend form to cover the audit period subject to the statute of limitations.
- (1) The auditor must timely submit the Consent to Extend form to their supervisor for review prior to giving to the taxpayer.
- (2) This form must be executed in accordance with the Bureau's extension policy prior to granting any postponement.
- (3) The CNI, loans tax and capital stock/ foreign franchise taxes for the audit year may be included on one form.
- (4) The gross receipts telecommunications intrastate, interstate and mobile taxes for the audit year may be included on one form.
- (5) When collateral audits are performed, a separate waiver is needed for each year.
- (c) The taxpayer must NOT be asked to sign Consent to Extend nor should the auditor examine the period about to be lost due to the statute of limitations or record retention requirements on any audit assignment dated or started within two months of the expiration of statute.
- (d) When properly completed, the Consent to Extend becomes a binding legal document.
 - (e) As soon as the Consent to Extend has been obtained:
- (1) Submit copy to your regional manager to sign and enter the waiver from, to and exp. dates into AASTART.
- (2) After regional manager has signed the form, the supervisor should immediately enter in CTSTART on the note screen the following:
- "The taxpayer has signed the consent to extend form for the tax year ending mm/dd/yyyy. This extends the last day to assess this tax year until mm/dd/yyyy."

- (3) Scan the signed form and e-mail to headquarters' staff.
- (i) Headquarters' staff will revise the deadline date and due in headquarters date based on the extended date. An e-mail will be sent to the region notifying them of the new dates.
- (ii) This document will be forwarded to the Bureau of Corporation Taxes to attach to the imaged tax report.
- (f) The amount of tax due may be assessed at any time within the extended period.
- (g) The period so extended may be further extended by subsequent consents in writing made before the expiration of the extended period.
- (h) In those instances where the taxpayer has not responded to the auditor's reasonable attempts of contact or the taxpayer refuses to allow the auditor access to the records: see CTM103.4. Estimated Assessments.

Chapter 115. NARRATIVE/GENERAL COMMENTS

CTM115.1. Pre-audit conference.

- (a) This is the first day of the fieldwork.
- (b) Indicate date, location and attendees' names and titles.
- (c) Indicate names and titles of those who assisted in the audit and their telephone number(s).
- (d) Indicate the year under audit, the dates submitted/determined/(re)settled, and any appeals with any redeterminations/resettlements or refusals. Identify any collateral years being audited.
- (e) State abbreviated name or initials that will be used to refer to the taxpayer in the narrative.

CTM115.2. Commercial domicile.

- (a) Principal place from which the trade or business of the taxpayer is directed or managed. Corporate headquarters and commercial domicile are usually the same but not always. If uncertain, ask the taxpayer.
- (b) Indicate commercial domicile and location(s) where audit was performed. Also on REV-149, indicate name and address where finalized audit package should be sent.

CTM115.3. Corporate structure.

- (a) Parent/subsidiary information.
 - (1) Indicate if taxpayer is separate corporation with no related entities or
- (2) A corporation within a consolidated group. Indicate the ultimate parent corporation of consolidated group. If taxpayer is not the ultimate parent also indicate the parent of the taxpayer.
 - (3) Review IO-Ks, annual reports, organization chart and internet site.
- (i) If the taxpayer or its parent is publicly traded they must file with the Security Exchange Commission (SEC). Copies of the 10-Ks can be found on the internet at http://www.sec.gov/index.htm. Research this site and select the appropriate 10-K for the year of audit. Copy and paste the internet site for the 10-K into this section of the narrative. There is no need to obtain and submit a copy in this case.
- (ii) If the taxpayer or its parent does not file with the SEC, obtain copies of any audited financial statements.
 - (iii) Review 10-Ks and / or annual reports to determine:
 - (A) If unitary or multiform organization.
 - (B) Any major acquisitions or disposals during year.
 - (C) Any mergers.

	(D)	Any	accounting	changes	that	occurred	during	year	that
may impact audit.									

- (iv) Obtain a world wide organization chart to show organization during the audit period and the current date showing ownership of all companies within the group.
 - (v) Identify any internet sites the taxpayer may have.
 - (b) Filing with the Internal Revenue Service.
- (1) Separate corporation returns determine that the copy of the federal return filed with the PA report is the same as returned to and ascertained by the federal government.
- (2) Corporation participating in the filing of consolidated returns determine that the PA report includes the copy of the federal return shows the taxable income which would have been returned to and ascertained by the federal government if separate returns had been made to the federal government for the current and prior taxable years, subject, however, to any correction thereof, for fraud, evasion, or error as finally ascertained by the federal government.
- (3) Obtain copies of income statement, balance sheet, Schedule A, M-1s and M-2s or M-3s including supporting schedules for all companies within the consolidated group.
- (i) This is to verify that the Federal Form 1120, as filed with the Department, is on a separate company basis. The pro forma should be prior to any eliminations for consolidation.
- (ii) Review copy of Federal Form 8886 Reportable Transaction Disclosure Statement.
- (iii) Exam intercompany activities between the taxpayer and other related companies.
- (iv) State in the narrative if the Federal Form 1120 as filed with the return agrees with documentation reviewed. If discrepancies exist, indicate such in

this section of the narrative but provide details in the appropriate sections further in the narrative.

CTM115.4. Internal Revenue Service audits.

- (a) Indicate all years examined and finalized by the Internal Revenue Service and specify if Pennsylvania Report of Change returns have been filed.
- (1) Just prior to going to the taxpayer, review the CT Ledger System to determine in what year the last Revenue Agent Report (RAR) was filed. (t/c R14)
- (2) Do not submit figures or copies of Federal RAR's and Pennsylvania REV-128C Report of Change in CNI Tax (R/C) for years which the taxpayer has already notified the Department unless it is the year under audit.
 - (3) If no RAR's are filed, obtain copies along with a completed R/C 128.
- (i) If R/C is not completed, instruct taxpayer where to file and supply R/C128 form or instruct them how to obtain a copy from the Department's internet site. However still obtain copies of the RARs.
- (ii) If taxpayer made a payment(t/c 14) but did not file a RAR (t/c R14), obtain copies of the RAR and R/C.
- (iii) Forward to Headquarters any RARs and R/Cs obtained in the field as soon as possible upon return to office. Indicate date received. Attach envelope received in, if sent by mail.
- (4) For years under audit, any RARs received must determined/settled prior to the completion of audit.
 - (b) Indicate for audit year any RARs received and date determined/settled.

CTM115.5. Business activities of the corporation.

- (a) If no exempt activities, obtain the following:
- (1) A detailed description of the taxpayer's activities within Pennsylvania by location and division is required at this point.

- (2) General statements for activities outside Pennsylvania are adequate.
- (b) If there are exempt activities, obtain the following:
- (1) If engaged in exempt activities both within and outside Pennsylvania, the detailed description will precede the Capital Stock/Franchise Tax apportionment factor comments.
- (2) Only a brief general description is required in this section of the narrative.
- (c) Indicate in the narrative that the above-indicated descriptions were provided by the taxpayer (written description, brochures, web sites, etc.) and have been verified by the auditor, unless otherwise indicated by a description of a plant tour later in the narrative.

CTM115.6. Subjectivity to taxation.

- (a) Subjectivity in Pennsylvania:
- (1) CNI Tax, if the taxpayer does any of the following: (72 P.S. § 7401.(3)2.(a)(2)/61 Pa. Code § 153.1)
 - (i) Doing business.
 - (ii) Carrying on activities.
 - (iii) Having capital or property employed or used.
 - (iv) Owning property.
- (2) Capital Stock/Franchise, if the taxpayer does any of the following: (72 P.S. § 7601(a)/61 Pa. Code § 155.1)
 - (i) Doing business.
- (ii) Carrying on activities including solicitation (included as of 7/2/86).
 - (iii) Having capital or property employed or used.

(iv)	Owning	pro	perty.

- (b) Subjectivity outside of Pennsylvania:
- (1) A taxpayer is taxable in another state if in that state, the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.
- (i) Only if a state does not have any of the above taxes does the phrase "that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." is applicable.
- (ii) The company cannot use this to say they would be subject but they just did not file. Actions speak louder than words. If they did not file, they must feel they are not subject otherwise that would be evasion of tax.
- (iii) If a state does not subject corporations to a CNI but does have a Franchise tax and the company does not file a Franchise tax return, they cannot say they would have been subject to CNI if the state had CNI tax. The CNI tax nexus standards are at a higher level than Franchise tax, so if they were not paying Franchise tax they would not be subject to CNI tax either.
- (iv) Per Commonwealth of Pennsylvania v. Greenville Steel Car Company, 469 Pa. 444, 366 A.2d 569 (1976) there is a two prong apportionment test company must be doing business outside (subjectivity) which renders it taxable outside Pennsylvania (filing returns). Must be both subject and filing a return to qualify for nexus outside the state.

(2) If "Subjectivity" is an issue:

- (i) Have the taxpayer complete the Declaration Of Nexus Form.
- (ii) Obtain a detailed description of all activities outside Pennsylvania.
- (iii) Obtain and review complete copies of signed tax reports filed in the other states. Be sure the copies include pages showing state income tax and

apportionment factor computations in support of taxpayer's subjectivity outside Pennsylvania.

- (iv) If taxpayer is included in a combined or consolidated state return, determine that taxpayer has nexus in that state on a separate company basis. If not subject on a separate company basis, the taxpayer would fail the two prong test.
- (v) If the sole contact of a corporation outside of Pennsylvania is the purchase and lease back of property under a Safe Harbor lease agreement, where title to the property <u>does</u> pass to such corporation, the corporation is subject to tax in that state (per 61 Pa. Code § 153.30).
- (vi) The Department has exchange agreements with most other States. Copies of other state returns may be obtained if the validity of the copy received is questioned. Contact headquarters' personnel to request copies from another state.
- (c) This topic does not have to be included in the narrative if subjectivity in other states is not an issue. This must be addressed however if the taxpayer is subject in only one or two states and has minimal taxes paid.

CTM115.8. Interests in unincorporated entities. (72 P.S. § 7402.2 & 61 Pa. Code § 153.29)

- (a) 72 P.S. § 7402.2 was added under Act 89 of June 2002 and is considered a clarification of existing law and shall not be constructed as a change in existing law.
- (b) A corporation's interest in an entity, which is not a corporation, shall be considered a direct ownership interest in the assets of the entity rather than an intangible interest.
- (c) Investment in a Partnership/Joint Venture: 72 P.S. § 7402.2 & 61 Pa. Code § 153.29
- (1) Obtain copies of Federal Form 1065, Schedule Ks, Schedule K-1s or other appropriate Federal schedules. Include copies as exhibit(s) in audit package.
 - (2) List partnerships/joint venture and percentage of ownership.

- (3) If partnership is in Pennsylvania, obtain name and SS# or EIN of all other partners. Verify that the partners are filing in Pennsylvania. If not, this information should be attached to the 1105 to be forwarded to the Discovery Unit.
- (4) If information is not available or taxpayer chooses not to include, attach statement from taxpayer indicting partnership has no activity in Pennsylvania and has chosen not to include information in factors.
 - (d) Interest in a limited liability company (LLC):
 - (1) IRS Classification of LLCs.
- (i) Single member LLCs classified as a disregarded entity (considered as a division or branch). This is the default classification unless electing to be classed otherwise using FF 8832 Entity Classification Election.
- (ii) Multimember LLCs classified as a partnership. This is the default classification unless electing to be classed otherwise using FF 8832.
- (iii) LLCs classified as corporations must elect this treatment and have filed a FF 8832.
- (2) CNI. Single member and Multimember LLCs are disregarded entities for CNI purposes and will be included in the partners/owner tax return. LLCs classified as corporations will not be included in the partner/owner return but will file their own return.
- (i) For single member LLCs obtain copies of the FF1120, balance sheet and book income with spreadsheets showing the breakout between the taxpayer and each LLC.
- (ii) For Multimember LLCs classified as a partnership follow the partnership procedures above.
- (iii) Verify that LLCs classified as corporations are not included in the taxpayer's return.
- (3) Capital Stock / Franchise. By definition under the Capital Stock/ Franchise law LLCs are considered a corporation and will file PA CS/FF returns on their own if they have nexus in PA.

		(i) T	he partne	rs/own	er wo	uld not	include	the LLC	in the	fractions	for
CS/FF.	The LLC	would	be consid	dered as	a su	ıbsidiar	y for boo	ok incon	ne and	equity	
purpose	S.										

- (ii) If the LLC has activity in PA, determine that the LLC is filing a Capital Stock or Foreign Franchise return.
- (iii) If the taxpayer is only subject in PA due to an LLC's activity in PA , then the taxpayer would file a CNI report only and the LLC would file a CS/FF report only.

(e) S-Corps:

- (1) Identify all stockholders, percentage ownership and indicate if PA residents or non-residents.
- (2) Review 1120S and PA RK-1/ NRK-1 returns for proper determination of taxable income and trace to all stockholders.
- (3) If changes in taxable income or stockholders did not report pass through income from S corp refer to Headquarters for a potential audit for the appropriate tax.

CTM115.9 Other financial information.

- (a) For all unincorporated entities with activity in PA, be sure all appropriate PA returns are filed. Verify that all partners filed reporting their portion of the pass thru entity's activities.
- (b) If the sole contact of a corporation inside of Pennsylvania is the purchase and lease back of property under a Safe Harbor lease agreement, where title to the property <u>does</u> pass to such corporation, the corporation is subject to tax in Pennsylvania (per 61 Pa. Code § 153.30).

(c) Amended reports.

(1) Prior to the start of the field work, review the CT ledger system to determine if any amended reports are filed.

- (2) If any amended returns are received from the taxpayer during the audit, forward to Headquarters the signed original amended returns to have processed by the Department.
 - (i) Indicate date received or attach envelope if received in the mail.
- (ii) If for the year under audit, scan into the audit package and address the amended changes in the narrative.
 - (d) Mergers.
 - (1) Obtain copy of Articles of Merger.
- (2) Identify merging companies, survivor corporation, PA filing status of all companies and the date of the merger.
- (3) Identify the IRC section under which the merger occurred. This is important to determine tax attributes that may be carried over to the survivor, revert back to the parent or are lost when the company ceases existence. Some areas that may be effected by a merger are:
- (i) PA Net Loss carry-ins from a merged company that had filed in PA. Will need to request merger information for the oldest PA NL carry-in forward.
- (ii) 5 year history of earnings fixed formula within the last five years. Will need to request merger information for the last five years.
- (e) Determine how intercompany transactions are handled and how consolidated returns are prepared.
 - (1) Identify sale, lease or transfer of such items as:
 - (i) Tangible goods for sale.
 - (ii) Fixed assets.
- (iii) Intellectual property such as trademarks, trade names, other marks, advertising slogans etc.
 - (iv) Subsidiaries.

- (v) Assignment of rights.
- (vi) Management fees.
- (vii) Interest expense/intercompany loans.
- (2) Obtain documentation such as agreements, contracts, business plans, Board minutes/resolutions, journal entries, etc. for these intercompany transactions.
- (3) Determine if there are passive investment companies to handle intercompany transactions.
- (i) Determine if royalties were paid to a Passive Investment Company for intellectual property, if so have the taxpayer complete a questionnaire.
- (ii) Determine if interest was paid to a Passive Investment Company for intercompany loans if so have the taxpayer complete a questionnaire.
- (f) Obtain copies of M-2s of all subsidiaries to verify dividend distributions to taxpayer.
 - (g) Indicate if taxpayer has any of the following:
 - (1) Safe harbor leases. 61 Pa. Code § 153.30 and 26 U.S.C.§ 168.
 - (i) Does taxpayer hold real title or title for tax purposes only?
 - (ii) Obtain copy of safe harbor lease and/or Federal Form 6793.
 - (iii) Identify if the taxpayer is the lessor or lessee.
 - (iv) How is safe harbor lease handled in audit?
- (v) Indicate if lease is included or excluded in the factors as submitted/determined/(re)settled and per audit. Provide a schedule.
 - (2) Leases.
 - (i) Are capital leases included in factor as rents or assets owned?

- (A) Identify how handled in property factor and that not included both ways.
 - (B) Identify if the lessee or the lessor.
 - (ii) Ask the taxpayer if there are any synthetic leases.

CHAPTER 116. POST AUDIT CONFERENCE

CTM116.1. Post audit conference.

- (a) The date, name and titles of attendees, and location should be detailed in the narrative.
- (b) Review all proposed changes with the taxpayer. It is recommended that the supervisor do a preliminary review of the audit adjustments so that there are not several post audit conferences.
- (1) Copies of preliminary audit schedules may be given to the taxpayer upon fieldwork completion. The auditor should emphasize to the taxpayer that the schedule copies are only preliminary at this point.
- (i) Audits under Act 119. Final copies of the narrative and schedules will be sent to the taxpayer with the assessment.
- (ii) Audits under the resettlements system. Final copies of the narrative and schedules will be sent to the taxpayer upon request.
- (2) All post audit conferences conducted on the phone, should be followed by a letter confirming the phone call occurred and detailing proposed changes.
- (3) All subsequent changes made after the post audit conference should be conveyed to the taxpayer.
 - (c) Answer all inquiries of the taxpayer.
 - (d) Inform taxpayer of their rights to petition.

(e) Have the taxpayer sign and date the post audit conference form. The post audit conference form must include the proposed changes but not the assessment amount.

CHAPTER 118 AUDIT PACKAGE SENT TO HEADQUARTERS

CTM118.1 Final audit package.

Verify that all documents to be included in the final imaged audit package are listed on the index, are correct, and in the final version.

CTM118.2 Status report.

- (a) Review the Corp Tax ledgers and verify the Audit Status Report has been completed correctly.
- (b) Any Settlements, Resettlements, Reports of Change, etc, must be documented and must be shown separately, with the tax amounts and the date that each occurred.
- (c) For Reports of Change or Amended Reports, the tax amount should be the increase or decrease to the tax, not the new tax amount.
- (d) Do not, for example, net the self assessed and settled tax amounts and show them on the Self Assessed Tax line for an audit resettlement.

CTM118. 3 Audit assignment on WEB.

Check the WEB page of the audit assignment, the imaged documents tab, to verify all documents have been imaged, and all buttons are active.

CTM118.4 Audit application.

- (a) Check the Audit Application, Scanned Images button, after your audit has been imported.
 - (b) Verify "Current Status" for all documents is OK.

- (1) If "Additional image not on index" appears, this document is not listed on the index and needs to be added to the index or deleted from the images. Print preview the index after correcting to update the image of the index.
- (2) If "Possibly Out of Date" appears, the schedule numbers do not match the index. Highlight the image, then right click and select Edit Description. In the Sub Type, enter the schedule number to match the index.
- (3) If the Status of Open Years is listed, as well as "Audit Status Report", they may be duplicates. Highlight "Audit Status Report", right click and select Edit Description, and type in "Status of Open Years" in the Document Type, and the Workpaper number in the Sub type. Then delete the incorrect version.
- (4) Open the images of the schedules to verify they are shown as "Final", not "Preliminary".
- (5) Check "Date" of all Schedules to verify they match. If any do not match the date schedules were made final, or with the final version in the audit application, go back to "Work on Audit Files" and print preview those schedules to update the image.

CTM118.5 Compare summary sheet to CTSTART, settlement or resettlement sheets.

- (a) CTSTART.
 - (1) Verify CTSTART amounts match summary.
 - (2) Verify bonus depreciation lines completed properly.
 - (3) Add notes to notes screen, if needed, to clarify audit findings.
- (b) Resettlements.
 - (1) Verify box number and assignment number correct.
 - (2) Verify type of tax box checked is correct.
- (3) Verify, using CT ledger, that year-end is correct, date to supersede settlement or resettlement is correct and present, and tax and penalty amounts

correct. If there are any discrepancies, the probable cause is the Status of Open Years form, which must be corrected.

- (4) Compare all figures to Summary sheet, including final tax and debit or credit amounts.
 - (5) Verify your name is included as a signature.
- (6) If you make any changes to amounts that are carried forward on CTSTART, i.e. Book income or NL's, you should put a note in CTSTART, both in the audit year and any current unsettled years, to indicate the changes.
 - (c) Authority sheet.
 - (1) Verify "AG taxing officer" listed from CTSTART.
 - (2) Verify "original DLN" correct from ledger.
 - (3) Verify "Date of original settlement" correct from ledger.
 - (4) Verify taxes "X'ed" for those taxes that are being resettled.
- (5) Resettlement sheets should be included even if there is no tax change. This is to comply with the Auditor Generals instructions.

CTM118.6 Changes to the audit.

- (a) Anytime you make changes to the audit, you must print preview the item (for those included in the audit application) so that the images will be updated. Those items that are not part of the audit application, i.e. Exhibits, Authority Sheet, etc, will have to be scanned again.
- (b) Changes can be made to the audit up until the audit has been committed by Harrisburg. When making changes to the audit package after the region has confirmed the audit and transmitted the image to Harrisburg, you must inform Headquarters immediately what areas have been changed, so they can be reviewed before the documents are committed to Onbase.
- (c) After Headquarters has committed the audit, changes to the audit may only be made with Headquarters knowledge and approval.

(d) Any audits submitted incorrectly or with errors will be returned to field for corrections

Part II- Corporate Net Income Tax - PA Taxable Income

For statutory and regulatory guidance (see 72 P.S. § 7401 and 7402/ 61 PA. CODE § 153.1 – 153.81).

CHAPTER 201. IMPOSITION OF TAX

CTM201.1. A tax at a rate of 9.99% is imposed on corporations.

- (a) A corporation is any of the following:
 - (1) A corporation.
 - (2) A joint-stock association.
- (3) A business trust, limited liability company or other entity which for Federal income tax purposes is classified as a corporation.
 - (b) A corporation is not:
- (1) A business trust which qualifies as a real estate investment trust under section 856 of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. § 856) or which is a qualified real estate investment trust subsidiary under section 856(i) of the Internal Revenue Code of 1986 (26 U.S.C. § 856 (i)).
- (2) A business trust which qualifies as a regulated investment company under section 851 of the Internal Revenue Code of 1986 (26 U.S.C. § 856(i)) and which is registered with the United States Securities and Exchange Commission under the Investment Company Act of 1940 or a related business trust which confines its activities in this Commonwealth to the maintenance, administration and management of intangible investments and activities of regulated investment companies.

- (3) A corporation, trust or other entity which is an exempt organization as defined by section 501 of the Internal Revenue Code of 1986 (26 U.S.C. § 501).
- (4) A corporation, trust or other entity organized as a not-for-profit under the laws of this Commonwealth or the laws of any other state which:
- (i) Would qualify as an exempt organization as defined by section 501 of the Internal Revenue Code of 1986 (26 U.S.C. § 501);
- (ii) Would qualify as a homeowners association as defined by section 528(c) of the Internal Revenue Code of 1986 (26 U.S.C. § 528(c));
- (iii) Is a membership organization subject to the Federal limitations on deductions from taxable income under section 277 of the Internal Revenue Code of 1986 (26 U.S.C. § 277) but only if no pecuniary gain or profit inures to any member or related entity from the membership organization; or
 - (iv) Is a nonstock commodity or nonstock stock exchange.

CTM101.2. Subjectivity.

A corporation shall be subject to tax for any of the following privileges:

- (1) Doing business in this Commonwealth.
- (2) Carrying on activities in this Commonwealth, including solicitation which is not protected activity under the act of September 14, 1959 (Public Law 86-272, 15 U.S.C. § 381 et seq.).
 - (3) Having capital or property employed or used in this Commonwealth.
 - (4) Owning property in this Commonwealth.

CHAPTER 202. FEDERAL TAXABLE INCOME OR LOSS

CTM202.1. Federal taxable income or loss (FF 1120, 1120A, 1120S, 1120RIC, or 1120 REIC). (72 P.S. § 7401.(3)1.(a))

- (a) As returned to and ascertained by the federal government, or
- (b) In the case of a corporation participating in the filing of consolidated returns to the federal government,
- (1) The taxable income which would have been returned to and ascertained by the federal government if separate returns had been made to the federal government for the current and prior taxable years,
- (2) Subject, however, to any correction thereof, for fraud, evasion, or error as finally ascertained by the federal government.
- (c) In the case of regulated investment companies as defined by the Internal Revenue Code of 1954, as amended, "taxable income" shall be investment company taxable income as defined in the aforesaid Internal Revenue Code of 1954, as amended. (Per 72 P.S. § 7401(3)1.(n))
- (d) No deduction shall be allowed for the amount of the net operating loss deduction taken under 26 U.S.C. § 7 172. (72 P.S. § 7401(3)1.(m))

CTM202.2. Federal passive losses limitation.

- (a) Applies to the calculation of federal taxable income as reported to or as would have been reported to the IRS pursuant to IRC § 469.
- (b) Applies to individuals, estates, trusts, personal service corporations and closely held C corporations.
 - (c) Determination made on a separate company basis.
- (d) Losses from passive activities may only be used to offset income from passive activities.
 - (e) Unused losses may be carried forward indefinitely.
 - (f) Passive activities include the following:

- (1) Trade or business activities in which the taxpayer does not materially participate during the year.
- (2) Rental activities, even if taxpayer does materially participate in them, unless the taxpayer is a real estate professional. Refer to IRS Publication 925 for additional details.
 - (g) Application for Pennsylvania CNI Tax purposes.
- (1) If federal taxable income reported on the PA Corporate Tax report is from a federal income tax return actually filed with the IRS this would already be included in arriving at Line 28 and no adjustment would be required.
- (2) If the federal taxable income reported on the PA Corporate Tax report is from a pro forma federal income tax return or if the taxpayer is a federal S corporation but is a PA C corporation adjustments may be required. If making these adjustments the following is required:
- (i) The taxpayer must provide a schedule showing the calculation of federal taxable income.
- (ii) The taxpayer must provide a copy of the appropriate federal schedule, normally FF 8582, supporting the passive loss limitation and FF 6198, At Risk Limitation.
- (iii) The passive loss limitation carryforward must be entered in the note screen of the subsequent year.

CHAPTER 203. ADJUSTMENTS TO FEDERAL TAXABLE INCOME

CTM203.1. Separate company basis.

- (a) Must be on a separate company basis.
- (1) If taxpayer files on a separate company basis for Federal tax purposes. No changes to the federal return may be made. If you find errors,

headquarters can be contacted and we will forward the information to the IRS through our liaison.

- (2) If taxpayer files on a consolidated basis for Federal tax purposes, then verify that the PA Corporate tax report is on a true separate company basis before eliminations. Verify that the pro forma separate company return includes all transactions and that the intercompany transactions appear in the eliminations column of consolidating schedules. Also verify the pro forma against the books, records and taxpayer's working papers to ascertain any book and tax differences.
- (b) Other separate company transactions that may not be on the pro forma but should be included, such as:
- (1) Sale of assets between companies filing within a consolidated group, when for consolidated purposes the gain or loss is not recognized until sold outside the consolidated group. For separate company basis the gain or loss would be recognized at the time of sale to the related company.
- (2) Sales of inventory between companies filing within a consolidated group.
 - (3) Loans between companies filing within a consolidated group.
 - (4) Intercompany receivables and payables.
- (5) Review FF M-2 for distribution, from a sub, of appreciable property for 26 U.S.C. § 311(b) gains.

CTM203.2. Capital losses.

- (a) Capital losses on a separate company basis are allowed to the extent of capital gains on FF Schedule D per 26 U.S.C. § 1211 and 72 P.S. § 7401(3)1.(a). Therefore FF 1120 line 8, Capital gain net income should never be less than zero.
 - (b) Capital losses carried back or forward based on IRS statute.
- (1) Currently must be carried back three years and then can be carried forward five years.

- (2) Example of documentation to request FF 1139, Corporation Application for Tentative Refund or a FF 1120X, amended return.
- (3) If FF Schedule D has any loss carryforwards or carrybacks (reference Part I line 4) verify the following:
 - (i) The losses on prior years' FF Schedule D.
 - (ii) The losses were not applied against any prior or future years.
- (iii) Amended returns have been filed for federal and state (if there are carrybacks). However, if taxpayer's capital losses were utilized to offset capital gains in the consolidated return there will be no federal amended return filed.
- (c) Capital losses should not be shown as an other deduction or an other addition on the RCT-101. These capital losses should be included in the calculation of FF 1120, line 28.

CTM203.3. Charitable contributions.

- (a) Contributions per 26 U.S.C. § 170(b)(2) are limited to 10% of the taxpayer's taxable income computed without regard to charitable contributions, any net operating loss carryback to the taxable year under 26 U.S.C. § 172 and any capital loss carryback to the taxable year under section 26 U.S.C. § 1212(a)(1). 61 Pa. Code § 153.14.
- Therefore allowable contributions are: (line 28 plus contributions) x
 10%.
 - (2) Excess contributions can be carried forward 5 years.
- (i) For a year where there is a loss, the contribution loses its characteristics and becomes part of the federal net operating loss deduction. Therefore, there is no charitable contribution deduction to be carried forward.
- (ii) Charitable contributions, FF 1120 line 19, should be zero in a year where is a loss.
- (3) When calculating federal taxable income on a separate company basis a taxpayer may be entitled to a contribution deduction which is different than the

deduction allowed as part of the consolidated return.

- (b) The Gulf Opportunity Zone Act of 2005 temporarily suspended the 10% taxable income limit on charitable contribution deductions for contributions made "after August 27, 2005, and before January 1, 2006, to a qualified charitable organization [other than certain private foundations described in section 509 (a) (3)], for Hurricane Katrina, Rita, or Wilma relief efforts".
- (1) With this change it is possible for taxpayers filing reports for periods which include this period of time to report charitable contributions in excess of 10% of the federal taxable income before the charitable contribution deduction in the calculation of federal taxable income.
- (2) Taxpayer is required to separate charitable contributions into two categories: qualified deductions and non-qualified deductions.
- (3) The taxpayer must first calculate federal taxable income prior to any charitable contribution deduction and determine the 10% deduction limitation. The taxpayer then deducts non-qualified contributions up to the amount of the limitation.
- (4) The taxpayer may deduct <u>all</u> qualified contributions up to the amount of <u>federal taxable income</u> less the allowable deduction for non-qualified contributions.
- (5) The contribution deduction under these provisions may not create or increase a Net Operating Loss.
- (6) Any unused contribution deduction may be carried forward for 5 years and would be subject to the 10% limitation.
- (i) For a year where there is a loss, the contribution loses its characteristics and becomes part of the federal net operating loss deduction. Therefore, there is no charitable contribution deduction to be carried forward.
- (ii) Charitable contributions, FF 1120 line 19, should be zero in a year where there is a loss.

CTM203.4. Gain or loss from sale of subsidiary stock.

(a) Gains or losses included in Federal taxable income from the sale of subsidiary's stock attributed to excess losses or accumulated earnings and profits used

for consolidated purposes per Treas. Reg. § 1.1502 (1996) are not recognized on a separate company basis.

- (b) If not included in tax return filed request a breakdown of how gain was calculated, showing the reduction in basis of stock for NLs used by parent.
- (c) Recalculate the gain or loss on sale of stock for PA purposes without the reduction for NLs used by the parent.

CTM203.5. Domestic production activities (manufacturing) deduction. (IRC Sec 199).

- (a) Effective for years beginning on or after January 1, 2005.
- (b) Qualifications to claim this deduction are different than the qualifications to claim the Manufacturing, Processing, or Research and Development exemption for the Capital Stock Tax or Foreign Franchise Tax.
- (c) IRC Section 199(d)(4)(c) provides that the deduction shall be allocated among the members of the expanded affiliated group in proportion to each member's respective amount (if any) of qualified production activities income. In calculating PA Taxable Income a corporate taxpayer is entitled to the same deduction used in the calculation of Federal Taxable Income. However, the deduction claimed by a corporation who is part of a consolidated federal group may not exceed the deduction allocated to that corporation pursuant to IRC Section 199(d)(4)(c). (Revenue answer to question 13 -PICPA Question and Answer September 28, 2005.)

CTM203.6. Calculation of taxable income—Federal S corporation that is not a PA S corporation.

- (a) Additions from Schedule K of FF 1120S unless otherwise noted:
 - (1) Net real estate rental income.
 - (2) Other net rental income.
 - (3) Interest.
 - (4) Ordinary dividends.

- (5) Royalties.
- (6) Other portfolio income.
- (7) Gain (net of capital gains + Sect. 1231 gain against capital losses). Should not be less than zero.
- (8) Sect. 1231 (if a loss it is considered an ordinary loss-include in the calculation of taxable income, if a gain it is considered a capital gain, include the amount with capital gains and net against capital losses).
 - (9) Other income.
 - (b) Deductions from Schedule K of FF 1120S unless otherwise noted:
 - (1) Deductions related to portfolio income.
 - (2) Other deductions.
 - (3) Interest expense on investment debts.
 - (4) Total foreign taxes paid.
 - (5) Total expenditures to which section 59(e) election may apply.
 - (6) Domestic production activities deduction IRC section 199.
 - (c) Total = total net income before section 179 & charitable contributions.

CTM203.7. Extraterritorial income deduction.

- (a) Reported as either an other deduction or other expense on the federal income tax return.
 - (b) Included in the calculation of federal taxable income.
- (c) No statutory provision to add back this item when calculating PA taxable income.

(d) Additional details on extraterritorial income can be found on the instructions for federal form 8873.

CHAPTER 204. PENNSYLVANIA ADJUSTMENTS TO INCOME

Only adjustments specifically listed in 72 P.S. § 7401(3)1.(b) are permitted. If a particular item is not listed then no adjustment is permitted.

CTM204.1. Dividend deduction.

- (a) For years beginning on or after January 1, 1991, dividends received from the United States and foreign corporations are deductible to the same extent as allowed to arrive at the federal dividends deduction, as indicated on FF 1120, Federal Schedule C, column C.
- (b) An additional deduction will be allowed for amounts included under 26 U.S.C.§ 78 (Foreign Dividend Gross Up).
- (c) An additional deduction for foreign dividends reported on lines 13 and 14 of the Federal return Schedule C, based on the total ownership through attribution of these foreign subs equal to:
 - (1) 70%, dividends from less than 20%-owned foreign corporation
 - (2) 80%, dividends from 20%-or more-owned foreign corporation; or
- (3) 100%, dividends from foreign corporation that meets the "80-percent voting and value test" of 26 U.S.C §1504(a)(2) of the Internal Revenue Code of 1986 and would otherwise qualify for a 100% deduction under 26 U.S.C. § 243(a)(3) if the foreign corporation were a domestic corporation.
 - (d) Repatriated Dividends-- In 2004 and 2005 only.
 - (1) 85% federal deduction allowed.
 - (2) Remaining 15% allowed, if dividends qualified for 100% deduction.

- (e) Taxpayers are required to complete the Pennsylvania deduction schedule C-2. This schedule allows taxpayers to compute the additional deductions for foreign dividends and the total dividend deduction for taxable years beginning January 1, 1991 and thereafter.
 - (f) No deduction is allowed for dividends from trusts or noncorporate entities.
- (g) For tax year prior to 1991 dividends are deducted, to the extent included in taxable income for federal purposes.
- (h) Obtain or prepare a schedule of all dividends listing name and percentage ownership.
- (i) Must be direct owner of stock of investee corporation in order to receive dividend deduction.
- CTM204.2. Interest on securities of the United States and its instrumentalities. (Commonwealth of Pennsylvania v. Curtis Publishing Company, 59 Dauph 430, 64 Pa. D. & C. 135)
- (a) For tax years beginning on or after January 1, 1991 expenses of earning tax-exempt U.S. security income will be treated in a manner consistent with federal treatment of expenses attributable to exempt income from state and local obligations under Section 265 of the Internal Revenue Code. Therefore, interest on U.S. Securities is deductible but must be reduced by:
- (1) Any interest on indebtedness incurred to carry the securities. Interest expense should be prorated by the fraction of US & PA securities divided by total assets.
- (2) Any expenses incurred in the production of such interest income such as investment department expenses.
- (3) Any other expenses deducted on the Federal Income Tax return that would not have been allowed under 26 U.S.C § 265 if the interest were exempt from Federal Income Tax.
- (b) Effective for 1/1/93 on, Pa and U.S. interest from a regulated investment co is passed through to the investor._ Allow an exemption from CNI Tax for interest income received as a distribution or dividend from a regulated investment company to

the extent that such distribution or dividend is derived from obligations free from state taxation.

- (c) Corporation Tax Bulletin No. 94 lists securities determined to be obligations of the U.S. Government.
- (d) Make a statement in your narrative if they are owned U.S. Treasury Bills or repurchase agreements.
- (1) Treasury Bills are usually 30-90 days, if less than 30 days they are usually repurchase agreements.
- (2) Check the balance sheet for federal and Pennsylvania State government obligations.
- (3) Verify that the government obligations are held in the company's name or street name of the broker as custodian for the taxpayer.
- (4) Interest from repurchase agreements is not deductible from taxable income.
- (5) Per 26 U.S.C. §103 interest from state and local bonds are excluded from federal taxable income and should not be included as a deduction on the RCT-101.

CTM204.3. Gains on certain governmental obligations – (72 P.S. § 9901)

- (a) Profits, gains or income derived from the sale, exchange or other disposition of government obligations shall be subject to state or local taxation for obligations issued after 2/4/94. Verify original issue date as prior to February 4, 1994 when gain exclusion is claimed by taxpayer.
- (b) For Gains on certain Government obligations issued prior to 2/4/94 see /C. C. Collings & Co., Inc. v. Commonwealth of Pennsylvania, 488 A.2d 1187 (Pa. Cmwlth. 1985). Gains that are excluded from Pennsylvania taxable income and reported on RCT-101, line 2(d), other are as follows:
 - (1) Federal obligations.

- (2) Pennsylvania state and municipal obligations. Gains from obligations from other states are not to be excluded from taxable income.
- (c) Gains and losses on government obligations are netted. However net losses cannot be added back to income.
- (d) Net gain on government obligations cannot exceed capital gains included in FF 1120, line 28.
- (e) Commissions earned by brokers in connection with the sale of U.S. or Pennsylvania securities are not exempt from taxable income.

CTM204.4. Work opportunity tax credit. (72 P.S. § 7401(3)1.(c))

- (a) Deductions shall be allowed from taxable income in an amount equal to the amount of any reduction in an employer's deduction for wages and salaries as a result of the employer taking a credit for its FICA tax obligation on its employees' tips or "targeted jobs" pursuant to 26 U.S.C. § 45B or 26 U.S.C. § 51.
- (1) Deduction for FICA tax obligation on its employees' tips, 26 U.S.C. § 45B, must be supported by a Federal Form 8846.
- (2) Deduction for disallowed expenses for credits pursuant to 26 U.S.C. § 51 must be supported by Federal Form 5884.
- (b) No deduction is allowed for expenses disallowed by the Internal Revenue Service for credits covered under any other section of the Internal Revenue Code.
 - (c) Examples of credits not allowed:
 - (1) Empowerment zone employment credit (26 U.S.C. §1396).
 - (2) Welfare to work credit (26 U.S.C.§ 51A)
 - (3) Renewal community employment credit (26 U.S.C. § 1400H)

CTM204.5. Tax preference items. (Form 4626 - 72 P.S. §7401.(3)I.(d)/61 Pa. Code § 153.11, §153.12, §153.13 and §153.14)

- (a) Tax preference items as defined by 26 U.S.C. § 57 (72 P.S. § 401.(3)1.(d)).
 - (1) Excess investment interest;
 - (2) Accelerated depreciation on real property;
 - (3) Accelerated depreciation on personal property subject to a net lease;
 - (4) Amortization of certified pollution control facilities;
 - (5) Amortization of railroad rolling stock;
 - (6) Stock options;
 - (7) Reserves for losses on bad debts of financial institutions
 - (8) Capital gains; and
- (9) Accelerated cost recovery deduction under section 57(a)(12)(B) of the Internal Revenue Code, but only to the extent that such preference items are not included in "taxable income" as returned to and ascertained by the federal government.
- (b) Review taxpayer's detail for correctness. Tax preference is calculated on an individual asset basis. Netting is permitted when the tax depreciation falls below straight-line depreciation or when an asset is sold. The deduction cannot exceed the amount previously added back on a particular asset. Additionally, in order for a deduction to be permitted when an asset is sold, the depreciation recapture must be treated as an ordinary gain Form 4797 for Federal Income Tax purposes.
- (1) In order to recapture tax preference previously added back when it falls below straight line, a schedule must be obtained.
- (2) Cannot exceed total tax preference added back in prior years for which additional tax was assessed. (This special deduction was decided in Roosevelt Arms, Inc. v. Commonwealth of Pennsylvania, 608 A.2d 648 (Pa. Cmwlth. 1992)
 - (c) Taxpayers are allowed to recapture tax preference items previously added back when the accelerated depreciation falls below straight line. Taxpayers

recapturing Tax Preference items are required to provide a schedule showing the accelerated depreciation, straight line depreciation, and the amount added to or subtracted from taxable income for each year. The amount of the recapture cannot exceed total tax preference added back in prior years for which additional tax was assessed. (This special deduction was decided in Roosevelt Arms, Inc. v. Commonwealth of Pennsylvania, 608 A.2d 648 (Pa. Cmwlth. 1992)

CTM204.6. Special deduction.

A special deduction is available for corporations amortizing certified pollution control facilities under 26 U.S.C. § 169, when the rapid amortization period benefit ends. The deduction is limited to the difference between rapid amortization and straight-line depreciation when the rapid amortization ends. (61 Pa. Code § 153.14.(3) and (4)).

- (a) Must have a Pennsylvania DER Certificate
- (b) Obtain a schedule of amortization when it falls below straight line.
- (c) Obtain and submit Federal Form 4626 if not submitted with the report as filed.
- (d) If FF 4626 is not available submit an exhibit supporting the tax preference claim or a schedule showing your computations

CTM204.7. Taxes imposed on or measured by net income. (72 P.S. § 7401.(3)1.(0))

- (a) Taxpayer is required to provide a schedule of all taxes (state, local and foreign) expensed on federal income tax return.
- (b) If a state's tax is based on the higher of income or net worth value, the taxpayer is required to add back the entire amount of the tax in years where the liability is based on net income.
- (c) See Corp Tax Bulletin No. 2008-5 for a list of states that impose an income tax. The bulletin has been revised and published to identify Texas Net Capital Earned Surplus tax as a tax based on income, we will make audit adjustments to addback this tax.

- (d) If a state's tax is a combination of a tax on net income and a tax on another item, such as net worth or gross receipts, the income portion of the tax is added back.
- (e) Negative tax addbacks are allowed to the extent the tax was added back in prior Pennsylvania settlements. Negative taxes used to reflect tax benefits of utilizing a loss are not permitted.

CTM204.8. Employment incentive payment program (EIP) tax. (72 P.S. § 8702-A.(after 1/1/2000)) / (72 P.S. § 8701-A (Prior to 1/1/2000)) / (61 Pa. Code § 2.4.)

- (a) The EIP credit is added to taxable income in the year in which it is earned, not the year in which it is used.
- (b) There are no provisions to decrease taxable income for the amount of EIP credit included in PA Taxable income in the year it was earned which expired prior to being used.

CTM204.9. Pennsylvania NL deduction. (72 P.S. §401.(3)4.(c)(1))

- (a) For tax years beginning after December 31, 2006, the limitation on the use of the Net Loss Deduction is increased to the greater of \$3,000,000 or 12 1/2 percent of PA Taxable Income before the Net Loss Deduction. The deduction can not exceed the amount of the loss or losses carried over from the prior year. For examples see REV-1200, Instruction booklet for RCT-101.
- (b) For tax years beginning after December 31, 1998 and before January 1, 2007, the net loss deduction shall be the lesser of \$2,000,000 or the amount of the loss or losses carried over.
- (c) Taxpayers are required to complete the Net Loss Schedule, RCT-103, reflecting the Net Losses available to be used in the current year, the Net Losses used in that year, and the Net Losses carried forward to the subsequent year.

(d) Taxable Year Carryover

1998 and thereafter	20 taxable years
1995-1997	10 taxable years

- (e) The net loss shall be carried to the earliest taxable year to which it may be carried under this schedule.
 - (f) Short periods are considered one taxable period for NL carryover.
- (g) There is no provision to forgo the use of a Net Loss for a period in order to use a credit against the liability.
 - (h) Amount carried forward would be net loss computed after apportionment.
- (i) The carry forward period for NL is based on the starting date of tax period when the NL is generated.
- (j) Adjusting NLs of prior year reports beyond the statutory deadlines is permitted.
- (1) If a prior year is beyond the statutory deadline for resettlement or assessment the Department is prohibited from adjusting the tax liability due to a change in a Net Loss.
- (2) This does not prevent the Department from changing a Net Loss generated in a closed year or the application of the Net Losses in the closed years and initiating resettlement, or assessment, of the CNI Tax for years which are still within the statutory resettlement or assessment period, or adjusting the NL carried forward into an nonfiled year, if appropriate.
- (k) No loss shall be allowed to be carried over from a taxable year when the corporation elects to be treated as a Pennsylvania S corporation pursuant to Section 307 of Article III of this act to a taxable year when the corporation is subject to the tax imposed under Article IV.
 - (I) Change in Ownership. (72 P.S. § 7401(3)4.(g))
- (1) Change in ownership by purchase, liquidation, acquisition of stock or reorganization of a corporation in the manner described in 26 U.S.C.§ 381 or 26 U.S.C.§ 382, the limitations provided in the Internal Revenue Code with respect to net operating losses shall apply for the purpose of computing the portion of a net loss carryover recognized.

- (2) Sale of Stock treated as sale of assets under 26 U.S.C. §338(h)(10)/
 --Under this election the company is deemed to have sold all of its assets in a complete liquidation under 26 U.S.C. § 381 and the PA NLs revert to the original parent company. This is consistent with the ruling in (Canteen Corporation v. Commonwealth of Pennsylvania, 818 A.2d 594 (Pa. Cmwlth. 2003)). In this case the court ruled that the Department must treat these transactions as a sale and distribution of assets in the calculation of CNI Tax.
- (3) To determine the portion of such deduction attributable to the net loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without regard to a net operating loss deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.
- (i) E.g. A merges into B during the year. In order to determine A's loss that would be able to be used during the year of merger:

days from the merger date to the end of the year X PA Taxable Income Total days in the tax year

- (ii) The rules for NL carry-forward applicable to that date should be used and the statutory deduction limitations apply.
- (4) When merging two or more corporations with different fiscal year ends the survivor will combine the NL's of the merging corporation with the NL's generated by the survivor based on the beginning of the merging corporation's fiscal year.
 - (m) Net Losses and Limited Liability Companies.
- (1) Unused net losses (NLs) of a limited liability company (LLC) that were incurred when the LLC was treated as a corporation subject to Pennsylvania CNI tax could not be claimed by its member in tax years after the LLC stopped being treated as a corporation. Pennsylvania law treating all LLCs as corporations was changed to conform to Pennsylvania's classification of an LLC to the entity's classification under federal law.

- (2) If a Corporation reorganizes into a Single Member LLC, disregarded for federal income purposes and whose member is a corporation as defined in Article IV of the Tax Reform Code of 1971, any Pennsylvania Net Losses generated by the entity prior to the reorganization may be used the member. For federal income tax purposes the NOL in this situation belongs to the member under IRC Section 332.
- (3) If a Corporation reorganizes into a Multi-member LLC any Pennsylvania Net Operating Losses generated by the entity prior to the reorganization may not be used any member. For federal income tax purposes the LLC would either be a partnership or a corporation and the NL in this situation does not belong to the member under IRC Section 332.
- (n) Federal Audits and Net Losses. When the result of the Report of Change affects the tax liability in a subsequent year that had been settled more than three years prior, and was not part of the federal audit, the Bureau of Corporation Taxes has no authority to resettle the CNI Tax for the closed periods. However, this does not prevent us from changing the application of the Net Losses in the closed years and initiating resettlement of the CNI Tax for years which are still within the statutory resettlement period, or adjusting the NL carried forward into an unsettled year, if appropriate.

CTM204.10. Bonus depreciation.

- (a) The provisions of IRC Sec 168(k) are as follows:
- (1) Authorizes taxpayers to deduct an extra Bonus depreciation deduction. The amount of the deduction is either 30% or 50% depending on when the asset was purchased and put in service.
 - (2) Remaining portion of asset depreciated under normal rules.
- (3) Total Federal depreciation equals the amount of bonus depreciation plus the depreciation under normal rules.
- (b) Economic Stimulus Act of 2008 authorizes taxpayers to deduct an extra 50% Bonus Depreciation on certain assets acquired after December 31, 2007 and placed into service before January 1, 2009.
- (c) Jobs and Growth Act of 2003 authorizes taxpayers to deduct an extra 50% Bonus Depreciation on certain assets acquired after May 5, 2003 and placed into

service before January 1, 2005. During this period taxpayers were still able to take the 30% deduction in lieu of the 50% deduction

- (d) Federal Job Creation and Worker Assistance Act of 2002 authorizes taxpayers to deduct an extra 30% Bonus Depreciation on certain assets acquired after September 10, 2001 and before September 11, 2004, and placed into service before January 1, 2005.
 - (e) Qualifying Property.
 - (1) New property with a recovery period of 20 years or less.
- (2) Qualified leasehold improvement property- generally any improvement to the interior of a building that is nonresidential real property.
- (3) Bonus Depreciation applies after any reduction for a Section 179 allowance.
- (4) For property with long production periods (two + years), the placed in service date can be extended to January 1, 2006 (Federal Job Creation and Worker Assistance Act of 2002 and Jobs and Growth Act of 2003).
 - (5) Property amortized under Section 197 does not qualify.
- (f) Pennsylvania has elected <u>not</u> to follow the federal depreciation method discussed previously. Businesses must adjust their depreciation expense when they file their corporate income tax returns. This involves a two step process.
- (1) Step one: The amount of Federal bonus depreciation must be added back to income. This is the amounts reported on Line 14 and Line 25 of the Federal 4562.
- (2) Step two: Taxpayer is entitled to a deduction, equal to a fraction of 3/7 times the amount of depreciation calculated under normal rules with the remaining basis.
- (3) If the taxpayer disposes of an asset, or the asset is fully depreciated, prior to the taxpayer recovering all of the disallowed bonus depreciation the taxpayer is allowed to deduct the remaining disallowed depreciation in the last year the asset is depreciated on the federal income tax return.

- (4) No other method of recovering the disallowed depreciation deduction is permitted.
- (5) Taxpayer is required to use the REV-799 CT, also known as Schedule C-3 and C-4 to report bonus depreciation calculations.
- (g) IMPORTANT: other sections in the Internal Revenue code provide for Bonus Depreciation, such as the New York Liberty Zone--IRC § 1400L and the Gulf Opportunity Zone--IRC § 1400N.
- (1) Unless the Federal bonus depreciation claimed is under IRC § 168(k) we do not decouple.
- (2) This is true even if the applicable section of the Internal Revenue Code refers back to IRC § 168(k) for some of its provisions.

CTM204.11. Business and nonbusiness income.

- (a) Definitions for 1999 and later have been revised.
- (1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if either the acquisition, the management or the disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. The term includes all income which is apportionable under the constitution of the United States per 72 P.S. § 7401(3)2.(a)(1)(A).
- (2) "Nonbusiness income" means all income other than business income. The term does not include income which is apportionable under the constitution of the United States per 72 P.S. § 7401(3)2.(a)(1)(D).
 - (3) NBI regulation has been repealed.
- (b) When reporting nonbusiness income the taxpayer must provide the following:
 - (1) Schedule of Non-Business Income, REV-934.

- (2) A schedule showing the calculation of the nonbusiness income. This schedule must include receipts and ALL related expenses.
 - (3) Justification for classifying the items as nonbusiness income.
- (4) A tax return from the state to which the taxpayer is allocating the item(s) as nonbusiness income.
- (5) An explanation of how assets used in the generation of the nonbusiness income is reported in the Property Factor in the current year and all prior years.
- (6) An explanation of how the income and expenses related to these assets were reflected in federal taxable income in the current year and all prior years.
- (7) An explanation of how the income and expenses related to these assets were reflected in state tax filings in the current year and all prior years.
- (c) Sale of Stock treated as sale of assets under 26 U.S.C. § 338(h)(10) (Canteen Corporation v. Commonwealth of Pennslyvania, 818 A.2d 594 (Pa. Cmwlth. 2003)).
- (1) The Commonwealth Court reasoned that the Commonwealth could not include the fictional gain produced by this federal election in taxable income and then ignore the additional fiction that under this election the company is deemed to have sold all of its assets in a complete liquidation and distribution of assets.
- (2) For taxable years beginning after December 31, 1998 Because of statutory amendments to the definition of business income and in accordance with regulation 61 Pa. Code §153.81, taxable income generated as a result of a section 338 election will be treated as business income, per Department Statement of Policy.
- (3) For taxable years beginning before December 31, 1998 -- The 338(h)(10) deemed sales would be non-business income.
- (d) Describe claim and provide reason for denying or accepting claim under the revised definitions. Any claims must be addressed under audit even if denied at settlement.

- (e) Request from taxpayer written justifications for the claim. Verify information and address these justifications in the audit.
- (f) Obtain copies of other states returns to determine how the taxpayer filed for other states.

Part III- Capital Stock/Foreign Franchise Tax CHAPTER 301. FIXED FORMULA

CTM301.1. Generally.

- (a) For statutory and regulatory guidance (see 72 P.S. § 7601AND 7602/61 PA. CODE § 155.1 155.30).
 - (b) Sunset Law tax expires for tax years beginning after 12/31/2010.
- (c) Minimum tax no minimum tax for tax years beginning on or after January 1, 2000.
 - (d) This tax is imposed on Corporations
 - (1) "Corporation." is any of the following entities:
 - (i) A corporation.
 - (ii) A joint-stock association.
 - (iii) A business trust.
- (iv) A limited liability company. This clause excludes a restricted professional company which is subject to 15 Pa.C.S. Ch. 89 Subch. L (relating to restricted professional companies).
- (v) An entity which for Federal income tax purposes is classified as a corporation.

(vi) A business trust which is a real estate investment trust as
defined in section 856 of the Internal Revenue Code of 1986 (Public Law 99-514, 26
U.S.C. § 856) more than fifty percent of the voting power or value of the beneficial
interests or shares of which are owned or controlled, directly or indirectly, by a single
corporation that is not:

- (A) A real estate investment trust as defined in section 856 of the Internal Revenue Code of 1986;
- (B) A qualified real estate investment trust subsidiary under section 856(i) of the Internal Revenue Code of 1986;
- (C) A regulated financial institution as defined by section 401(6) of Article IV; or
- (D) Formed as a holding company, subsidiary or affiliate of a regulated financial institution prior to December 1, 2003.
- (vii) A business trust which is a qualified real estate investment trust subsidiary under section 856(i) of the Internal Revenue Code of 1986 owned, directly or indirectly, by a real estate investment trust as defined in section 856 of the Internal Revenue Code of 1986 more than fifty percent of the voting power or value of the beneficial interests or shares of which are owned or controlled, directly or indirectly, by a single corporation that is not:
- (A) A real estate investment trust as defined in section 856 of the Internal Revenue Code of 1986;
- (B) A qualified real estate investment trust subsidiary under section 856(i) of the Internal Revenue Code of 1986;
- (C) A regulated financial institution as defined by section 401(6) of Article IV; or
- (D) Formed as a holding company, subsidiary or affiliate of a regulated financial institution prior to December 1, 2003.
 - (2) The term does not include any of the following:
- (i) A business trust which qualifies as a real estate investment trust under section 856 of the Internal Revenue Code of 1986 (26 U.S.C. § 856) or which is

a qualified real estate investment trust subsidiary under section 856(i) of the Internal Revenue Code of 1986 (26 U.S.C. § 856(i)).

- (ii) A business trust which qualifies as a regulated investment company under section 851 of the Internal Revenue Code of 1986 (26 U.S.C. § 851) and which is registered with the United States Securities and Exchange Commission under the Investment Company Act of 1940 (54 Stat. 789, 15 U.S.C. § 80a-1 et seq.) or a related business trust which confines its activities in this Commonwealth to the maintenance, administration and management of intangible investments and activities of regulated investment companies.
- (iii) A corporation, trust or other entity which is an exempt organization as defined by section 501 of the Internal Revenue Code of 1986 (26 U.S.C. § 501).
- (iv) A corporation, trust or other entity organized as a not-for-profit organization under the laws of this Commonwealth or the laws of any other state which:
- (A) Would qualify as an exempt organization as defined by section 501 of the Internal Revenue Code of 1986 (26 U.S.C. § 501);
- (B) Would qualify as a homeowners association as defined by section 528(c) of the Internal Revenue Code of 1986 (26 U.S.C. § 528(c));
- (C) Is a membership organization subject to the Federal limitations on deductions from taxable income under section 277 of the Internal Revenue Code of 1986 (26 U.S.C. § 277) but only if no pecuniary gain or profit inures to any member or related entity from the membership organization; or
 - (D) Is a nonstock commodity or a nonstock stock exchange.
- (v) A cooperative agricultural association subject to 15 Pa.C.S. Ch. 75 (relating to cooperative agricultural associations).
 - (vi) A business trust if the trust is all of the following:
- (A) Created or managed by an entity which is subject to the tax imposed by Article VII or XV or which is an affiliate of the entity which shares at least eighty per cent common ownership.

(B) Created and managed for the purpose of facilitating the securitization of intangible assets.

(C) Classified as a partnership or a disregarded entity for Federal income tax purposes.

CTM301.2. Capital stock value.

- (a) For tax years beginning on or after January 1, 1984, Capital stock value is determined by the following algebraic equivalent: .5 ((average net income divided by .095)+(net worth x.75)) (61 Pa. Code §155.25).
- (b) For tax years beginning on or after January 1, 1987, the Capital Stock Value is reduced by the Statutory Valuation deduction for that year. The deduction is effect is as follows:

On or After	But Before	Deduction
1-1-2007		\$150,000
1-1-1997	1-1-2007	\$125,000

CTM301.3. Average net income.

- (a) Sum of the net income or loss for each of the current and preceding four years divided by five.
- (b) If the company has not been in existence for five years or if short periods were involved, the average net income or loss would be the sum of the net income or loss for each year (or part year) in existence divided by the number of years (or part year) in existence (Doyle Equipment Company v. Commonwealth of Pennsylvania, 542 A.2d 644 (Pa. Cmwlth. 1988).
 - (c) Cannot exceed five full years.
 - (d) Carry out decimal to three places only.
 - (e) Is based on the corporations Incorporation date, not the business start date.
 - (f) In no case shall the average net income be less than zero.

- (g) In no case shall the average net income include:
 - (1) Net income or loss for a period of time prior to incorporation
 - (2) Net income or loss of a predecessor or a successor corporation
- (h) In the case of a mere change in identity, form or place of organization, net income or loss prior to the change shall be utilized in determining average net income.
- (i) In the event of a change in corporate structure to the extent that a change occurs as a result of a tax evasion motive, net income or loss may be adjusted to negate the effects of the change in corporate structure. Where there is evidence of a tax evasion motive, average net income will be determined based on the substance of the transaction.

CTM301.4. Short periods.

- (a) For Average Book Income, the term year refers to 12 consecutive months. Tax period refers to the time frame for which a tax return is filed. This may be less than one full year. History of earnings includes all consecutive tax periods within the last five years (not to exceed 60 months). Therefore, possible to have more than five tax periods in the five year history of earnings.
- (b) For a taxpayer in existence for more than five years with one or more tax periods of less than twelve months the beginning of the earliest period must not be greater than five years prior to the end of the current tax period. Full tax periods must be used. The earliest period is not prorated to arrive at five years. If the beginning of the earliest tax period is more than five years prior to the end of the current tax period that period is disregarded and the divisor is less than five.

CTM301.5. Rules relating to proration.

- (a) Capital Stock/Franchise Tax based on a full year and prorated when report filed for less than a full year.
- (b) For reports filed for a period of less than 12 full months the tax is prorated. This is calculated as follows:
- Capital Stock Value X apportionment factor X tax rate = tax for full year X number of days in short period divided by 365 (366 for leap years).

CTM301.6. Net book income or loss.

- (a) Net book income or loss is the income or loss per the books (not Federal taxable income/ loss) on a separate company basis.
- (b) The net book income or loss of the entity for any taxable year shall be the amount set forth as income per books on the income tax return filed by the entity with the federal government for such taxable year, or if no such return is made, as would have been set forth had such a return been made, subject, however, in either case to any correction thereof, for fraud, evasion or error (72 P.S. § 7601(a)).
- (c) Book income must be calculated using the same method as is used to prepare the balance sheet, since book income is a component of the balance sheet.
- (d) In the case of an entity that has an investment in an investee corporation (corporation as defined under 72 P.S.§ 7601), the net income or loss shall be computed on an unconsolidated basis, exclusive of the net income or loss of such other corporation and inclusive of dividends received (appearing on the M-1s or M-3s and M-2s). (Philadelphia Suburban Corporation v. Commonwealth of Pennsylvania, 535 Pa 298, 635 A.2d 116 (1992)).
- (1) An investment in a Limited Liability Company or Business Trust is treated the same as an investment in an incorporated entity.
- (2) Pass-through income from an investee corporation is excluded from book income.
- (3) Pass-through losses from an investee corporation are excluded from book income by adding it back if included.
- (4) Distributions are considered to be dividends from an investee corporation and should be included in book income.
- (5) If separate books and records are not kept all income is considered distributed in the year it is passed-through (losses are not distributed).
 - (e) Book income issues concerning controlled groups--income taxes.
- (1) Groups of corporations that file a consolidated federal income tax return must allocate the federal income tax expense to the members of the group

when calculating the Net Income per Books of any member corporation subject to the Capital Stock or Franchise Tax.

- (2) Subsidiary corporations are allowed to decrease book income for their share of the federal income tax expense while the parent corporation is not allowed to deduct the entire federal income tax of the group when calculating its separate company book income.
- (3) This also applies to single member LLC's when the member is a corporation.
- (f) The Department's administrative practice is to calculate the book income of a Federal "S-Corp" as follows:
 - (1) Ending retained earnings less
 - (2) Beginning retained earnings plus
 - (3) Distributions and
- (4) Adjusted for increases and decreases to retained earnings that do not affect book income.
- (5) If the change in retained earnings plus distributions does not equal net income per books, the taxpayer must provide a reconciliation of beginning and ending retained earnings. Beginning in 2006, this reconciliation must be provided on PA Schedule A-2.

CTM301.7. Adjustments to book income.

- (a) Beginning in 2006, taxpayers are required to report adjustments to book income on PA Schedule A-3.
- (b) For those corporations with total assets of \$10 Million or more Schedule M-3 (Net Income (Loss) Reconciliation for Corporations) must be completed effective in years ending on or after 12/31/2004.
 - (c) PA requires the calculation of net income per books on a separate company basis.

- (d) This has been interpreted as a requirement to use the cost method.
- (1) Under the cost method the taxpayer's share of the income of the investee corporation is not included in net income per books until the income is distributed by the investee corporation to the taxpayer.
- (2) When the income is distributed to the investor it is included in book income as a dividend.
- (3) Barron's Business Guides Dictionary of Accounting Terms defines dividend as "distribution of earnings paid to stockholders based on the number of shares owned. The most typical type of dividend is a cash dividend. Dividends may be issued in other forms such as stock and property. Dividend reinvestment plans also exist where stockholders can reinvest the proceeds of the dividend to buy more shares of stock."

CTM301.8 through .10. Reserved

CTM301.11. M-1s/M-3s & M-2s.

(a) Close analysis of which line each adjustment appears on the M-1s should be made to determine how it impacts book income. (E.g. equity losses may appear as expenses on books instead of negative income.) The following list provides examples of issues that may impact book income and how to handle the issue:

		Add to Book	Subtract from Book	No
Schedule	Issue	Income	Income	Adjustment
M-1/M-3	Dividends received from investee			
and M-2	companies	Yes		
M-2	Any other increase in retained earnings from the distribution of earnings from an investee corporation would be a dividend received from the investee corporation. (see (c) below)	Yes		
				Unless
		If actually		actually
M-1/M-3	Deemed Dividends 26 U.S.C. § 78.	received		received
M-1/M-3	FSC Dividends 26 U.S.C. § 245(c			
and M-2)(1)(A)	Yes		

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I		1	I	Unless
		If actually		actually
M-1/M-3	DISC Dividends 26 U.S.C. § 246(d).	received		received
101-17101-3	DISC DIVIDENTAS 20 0.3.0. § 240(d).	received		Unless
		If actually		actually
M-1/M-3	Consent dividends 26 U.S.C. § 565	received		received
101-17101-3	Consent dividends 20 0.5.c. § 303	received		Unless
		If actually		actually
M-1/M-3	Sub Part F Income 26 U.S.C. § 952	received		received
101 17101 3	3db FdFF	received		Unless
		If actually		actually
M-1/M-3	Foreign dividend gross-up.	received		received
101-17101-3	r or eight dividend gross-up.	received	Income	received
			reported	Income or
M-1/M-3	The income or loss of investee	Loss reported	on	Loss reported
and M-2	corporations	on M-1/M-3	M-1/M-3	on M-3
M-1/M-3		011 111 17 111 0	,	0.1 III 0
and M-2	Equity in non-investee companies			Yes
	Cumulative effects of an accounting			
	change. Does not include change from			
M-2	cash to accrual (a GAAP adjustment).	Yes	Yes	
M-2	Changes in accounting estimates.	Yes	Yes	
M-2	Changes in accounting principle.	Yes	Yes	
	Prior period book income adjustments			
	defined as a correction of an error in a		Yes if	
	prior period statement, by FASB- 16,	Yes if	decrease	
	amended by FASB- 109. Include all	increase to	to	
	adjustments in the year the prior period	Retained	retained	
M-2	adjustment was made.	Earnings	earnings.	
	Comprehensive IncomeGenerally			
	Accepted Accounting Principals require			
	certain items to be recognized as			
	Comprehensive Income. These items			
	are not part of Net Income per Books			
	and are reported on the balance sheet			
	as a separate component of			Duananh
	Shareholders' Equity. Must review	Not reported		Properly
	financials to verify the unrealized gains	Not reported		reported as a
	and losses are reported as a separate component of equity as required by	as separate component of		separate component of
M-2	GAAP	equity.		equity.
171 2	Equity changes due to merger	Squity.		Squity.
	reorganizations and purchase			
	accounting should not be included in			
	book income. Does not include an	Any increase		
	increase in retained earnings due to the	of retained		
M-2	merger or liquidation of an investee	earning		Yes

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	corporation into the taxpayer.			
M-2	Cumulative effect of change from a non-GAAP method of accounting to <u>GAAP</u> .			Yes
101-2	An increase in retained earnings due to			163
	a quasi-reorganization (also known as			
	"Fresh Start Balance Sheet			
	Adjustment"). Any item described as			
	fresh start accounting should be	Yes for any		
	analyzed to determine if it is truly fresh	part that is		Yes.
M-2	start accounting and if any part of it is forgiveness of debt.	forgiveness of debt.		(Fresh start portion only)
171-2	FASB 106 -Accounting for retirement	GCDI.		portion only)
	benefits other than pensions. If			
	immediate recognition of the cumulative			
	affect of adjustments for events prior to			
	12/22/90 this will be treated as an			
M-2	accounting change.	Yes		
M-2	FASB 109-Accounting for income taxes.	Yes		
	FASB 115-Accounting for certain			
M-1/M-3	investments in debt and equity securitiesTrading securities	If reported on		If reported on
and M-2	unrealized gains/losses.	M-2		M-1
and W 2	FASB 115-Accounting for certain	IVI Z		101 1
	investments in debt and equity			
	securities Available for saleunrealized		lf	
M-1/M-3	gains/losses	If gain /Yes	loss/Yes	
	FASB 115-Accounting for certain			
	investments in debt and equity			
N. 4 /N. 4 O	securities Held to maturityunrealized	16 1 07	lf O/	
M-1/M-3	gains/losses	If gain /Yes	loss/Yes	
	FASB 115-Accounting for certain investments in debt and equity			
	securities Available for saleunrealized	Not properly		Properly
	gains/losses. Must review financials to	reported as a		reported as a
	verify the unrealized gains and losses	separate		separate
	are reported as a separate component	component of		component of
M-2	of equity as required by GAAP.	equity.		equity
	FASB 115-Accounting for certain			
	investments in debt and equity	Nat and some		Nat were well
	securities Held to maturityunrealized	Not properly		Not properly
	gains/losses. Must review financials to verify the unrealized gains and losses	reported as a separate		reported as a separate
	are reported as a separate component	component of		component of
M-2	of equity as required by GAAP.	equity.		equity.

M-2	Adjustments required under FIN 48 to "derecognize" income tax accruals and deferrals. FIN 48 requires an adjustment to beginning retained			Yes.
M-2	earnings in the year of implementation.	Incomo	Locc	res.
Not	Distributive share of partnerships. Distributive share of partnerships. If partnership earnings are not included in Net Income Per Books, the taxpayer's distributive share of the earnings per book should be calculated and included (add partnership earnings, subtract	Income	Loss	
Reported	partnership losses). (see (d) below)	Income	Loss	
M-1/M-3	Foreign currency translation adjustment.	If actually received		Unless actually received
M-2	Debt forgiveness. Situations are defined in S.O.P. 90-7.41. See Shawnee Development, Inc v. Commonwealth, 819 A.2d 528 (Pa. 2003).	Yes		
M-2	Gain on sale of assets in liquidation.	Yes		
	Changes based on a Federal Audit or an amended return that affect book		V. a	
M-2	income.	Yes	Yes	
M-2	Increases when no details are provided.	Yes		
M-2	Decreases when no details are provided.			Yes
M-2	Foreign currency translation adjustments			Yes
Not	"hypothetical" federal taxes.			
Reported				Yes

- (b) Dividends received from investee companies.
- (1) Dividends received from investee companies are generally found on federal schedules M-1/M-3 or M-2.
- (2) Review M-2s of subsidiaries, including LLC's, to determine if dividends were paid.
- (3) Verify stockholder (immediate parent) received dividends. In some instances it has been determined that the dividend was recorded directly onto the ultimate parent's return and was not recorded on the immediate parent's return as prepared on a separate company basis.

- (c) Increase in retained earnings due to liquidation or mergers
 - (1) The following details of the transaction must be provided:
- (A) The taxpayer's relationship to the company being merged or liquidated..
- (B) The amount of the increase which represents the retained earnings of the company being merged or liquidated. This would be considered a dividend distribution.
- (C) The amount of the increase which represents return of capital (stock + paid in capital) of the company being merged or liquidated.
- (D) The amount of the increase which represents the gain on the company being merged or liquidated.
- (E) Any authoritative pronouncement, such as a FASB or SEC Regulation, which would allow a taxpayer accounting for an investment on the cost method to record this transaction as an increase in retained earnings without affecting net income.
- (2) Based on this it will be necessary to determine if the increase in retained earnings of the taxpayer is a distribution of earnings from an investee corporation to the taxpayer. If so then the increase in retained earnings would be a dividend received from the investee corporation and included in the book income of the taxpayer. Any gain would also be included in the book income of the taxpayer.
 - (d) Other partnership issues.
- (1) Under 72 P.S. § 7602.6(a), an investment in a partnership is a direct ownership in the assets of the partnership.
- (2) This clarifies 72 P.S. § 7601(a) which requires the use of separate company book income in the calculation of the Capital Stock value.
- (3) If partnership earnings are not included in Net Income per Books, the taxpayer's distributive share of the earnings per book should be calculated and included (add partnership earnings, subtract partnership losses).

- (4) Separate company book income should include the distributive share of book earnings from direct investments in partnerships / joint ventures.
 - (e) Equity income/loss of investee companies.
- (1) The income or loss of investee corporations are generally found on federal schedules M-1/M-3 or M-2. If the investee corporation is a Limited Liability Company or Business Trust it will be necessary to obtain the federal Schedule K-1 issued by the Limited Liability Company or Business Trust (files federal Form 1065) or a copy of the income statement, balance sheet and reconciliation of net worth of the investee entity (disregarded entity).
- (2) Loss add to book income since this item decreased book income. A positive number on M-1, currently lines 4 or 5, or a negative number on line 7 or 8, represents an equity loss.
- (3) Income subtract from book income since this item increased book income. A negative number on M-1, currently lines 4 or 5, or a positive number on lines 7 or 8, represents equity income.
- (f) Comprehensive income. Generally Accepted Accounting Principals require certain items to be recognized as Comprehensive Income. These items are not part of Net Income per Books and are reported on the balance sheet as a separate component of Shareholders' Equity. Since these items are included in the calculation of net income or retained earnings they should not appear on federal schedule M-1 or federal schedule M-2 (FASB-130).

CTM301.12 through .19. Reserved

CTM301.20. Net worth, general rule.

- (a) The net worth shall be the sum of the entity's issued and outstanding capital stock, surplus and undivided profits as per the books set forth on the Federal Form 1120, Balance Sheet (currently known as Schedule L).
- (b) All other components of shareholders' equity are included in net worth in accordance with Generally Accepted Accounting Principles.
- (c) ESOPs, translation adjustments and investment equity securities (FASB 115) should be included in net worth.

- (d) Treasury stock is to be reflected in the net worth calculation per 61 Pa. Code §155.27.(d), as a reduction to net worth.
- (e) Capital stock, paid in capital and preferred stock are examples of components of net worth.
 - (f) Redeemable preferred stock as equity or liability (FASB 150).
- (1) This statement requires an issuer to classify certain instruments as liabilities effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003.
- (2) If it appears on the financial statements after the liabilities but before the equity section, include as part of the equity.
- (3) If it appears on the financial statements for periods beginning after June 15,2003, either in the liabilities or the equity section, accept as presented.
- (g) Contingent liabilities, if stated as a liability on the books, should be excluded from net worth. (per 61 Pa. Code § 155.27 (f)). Contingent liabilities, stated in a footnote on the books can not be deducted from equity.
- (h) The net worth of a limited liability company or business trust is assets minus liabilities. (72 PS § 7601 (a)).

CTM301.21. Net worth, special rules.

- (a) Consolidated net worth--For an entity that has investments in the common stock of other corporations, the consolidated net worth of such entity shall be computed in accordance with Generally Accepted Accounting Principles. This includes LLCs and business trusts as they are corporations for CS/FF purposes.
- (b) Use annual reports or consolidated financial statements as presented by the taxpayer that include all such corporations, both foreign and domestic. Read footnotes to the annual report to determine if all such corporations are included.
- (c) Research the company's Web page and/or the SEC http://www.sec.gov/index.htm, etc, for financial information.

- (d) Minority interests held by others in consolidated subsidiaries should not be included in net worth.
- (e) Limited liability companies are not required to use consolidated net worth in the calculation of the Capital Stock Value regardless of federal filing status.
- (f) When the taxpayer does not provide a consolidated report one method to calculate consolidated net worth would be to take the taxpayer's net worth plus the equity for each such corporation less the investment in those corporations. The balance sheets of all subsidiaries and schedule of investment in such corporations should be obtained.
- (1) If taxpayer does not provide detail of investment in subsidiaries, only subtract the common stock of the subsidiary, not any paid in capital amounts, as the investment. If the subsidiaries equity is less than its common stock, the net adjustment cannot be less than zero.
- (2) If the taxpayer provides detail regarding the investment accounts but does not provide any corresponding balance sheets, the investment is not subtracted and estimates would be created.
- (3) When an investment of less than 20% owned company is reported on the cost method, the investment would be included at fair market value.
 - (4) Foreign subsidiaries are usually shown on Federal Form 5471.

CTM301.22. Other net worth issues.

- (a) In no case shall the net worth be less than zero.
- (b) The net worth is determined on the last day of the fiscal year.
- (c) In the case of a merger use the amount of pre-merger net worth.
- (d) In the case of sale of stock treated as a sale of assets under IRC Sec 338, a net worth of zero, as reported to the IRS, is not acceptable. In these cases the ending net worth of the period in which the transaction occurred will be the net worth immediately prior to the transaction. The beginning net worth of the subsequent period will be the net worth immediately after the revaluation of the assets.

- (e) Effective for tax years beginning on or after January 1, 1987, if the net worth arrived at for the current year is greater than twice or less than one-half of the net worth as of the first day of the current tax year, the average of the beginning and ending net worth shall be used for calculation of the capital stock value (72 P.S. § 7601(a)definition of "net worth" paragraph (2)).
- (1) If the net worth at the beginning or end of year is less than zero, use zero in the averaging computation for the amount that is less than zero.
- (2) No proration is allowed for any dramatic increases or decreases in the net worth throughout the year.
 - (f) The net worth is subject to any corrections for fraud, evasion or error.

CHAPTER 302. EXEMPTIONS

CTM302.1. General information.

- (a) Exempt from taxation
- (1) Capital stock of entities which is invested in and actually and exclusively employed in carrying on manufacturing, processing, research or development within the state.
- (2) While the manufacturing exemption, processing exemption, and research and development dxemption are different exemptions and covered by separate parts of the statute, all three exemptions are calculated in the same manner.
- (3) The manufacturing exemption, processing exemption, and research and development exemption are only applicable to years beginning after December 31, 1998.
 - (4) Applies regardless of where exempt activity occurs.
- (5) The statute which granted these exemptions prior to January, 1, 1999, was declared unconstitutional and was severed from the law (PPG Industries, Inc.V. Commonwealth of Pennsylvania 567 Pa. 580, 790 A.2d 261 (2001) petition for

reconsideration denied 2002 Lexus 253 (February 1, 2002) decision without published opinion).

(b) Exemption is an election

- (1) Manufacturing, processing and research and development exemption is an election to be made by the taxpayer.
- (2) To create manufacturing factors for the taxpayer is considered a conflict of interest and not allowed. Taxpayer must create own factors and then auditor can audit them.

(3) Exclusion vs. Exemption

- (i) Manufacturing, processing and research and development provisions are *exemptions* to the capital stock tax and are to be strictly construed against the taxpayer. Commonwealth v. Deitch Co., 449 Pa. 88, 95, 295 A.2d 834, 838 (1972).
- (ii) The difference is significant because exclusions are never within the taxing statute in the first place while exemptions are initially within the taxing statute but are subsequently removed by statute. As a result, exemptions are construed against the taxpayer while exclusions are construed in favor of the taxpayer. The provisions in question have been consistently treated as exemptions. See Stewart Honeybee Products v. Commonwealth, 525 Pa. 222, 579 A.2d 872 (1990), and Suburban Cable TV Co. v. Commonwealth, 131 Pa. Commonwealth Ct. 368, 570 A.2d 601 (1990), affirmed per curiam, 527 Pa. 364, 591 A.2d 1054 (1991).
- (c) Statutory changes to exemption impact on factors: For years beginning on or after 1/1/99 the numerator of the property, or payroll factors shall not include any property, or payroll attributable to manufacturing, processing, research or development activities in the Commonwealth and any property, or payroll attributable to manufacturing, processing, research or development activities outside the Commonwealth shall also be excluded from the numerator of the property or payroll factors.

CHAPTER 303. MANUFACTURING

- **CTM303.1. Manufacturing.** Manufacturing is not defined in the statutes. In determining if the taxpayer's activity qualifies for the manufacturing exemption we must look to the various court decisions on this issue. Even though the statute prior to January 1, 1999, was declared unconstitutional and replaced with the current statute, decisions on the definition of manufacturing rendered prior to January 1, 1999, are still relevant. Some of the more notable cases are as follows:
- (a) Kirks Milk Products, Inc., v. Commonwealth of Pennsylvania, 58 Pa. 230, 427 A.2d 688 (1981) established a two-part test for determining whether an activity constitutes manufacturing. Manufacturing occurs when:
 - (1) A high degree of skill, science and labor is applied, and
- (2) A substantial transformation in form, qualities, and adaptability in use results in a new, different and useful article.
- (b) Kimberton Company v. Commonwealth of Pennsylvania. 520 A.2d 904 (Pa. Cmwlth. 1987) established that a superficial or cosmetic change in the existing product was insufficient to constitute manufacturing. The taxpayer had embroidered a design on ready made clothing. The court held that it was not a new and different product.
- (c) Commonwealth v. McGrady-Rodgers Co., 316 Pa. 155, 158, 174 A. 395 (1934) held that the articles produced must be an article of Commerce and not for its own use. Other cases addressing this topic are:
- (1) In Commonwealth v. H. J. Williams Co., Inc, 78 Dauph 377, although the corporation is organized for manufacturing, as well as other activities, the production of concrete for its own use does not qualify for the manufacturing exemption. Manufacture entails the making of an article of commerce.
- (2) Manufacturing for sale and for use In Commonwealth v. Interstate Amiesite Corp., 412 Pa. 180, 194 A.2d (1963) the taxpayer manufactured asphalt for sale and for use in their paving business. The court ruled that the taxpayer received the exemption for the manufacturing of the asphalt but it did not extend to the paving activities.

(d) Manufacturing by others

(1) In Commonwealth v. Weldon Pajamas, Inc., 86 Dauph 227, taxpayer was not actually engaged in manufacturing and is not entitled to the Franchise Tax

Manufacturing Exemption, even though its wholly-owned Pennsylvania subsidiary is engaged in manufacturing. The taxpayer owned the inventory and the subsidiary performed the manufacturing activity on the inventory.

- (2) In School District of Philadelphia v. Rosenberg ,402 Pa. 365, 167 A.2d 259 (1961)the taxpayer designs patterns, cuts material and arranges that material into garments to be sewn by subcontractors. The taxpayer was engaged in manufacturing.
- (e) Leasing of a plant to manufacturer The exemption is for capital stock invested and actually and exclusively employed in manufacturing. Therefore if the taxpayer leases it's plant to another manufacturing company the taxpayer can take the manufacturing exemption for that property per Commonwealth. v. Jeca Corp., 81 Dauph. 36, 31 D. & C.2d 759.
- (1) Since neither the courts nor the legislature has defined "plant" the dictionary definition applies. Webster's defines plant as Building and Equipment used in a business. To qualify for the exemption the taxpayer must rent both building and equipment. The renting of one without the other does not constitute the leasing of a "plant" and does not qualify for the exemption.
- (2) Exemption is only for the plant. No exemption for payroll or sales factor.
- (f) In Ski Roundtop, Inc. v. Commonwealth of Pennsylvania 520 Pa 227, 553 A.2d 928 (1989) the taxpayer manufactured liquid water and pressurized air into a new product, man-made snow, which allows skiers to glide thereon while descending a mountain.
 - (1) This was not a permanent change or an article of commerce.
 - (2) This court case is not normally used in deciding other court cases.
 - (g) Construction, assemble and production of electric.
- (1) Construction on site of such items as bridges, buildings etc would not be manufacturing. However, if a taxpayer manufactures components for such items in a plant to be sold for use at a construction site it would be manufacturing.

- (2) In Philadelphia School District v. Parent Metal Products, Inc, 402 Pa. 361,167 A.2d 257 (1961), the court determined that the assembling of ready-made parts purchased from a manufacturer is not, in itself, manufacturing.
- (3) The courts determined in Potomac Edison Company v. Commonwealth of Pennsylvania, 411 A.2d 1287, (Pa. Cmwlth, 1980) that the production of electricity is not manufacturing.
 - (h) Use the manufacturing activities questionnaire
- (i) Manufacturing exemption is for manufacturing both in and out of Pa, effective for years beginning on or after 1/1/99. (PPG Industries, Inc.V. Commonwealth of Pennsylvania 567 Pa. 580, 790 A.2d 261 (2001) petition for reconsideration denied 2002 Lexus 253 (February 1, 2002) decision without published opinion)
- (1) Headquarters in PA will be granted the exemption based on manufacturing activities both in and out of PA.
- (2) Exemption in PA will be extended for sales activities for or warehousing activities of goods manufactured outside PA.
- (j) Exemption follows through to partnerships; must use same apportionment method as partner. (E.g. taxpayer uses single factor then must use single factor for partnership)

CHAPTER 304. PROCESSING EXEMPTIONS

- CTM304.1. Processing exemptions. 72 P.S. § 7601,(a) definition of "processing" paragraphs (1) through (15) NOTE: The outline of this chapter follows the law so that cites could more easily be noted. The bullets under each of the law definitions are not part of the law, but are to aid in the understanding of the application of the law.
- (a) Activities that are engaged in as a business enterprise and that precisely meet the definition are exempt:

- (1) The filtering or heating of honey, the cooking or freezing of fruits, vegetables, mushrooms, fish, seafood, meats or poultry, when the person engaged in such business packages such property in sealed containers for wholesale distribution.
 - Effective January 1, 1995
 - Only for wholesale distribution.
 - Grinding, roasting, and blending of coffee does now qualify for the exemption (see 20 below for the specifics.)
- (1.1) The processing of fruits or vegetables by cleaning, cutting, coring or chopping and treating to preserve, sterilize or purify and substantially extend the useful shelf life of the vegetables, when the person engaged in such activity packages such property in sealed containers for wholesale distribution.
 - Effective January 1, 1999
 - Only for wholesale distribution in sealed containers.
- (2) The scouring, carbonizing, cording, combing, throwing, twisting or winding of natural or synthetic fibers, or the spinning, bleaching, dyeing, printing or finishing of yarns or fabrics, when such activities are performed prior to sale to the ultimate consumer.
- (3) The electroplating, galvanizing, enameling, anodizing, coloring, finishing, impregnating or heat treating of metals or plastics for sale or in the process of manufacturing.
- (3.1) The blanking, shearing, leveling, slitting or burning of metals for sale to or use by a manufacturer or processor.
 - Effective January 1, 1997.
 - (4) The rolling, drawing or extruding of ferrous and nonferrous metals.
 - In Eastern Diversified Metals Corporation v. Commonwealth of Pennsylvania, 297 A.2d 167 (Pa. Commw. 1972) the court determined that the company engaged in reclaiming metal from scrap wire by separation is not entitled to the exemption for

manufacturing or processing. The company's activities do not fall within the definition of "processing" because it does not "roll, draw or extrude ferrous and non-ferrous metals."

- This activity may qualify under the salvaging, recycling or recycling exemption if it is recycled into a manufacturing process.
- (5) The fabrication for sale of ornamental or structural metal or metal stairs, staircases, gratings, fire escapes or railings (not including fabrication work done at the construction site).
 - Must be for sale and not for own use.
 - Not for fabrication work done at the construction site
 - (6) The preparation of animal feed or poultry feed for sale.
 - Must be for sale and not for own use.
 - Feed is regulated by the Federal and State governments.
- (7) The production, processing and bottling of nonalcoholic beverages for wholesale distribution.
 - Must produce, process and bottle.
 - Bottled water does not receive the exemption.
 - Only for wholesale distribution.
- (8) The slaughtering and dressing of animals for meat to be sold or to be used in preparing meat products for sale, and the preparation of meat products, including lard, tallow, grease, cooking and inedible oils for wholesale distribution.
 - Must slaughter and dress.
 - For wholesale distribution.
- (9) The operation of a sawmill or planing mill for the production of lumber or lumber products for sale. The operation of a saw mill or planing mill begins

with the unloading, by the operator of the saw mill or planing mill, of logs, timber, pulpwood or other forms of wood material, to be used in the saw mill or planing mill.

- Must be a mill producing these items for sale.
- Can not be for own use.
- In Commonwealth of Pennsylvania v. Babcock Lumber Co, 272 A.2d 522 (Pa. Cmwlth 1971), the courts determined that a company is not entitled to the manufacturing exemption on receipts from the sale of kiln dried lumber since a new product does not emerge as a result of the kiln drying. The processing exemption does not apply to presurfacing of the lumber; "processing" is strictly limited to enumerated activities which do not include presurfacing.
- (10) The milling for sale of flour or meal from grains.
 - Must be for sale and not for own use
- (10.1) The aging, stripping, conditioning, crushing and blending of tobacco leaves for use as cigar filler or as components of smokeless tobacco products for sale to manufacturers of tobacco products.
 - Effective January 1, 1997
 - All of these activities must be performed to qualify for the exemption.
 - Must be sold to manufacturers of tobacco products.
- (11) The publishing of books, newspapers, magazines or other periodicals, printing and broadcasting radio and television programs by licensed commercial or educational stations.
 - Can not be for own use.
 - For publishing and broadcasting must be to general public.
 - Closed circuit TV is not exempt.

- Paid TV producers who transmits to a cable company that transmits the program to the general public does get the exemption.
- (12) The processing of used lubricating oils.
- (13) The blending, rectification or production by distillation or otherwise of alcohol or alcoholic liquors, except the distillation of alcohol from by products of wine making for the sole purpose of fortifying wine.
- (14) The salvaging, recycling or reclaiming of used materials to be recycled into a manufacturing process.
 - Must be recycled into a manufacturing process.
 - No exemption granted if sold to scrap dealer who then sells to manufacturer. Only scrap dealer would get exemption.
- (15) The development or substantial modification of computer programs or software for sale to unrelated persons for their direct and independent use.
 - Can not be for own use.
- (16) The cleaning and roasting and the blending, grinding or packaging for sale of coffee from green coffee beans or the production of coffee extract.
 - For years beginning after 6/30/97
 - Must clean and roast and blend, grind or package
- (17) The refining, blasting, exploring, mining and quarrying for or otherwise extracting limestone, sand, gravel or slag from the earth or from waste or stock piles or from pits or banks and the cleaning, crushing, grinding, pulverizing, sizing or screening of limestone, sand, gravel or slag, including blast furnace slag.
 - Must be doing refining, blasting, exploring, mining and quarrying and one of the following cleaning, crushing, grinding, pulverizing, sizing or screening.
 - Applies only to extracting of limestone, sand, gravel or slag

- For years beginning after 12/31/98.
- (18) The preparation of dry or liquid fertilizer for sale.
 - For years beginning after 12/31/99.
 - Must be for sale and not for own use.
- (19) The production, processing and packaging of ice for wholesale distribution.
 - For years beginning after 2000.
 - Must do all three: production, processing and packaging
 - For wholesale distribution

CHAPTER 305. RESEARCH AND DEVELOPMENT

CTM305.1. Research and development.

- (a) The activities relating to the discovery of new and the refinement of known substances, products, processes, theories and ideas, but not including activities directed primarily to the accumulation or analysis of commercial, financial or mercantile data.
- (b) In Lancaster Laboratories, Inc. v. Commonwealth of Pennsylvania, 631 A.2d 739 (Pa. Commw 1993) the taxpayer received samples from its customers, tested the samples and reported its findings. They did not qualify for the research and development exemption since the laboratory did not research or develop any products.

CHAPTER 306. OTHER EXEMPTIONS

CTM306.1. Family farm corporation. (72 P.S. § 7602.2 / 61 Pa. Code §155.2)--Pennsylvania corporation with at least seventy-five percent of the assets of

ned

			ed to the business of agriculture and at least 75% of all stock is owned e same family shall be exempt from the tax.		
((a)	Business of agriculture includes:			
		(1)	Soil preparation, planting, raising and harvesting crops.		
		(2)	Beekeeping		
		(3)	Rearing of livestock		
		(4)	Aquaculture		
(5) Growing flowers and plants in greenhouses (Reininger Brotv. Commonwealth, 104 Pa. Commw. 591 (1987).					
((b)	Business of agriculture does not include:			
		(1)	Recreational activities such as, but not limited to:		
			(i) Hunting		
			(ii) Fishing		
			(iii) Camping		
			(iv) Skiing		
			(v) Show competition or racing		
fish, ca activiti		(2) dogs o	The raising, breeding, or training of game animals or game birds, r pets, or animals intended for use in sporting or recreational		
		(3)	Fur farming		

Stockyard and slaughterhouse operations

Manufacturing or processing operations of any kind.

(4)

(5)

- (c) Members of the same family means:
 - (1) An individual
 - (2) Such individual's brothers and sisters.
 - (3) Brothers and sisters of such individual's parents and grandparents
 - (4) The ancestors and lineal descendants of any of the above.
 - (5) Spouses of any of the above.
- (6) Individuals related by half blood or legal adoption shall be treated as if they were related by the whole blood.
- (d) Beginning in 1998--Assets devoted to the business of agriculture includes leasing to members of the same family who use the assets in the business of agriculture.
 - (e) When claiming this exemption the taxpayer must provide the following:
- (1) A schedule of assets reported on the ending balance sheet, at net book value, indicating which assets are used in the business of agriculture.
 - (2) A schedule of all shareholders and their relationships.
 - (3) A description of business activity.

CTM306.2. Holding company.

- (a) Holding company status is an election made by a taxpayer that meets the following qualifications.
- (1) 90% of gross income is derived from dividends, interest, gains from the sales exchange of stock or securities and the rendition of management and administrative services to subsidiary corporations and
- (2) 60% of the actual value of assets consist of stock, securities or indebtedness of subsidiary corporations.

- (3) For purposes of the holding company tests limited liability companies and business trusts are considered corporations, regardless of federal filing status. Partnerships are not considered corporations unless the partnership is filing as a corporation with the IRS.
- (4) If the taxpayer has investments in limited liability companies or business trusts that do not file as corporations with the IRS the following information must be provided:
- (i) Proforma income statement accounting for the investment in the limited liability company or business trust as a corporation (removing the current income and including the distributions received as dividends).
- (ii) For each limited liability company or business trust which files as a partnership with the IRS--A copy of FF Schedule K-1.
- (iii) For each limited liability company or business trust that is disregarded for federal income tax purposes--An income statement, beginning and ending balance sheet, and reconciliation of net worth.
- (b) A qualifying corporation that elects holding company status is taxed on 10% of their capital stock value.
- (c) Holding company status cannot be combined with any other exemption or apportionment in the calculation of capital stock or foreign franchise tax.
- (d) Since holding company status is an election made by the taxpayer the Department of Revenue does not have the authority to utilize any other method in calculating the capital stock or foreign franchise tax of any taxpayer making this election so long as the taxpayer qualifies as a holding company.
- (e) If the taxpayer does not qualify for holding company status then the tax must be calculated using the proportion of taxable assets or three-factor apportionment, if appropriate. If the taxpayer does not qualify for three-factor apportionment and has no exempt assets then the tax is based on 100% of the capital stock value.
- (f) When claiming holding company status the taxpayer must provide the following:

- (1) A schedule of assets, at net book value, indicating which assets qualify the taxpayer for holding company status.
- (2) Schedule of receipts reported on the federal income tax return, indicating which receipts qualify the taxpayer for holding company status.

CTM306.3. Student loan assets.

- (a) For years beginning after 12/31/98.
- (b) The term includes the following assets:
 - (1) Student loan notes.
 - (2) Federal, state or private subsidies or guarantees of student loans.
- (3) Instruments that represent a guarantee of debt, certificates or other securities issued by an entity created for the securitization of student loans, or by a trustee on its behalf.
- (4) Contract rights to acquire or dispose of student loans and interest rate swap agreements related to student loans.
- (5) Interests in or debt obligation of other student loan securitization trusts or entities.
- (6) Cash or cash equivalents representing reserve funds or payments on or with respect to student loan notes, the securities issued by an entity created for the securitization of student loans or the other student loan related assets. Solely for purposes of this definition, "cash or cash equivalents" shall include direct obligations of the United States Department of the Treasury, obligations of federal agencies which obligations represent the full faith and credit of the Unite States investment grade debt obligations or commercial paper, deposit accounts, federal funds and banker's acceptances, prefunded municipal obligations, money market instruments and money market funds.

CTM306.4. Pollution control devices.. (72 P.S. § 7602.1 / 61 Pa. Code § 155.11).

Property employed or utilized within the Commonwealth of Pennsylvania for water and air pollution control or abatement devices which are being employed or utilized for the benefit of the general public shall be exempt from the tax. Must have a Pennsylvania DER Certificate.

CHAPTER 307. PLANT TOURS AND OTHER VERIFICATION

CTM307.1. Plant tours.

- (a) Tours of PA and audit sites locations
- (1) When the taxpayer is engaged in manufacturing, processing or research and development, tours of all Pennsylvania locations, for which an exemption is claimed, must be performed. A detailed explanation of both the manufacturing and non-manufacturing activity that impact the exemption claimed in Pennsylvania is required in writing from the taxpayer prior to the commencing of the audit. A detailed written description of the exempt actives <u>must be provided</u> by the taxpayer to support the exemption claimed. Must perform tours for exempt activities for partnerships also.
- (2) If numerous locations, consult with your supervisor to determine number of locations to visit.
- (3) All locations claimed or granted a partial or full exemption should be toured. If the date of a tour that was performed for a prior audit year was during the year currently under audit or later date, no tour is required.
- (b) A detailed written description of the exempt actives must be provided by the taxpayer to support the exemption claimed for PA property and payroll attributable to manufacturing, processing, research or development activities outside the Commonwealth.
- (1) Review the written description to determine if the activities qualify for the exemption under PA statue.
 - (2) Must do same for partnership exempt activities.
- (3) Review general ledger accounts, costing centers, etc to determine if the locations do perform exempt activities.

- (c) Obtain product brochures and plant layouts.
 - (3) List activities by location of the following:
 - (i) Divisions
 - (ii) Branches
 - (iii) Sales Offices
 - (iv) Plants
 - (v) Warehouses
 - (vi) Service Centers, etc.
- (4) The above detail is used to determine which locations are taxable, exempt or partially exempt, based on activity.

CTM307.2. Examples of activities on or after 1/1/99.

- (a) Taxable or partially taxable activities, but not limited to, as follows:
- (1) Merchandise purchased for resale, property used to store merchandise and payroll of employees handling said merchandise. fully taxable.
- (2) Nonmanufactured articles warehoused in Pennsylvania. fully taxable.
- (3) Service centers performing warranty work, rework or repairs: any property and, payroll fully taxable.
- (4) Sales office selling nonmanufactured products: any property and payroll. fully taxable.
- (5) Headquarters property and payroll performing functions for nonmanufacturing activities prorated based on manufacturing and nonmanufacturing for the whole company.

- (6) If "manufacturing" is for own use and not as an article of commerce, no exemption is granted.
- (7) The leasing of a plant to a manufacturer, by the lessor, gets the manufacturing exemption in the property factor.
- (i) Plant is defined as land, building, machinery and other equipment.
- (ii) Rental of less than all three components does not qualify for the exemption. (J.L. Mott v. Commonwealth of Pennsylvania, 316 A.2d 921 (Pa. Cmwlth 1974)))
 - (iii) The exemption does not extend to the payroll.
- (8) Water treatment facilities at the end of the manufacturing activity are not part of the manufacturing. They may get an exemption if they have pollution control certificates.
 - (9) Pizza making is not manufacturing.
- (10) A taxpayer providing a service for a manufacturer (e.g. sewing of shirts for customer who owns material) would not get a manufacturing exemption.

Part IV- Three-Factor Apportionment

CHAPTER 400. OVERVIEW OF THREE-FACTOR APPORTIONMENT

CTM400.1. General information.

- (a) Taxpayers claiming three-factor apportionment are required to complete tables supporting Apportionment (RCT-106 Page 2).
 - (b) The fraction is computed to 6 decimal places.

CTM400.2. General information - CS/FF.

- (a) If the taxpayer had investments in LLCs for CNI tax, the LLCs activities must be removed from the denominators and from the numerators if applicable before determining the manufacturing exemption.
 - (b) Activity must qualify for exemption being claimed.
- (c) Taxpayer must qualify for use of three-factor apportionment under 72 P.S. § 7401(3)2.(a)(2) and 72 P.S. § 7401(3)2.(a)(3).
 - (d) Calculation of the factors—denominator
- (1) When calculating the payroll and Sales factors used for capital stock/franchise tax, the activity of the taxpayer has no affect on the denominator on the fractions.
- (2) When calculating the property factor, all manufacturing construction-in-progress, (including partnerships, if applicable) used in exempt activities should be included in the denominator and excluded from the numerator. This grants the exemption for start-up.
 - (e) Calculation of the factors—numerator
- (1) Property, payroll and sales sourced to PA in the same manner used for CNI tax.
- (2) Property and payroll sourced to PA must be further divided into property and payroll used in manufacturing, processing, and research and development.
- (3) All sales sourced to PA are included in the numerator. There is no statutory exemption for Pennsylvania sales.

CTM400.3. General audit procedures.

(a) Indicate factor(s) as submitted/determined/(re)settled as appears on accompanying schedules. Do not include factor in the narrative.

- (b) Obtain chart of accounts, descriptions of the accounts and designations used to identify location or state of each entry. Determine what accounts need to be reviewed for audit purposes.
 - (c) Obtain taxpayers' workpapers used to compile factors.
- (d) Audit each factor, starting with the denominators of the CNI factors and then the CNI numerators.
- (e) For any investments in unincorporated entities such as partnerships or LLCs, create separate subschedules for each.
 - (f) For CS/FF:
- (1) The factors should not include LLCs as they are considered corporations for CS/FF.
- (2) If an exemption is claimed, start CNI numerators after any LLCs are removed. Determine what should be granted the exemption and subtract to arrive at the taxable portion for CS/FF.
- (3) See the discussion on each factor, for any differences in the denominators.

CHAPTER 401. PROPERTY FACTOR. 72 p.s. § 7401(3)2.(a)(10)-(12), 61 Pa. Code § 153.28

SUBCHAPTER A

CTM401.1. General Information.

- (a) The property factor is a fraction:
- (1) The numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this State during the tax period.

- (2) The denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.
- (3) But shall not include the security interest of any corporation as seller or lessor in personal property sold or leased under a conditional sale, bailment lease, chattel mortgage or other contract providing for the retention of a lien or title as security for the sales price of the property.
- (b) Real and tangible personal property owned and used is valued at the original cost and not at book value (cost less depreciation).
- (1) Original Cost the basis of the real and tangible personal property for federal income tax purposes at the time of acquisition. (61 Pa. Code § 153.28(a)(2)).
- (i) If cost of the item is expensed in the year of purchase, the basis is zero.
- (ii) Increases for the stepped up basis for accounting adjustments and decreases for financial accounting reserves as a line item should not be included in the valuation. However, revaluation of individual assets can be included in factor.
- (2) Owned property to which the taxpayer has both legal and equitable title, property to which the taxpayer has legal title subject to the security interest of another and property which the taxpayer is purchasing under an installment sales agreement or similar agreement under the terms of which legal title remains in the seller for security purposes until the purchase price is paid. (61 Pa. Code § 153.28(a)(3)).
- (3) Real and tangible personal property, including inventory, is included in the Property Factor in accordance with the valuation method used for federal tax purposes. 61 Pa. 153.28(e)(3)
- (c) The rent should be the rental of all real and tangible personal property at eight times the rental rate. (Rents defined under 72 p.s. § 7401(3)2.(a)(11))
- (d) Net annual rental rate the annual rental rate paid by the taxpayer for an item of real or tangible personal property less annual rental income received by the taxpayer from subrentals, but not less than zero. (61 Pa. Code § 153.28(a)(1)).

- (e) The term "used" includes:
 - (1) Property actually used by the taxpayer.
- (2) Property available to be used or capable of being used by the taxpayer even if the property is not actually used during the taxable year.
 - (3) Property owned by the taxpayer and rented to a third party.
- (f) Average property (defined under 72 p.s. § 7401(3)2.(a)(12)) value of property shall be determined by:
 - (1) Averaging the values at the beginning and ending of the tax period
- (2) The averaging of monthly values maybe required during the tax period to reflect properly the average value of the taxpayer's property.
- (g) Mobile and movable property, such as construction equipment, trucks, automobiles or leased electronic equipment:
- (1) Is determined for the purposes of the factor on an equitable and reasonable basis, such as on a time used or mileage basis.
- (2) Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor.
- (3) Property in transit between a seller and buyer which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination.

CTM401.2. Exclusions.

(a) Idle property not actually used or available for or capable of being used during the taxable year is excluded. (61 Pa. Code § 153.28 (d)(3)).

- (1) In the year in which property becomes idle, include in factor at full value.
 - (2) For all subsequent years exclude.
- (b) Construction in progress: real and tangible property owned but not used is excluded from the property factor. 61 Pa. 153.28 (d)(1).
 - (1) Daily or monthly averaging should be used for substantial fluctuations.
- (2) Beginning in 2005 the RCT-106 contains a separate line to remove this property from the property owned.
 - (c) Security interests are excluded per 61 Pa. Code § 153.28 (d)(2).
- (d) Pre-paid expenses are not considered assets and therefore not included in the factor. (E.g. office supplies, stores inventory account.)

CTM401.3. Intangible and depletable assets.

- (a) Intangible assets are not included in the factor.
- (b) Computer software:
 - (1) Custom is intangible. Exclude from factor.
 - (2) Canned is tangible. Include in factor.
- (c) Capitalized interest if identified by asset it is to be included in the factor. If identified in a lump sum then it is to be excluded from the factor.
 - (d) Mineral interests: 61 Pa. Code § 153.28 (c)(1) & (2)
- (1) Leasehold interests of depletable assets in place are included as owned at net value. As the asset is extracted, leaving less in the ground, the value should decrease. (e.g. if it is estimated that there is 500 barrels of oil in a location valued at \$1 a barrel, value before extraction would be \$500. If 200 barrels of oil were removed the net value of the oil still in the ground would be \$300. As $3/5^{th}$ of the oil remains: 3/5X500=300.)

- (2) Minerals, which have been severed or extracted, are included in the factor as inventories.
- (3) Mineral interests are excluded when such interest has been depleted beyond reasonable recovery. (61 Pa. Code § 153.28 (d)(3) Example 3).
- (4) Dry holes and unproved interests are not included, as they are not capable of being used during the tax year.
- (5) Capitalized intangible drilling costs are included in the factor as they are part of the cost of tangible assets.
- (6) Delay rentals are included as rents; however, production payments (royalties for minerals extracted) are not considered rents.

CTM401.4. Underlying unincorporated entities.

(a) Partnership/joint venture property--per 72 p.s. § 7402.2, and 61 Pa. Code § 153.29, interest in an unincorporated entity (partnership, joint venture or similar association) shall be considered a direct ownership interest in the assets of the underlying unincorporated entity. The "corporate" owner should include the proportionate share based on capital ownership as reflected on the Schedule K-1 of the underlying entities property factor for capital stock/franchise and CNI.

(b) LLCs/trusts:

- (1) The proportionate share of the underlying LLC/trust's (if not classified federally as a corporation) property factor will be included in the corporate owner's CNI property factor. The proportionate share is based on capital ownership as reflected on the Schedule K-1. The proportionate share of the LLC/trust's property factor is not included in the corporate owner's capital stock/franchise property factor because the LLC/trust is statutorily classified as a corporation and would report for capital stock/franchise on its own activity.
- (2) If the underlying LLC/trust is classified federally as a corporation, the proportionate share of the property factor is not included in the corporate owner's property factor.

CTM401.5. Synthetic leases.

The following table shows the difference between accounting for a "synthetic lease" for book purposes and tax purposes. Company A maintains legal title to the property in question.

	Co A Lessor	Co. B Lessee
Financial Statement - Lease	Owns Property Expense	Reports Rental Expense
	Depreciation Reports Rental Income	
Federal Income Tax -	Reports Interest	Owns Property
Financing Agreement	Income	Depreciation Expense Reports Interest Expense
Nexus	Yes - holds legal title	Yes - using the property
Three factor apportionment		
Sales Factor	Interest income	n/a
Property Factor	n/a	included at federal income tax cost base
Single factor proportion of taxable assets	Would include property	Would not include property

CTM401.6. Proration of the property numerator. 61 Pa.

153.28(b)(1)(i)(ii)(iii) and 61 Pa.153.28(b)(2)(i)(ii)

- (a) First year companies.
- (1) Doing business outside PA for more than 1 year, less than 1 year in PA. For foreign corporations which have done business outside PA for more than 1 year but has been subject to commonwealth taxation for less than 1 year (c of a date) the numerator of the property shall be prorated to reflect the portion of the year for which business was done in this commonwealth. The tax due shall be prorated only where all 3 factors are 0. Property numerator is prorated, tax is not prorated.
- (2) Doing business less than 1 year, same period outside PA as inside PA. In the case of a corporation which has been doing business outside of this commonwealth for the same period for which it has been subject to commonwealth taxation, which is less than 1 year, the property factor is not prorated, but the tax due

is prorated based on the portion of the year during which the corporation did business in and out of this commonwealth. The property numerator is not prorated, the tax would be prorated.

- (3) Doing business less than 1 year everywhere and less than that inside PA. In the case of a corporation which has been doing business everywhere less than 1 year and inside this. Commonwealth for a lesser time period, the PA property numerator is prorated based on the portion of the year in which it conducted PA activity, and the tax due is prorated based on the portion of the year during which the corporation did business inside and outside of this Commonwealth. The property numerator is prorated, the tax would be prorated.
 - (b) Last year companies.
- (1) If corporation ceases activities everywhere, tax is prorated, property numerator is not prorated.
- (2) In the case of a corporation withdrawing from this Commonwealth but continuing to do business elsewhere, tax is not prorated, property numerator is prorated.

SUBCHAPTER B

CTM401.11. Audit procedures.

- (a) Real and tangible personal property includes such items as land, buildings, machinery and equipment, furniture, fixtures, automobiles, trucks, inventories and other like interests.
- (b) Use beginning and ending year original cost method used for federal income tax purposes on the schedules. The basis of inventory is the valuation used to calculate the cost of goods sold on the FF1120.
- (c) Review the books and records of the taxpayer to determine if the factor is correct. Examples of records to be reviewed are fixed asset listings, depreciation schedules and general ledger accounts.

- (d) For substantial fluctuations in beginning and ending values of real and tangible personal property use monthly averaging (61 Pa. Code § 153.28(g)(1)(ii).). Review the following for areas of fluctuations:
 - (1) Assets sold Federal Form 4797 & Schedule D.
 - (2) CIP substantial difference between beginning and ending.
- (3) If numerator is daily or monthly averaged, the Pennsylvania assets in the denominator should also be adjusted the same.
- (e) Net annual rental rate the annual rental rate paid by the taxpayer (including taxes, insurance, interest, repairs, etc., if part of lease agreement) for any real and tangible personal property, less any annual rental income received by the taxpayer from sub-rentals of rented property. However, net rentals on an individual basis shall not be less than zero (61 Pa. Code § 153.28(a)(1)).
- (1) Rents should be expensed on Federal Form 1120. Rent can be found on:
 - (i) Line 16, rents.
 - (ii) Line 26, other deductions Get a breakdown of other deductions.
 - (iii) Schedule A cost of goods sold.
 - (iv) Other.
- (2) Review the rental/lease agreements to determine the rental rate and any other expenses included in the lease.
- (3) Rent should be reduced by any subrental income received for that specific rental.
 - (i) Should be accounted for on an individual basis.
- (ii) Subrental income should not be used to reduce rent expense of other rents.

- (iii) Do not reduce rent expense by rental income from assets owned.
- (3) If the taxpayer has an analysis of public warehousing expenses the expenses net of handling fees should be included in rent expense.
- (4) Rents should be referenced to in the narrative as rents x 8 and not as capitalized rents. This should not be confused with capital leases.
 - (f) Property owned or rented is assigned generally by situs.
 - (1) Exceptions: Inventory-in-transit, situs of destination.
- (2) Mobile property assign on a time used or mileage basis (61 Pa. Code § 153.28(c)(4)). (e.g.) airplanes used in the business of transporting people and/or property would be on a mileage basis. A company plane used by employees would be assigned based on hanger days.
 - (g) Capital leases.
- (1) Per FASB 13, a lease that transfers substantially all the benefits and risks inherent in the ownership of property is called a capital lease. Such a lease should be accounted for by the lessee as the acquisition of an asset and the incurrence of a liability. The lessor should account for such a lease as a sale or financing. These leases are referred to as sales-type or direct financing leases. All other leases are referred to as operating leases. Determine how lease is handled for federal tax purposes.
- (2) The lessor would not include assets accounted for under a sales-type or direct financing lease in the property factor. Assets accounted for under an operating lease are owned by the lessor and should be included in the property factor. If the leases are accounted for as operating leases for tax purposes and are recorded as receivables on the balance sheet the property should be included in the factor.
- (3) Per Departmental policy, the lessee can report capital leases as either rentals or property owned, but not both. Review M-1/M-3 for capital lease activity, and determine the taxpayer's treatment for property factor purposes.
- (4) Indicate capital leases as a separate item both on the schedules, reconcilements, and in narrative.

- (h) Partnership/joint venture property.
- (1) Per 61 Pa. Code § 153.29, interest in a partnership/joint venture or similar association shall be considered a direct interest and included in the fraction.
- (2) Obtain FF 1065 and by state apportionment schedules for all partnerships.
- (3) Compute taxpayers distributive share of property and rent based on the taxpayers percentage (ownership of capital reflected on the taxpayers schedule K-1). This computation is calculated using the audit application property sub-schedule. Use a separate sub-schedule for each partnership. Be sure to include beginning and ending values of property, as well as percentage of ownership.
 - (i) Limited liability company.
- (1) Multimember LLCs filing as a partnership will be included in the partners PA tax return just as any other partnership.
- (2) Single member LLCs that are disregarded entities are included in the fraction the same as a branch or division.
- (3) Be sure to separately identify all LLC property by using the audit application property sub-schedule., as it will not be included in the fraction for CS/FF purposes. Use a separate sub-schedule for each LLC.
 - (j) Safe harbor leases (61 Pa. Code § 153.30)(26 U.S.C. § 168(f)(8)).
- (1) Only when real title (not the tax title) passes under Pennsylvania law from the seller/lessee to the purchaser/lessor will the transaction be given safe harbor treatment.
- (2) If real title does not pass to the purchaser/lessor, the seller/lessee will be considered the owner of the property and will include the value of the property in the factor. The purchaser/lessor will not include the property in the factor.
- (3) When real title does pass to the purchaser/lessor, the purchaser/lessor will be considered the owner of the property and will include the

property in the factor. The seller/lessee will include the value of the property in the factor at eight times its net rental value.

- (4) Review Federal M-1s for safe harbor lease adjustments.
- (5) Obtain copy of safe harbor lease and/or Federal Form 6793.
- (6) Identify if the taxpayer is the lessor or lessee.
- (7) Indicate if lease is included or excluded in the factors as submitted/determined/(re)settled and per audit. Provide a schedule.
- (k) Everywhere totals are to be reconciled to the federal tax balance sheet amounts with discrepancies fully explained in the narrative and fully documented on the property schedules. The schedule property everywhere reconcilement should be from the tax balance sheet to the audited numbers. Detailed explanation must be provided for all reconciling items as to why or why not included in the factor.
 - (I) Must exhibit or prepare a schedule showing the by state breakdown.
- (m) Must verify the by state detail, back to original source documents. Identify all source documents, accounts etc. that were reviewed.
 - (n) Detailed explanations of proposed changes are required in the narrative.
- (1) Identify dollar amounts, fully detail reason for adjustments and the impact on both the numerator and denominator.
 - (2) Must exhibit documentation to support all changes.

CTM401.12. Audit procedures – CS/FF.

- (a) Indicate factor(s) as filed/amended/determined/(re)settled on accompanying schedules. Do not include factor in narrative.
 - (b) Denominator will be the same as CNI tax with some exceptions.
- (1) Any LLC property should be excluded from the factor as they are considered a corporation for CS/FF tax purposes.

- (2) All manufacturing construction-in-progress, (including partnerships, if applicable) used in exempt activities should be included in the denominator and excluded from the numerator. This grants the exemption for start-up. Verify that CIP does not include headquarters administrative activity or other similar areas not engaged in manufacturing.
- (3) Schedule everywhere property CS/FF would be used only if the denominator was filed different than that for CNI. Indicate on this schedule the adjustments for exempt construction in progress and LLC property and rent expense, if applicable.

(c) Numerator.

- (1) Submit schedules (PA property manufacturing apportionment) showing computation of manufacturing and nonmanufacturing property owned and rented by location. Include partnerships in this computation if they are involved in manufacturing activities.
- (2) Determine what property is taxable, exempt, or partially exempt and adjust accordingly, if necessary.
- (d) Detailed explanations of proposed changes are required in the narrative and on the audit schedules. Documentation to support the changes must be included as exhibits.
- (e) The factor as revised per audit should be shown on accompanying schedules. Do not include factor in narrative.

CHAPTER 402. PAYROLL FACTOR.

SUBCHAPTER A

CTM402.1. Definitions.

(a) Base of operation:

- (1) The place of more or less permanent nature from which an individual starts his work, and
 - (2) To which he customarily returns in order to:
 - (i) Receive instructions from the taxpayer
 - (ii) Communications from his customers, or
- (iii) To perform any other function necessary to exercise his duties for the taxpayer.

(b) Compensation:

- (1) Wages, salaries, commissions and any other form of remuneration paid to employees for personal services. Amounts considered paid include the value of board, rent, housing lodging, and other benefits, service or legal consideration furnished to employees by the taxpayer in return for personal services, provided that such amounts constitute income to the individual under 26 U.S.C. § 3121.
- (2) Per the October 21, 1986 State Tax Reviewer, a letter from the Department of Revenue stated 401(k)s are considered compensation.
- (3) Tips, workman's compensation, sick leave under an insurance policy, and any other compensation not paid for directly by the taxpayer are not included in the factor.

(c) Employee:

- (1) Any officer of the taxpayer.
- (2) Any person who, under the usual common law rules applicable in determining the employee/employer relationship has the status of an employee.
- (3) Any person who is an employee of another corporation whom you have direct supervision and control of and whose salary is reimbursed or paid through a management fee supported by the written agreement. (Commonwealth v. American Gas Co., 352 Pa 113,42 A.2d 161 (1945)).

- (4) This excludes independent contractors or any other persons not classified as employees.
- (d) Incidental services Any service which is temporary or transitory in nature or which is rendered in connection with an isolated transaction.
- (e) Place from which the service is directed or controlled The place from which the power to direct or control is exercised by the taxpayer.

CTM402.2. General information.

- (a) For statutory and regulatory guidance (see 72 P.S. § 7401(3)2.(a) and 61 Pa. Code § 153.25).
- (b) Taxpayer's claiming three-factor are required to complete tables supporting apportionment (RCT-106).
 - (c) The numerator is PA payroll, the denominator is payroll everywhere.
 - (d) The factor is computed to 6 decimal places.
 - (e) Subcontracting is not included.
 - (f) Generally, the payroll denominator will be the sum of the following:
 - (1) Salaries and wages.
 - (2) Officer's compensation.
 - (3) Director labor (cost of goods sold schedule).
 - (4) Commissions (other deductions or other costs).
 - (5) Bonuses (other deductions or other costs).
 - (6) Proportionate share of any underlying LLC/trust for CNI tax.
- (7) Proportionate share of any underlying non-LLC partnership for CS/FF and CNI taxes.

- (8) Management fees if it meets the criteria as payroll.
- (g) The payroll factor can be computed on a cash or accrual basis of accounting. Either method is acceptable if consistently used from year to year and the numerator and denominator are being reported on the same basis.

CTM402.3. Investment in unincorporated entities.

- (a) Partnership/joint venture payroll. Per 72 P.S. § 7402.2, and 61 Pa. Code § 153.29, interest in an unincorporated entity (partnership, joint venture or similar association) shall be considered a direct ownership interest in the assets of the underlying unincorporated entity. The "corporate" owner should include the proportionate share of the underlying entities payroll factor for CS/FF and CNI.
 - (b) LLCs/business trusts payroll -
- (1) The proportionate share of the underlying LLC/business trust's (if not classified federally as a corporation) payroll will be included in the corporate owner's CNI payroll factor. The proportionate share is based on capital ownership as reflected on the Schedule K-1. The proportionate share of the LLC/business trust's payroll factor is not included in the corporate owner's CS/FF payroll factor because the LLC/business trust is statutorily classified as a corporation and would report for CS/FF on its own activity.
- (2) If the underlying LLC/business trust is classified federally as a corporation, the proportionate share of the payroll factor is not included in the corporate owner's payroll factor.

CTM402.4. Pennsylvania compensation.

Compensation is in Pa if any one of the following tests, applied consecutively, is met:

- (a) The individual's service is performed entirely within Pennsylvania, or
- (b) The individual's service is performed both within and without Pennsylvania, but the service performed without Pennsylvania is incidental to the individual's service performed within Pennsylvania, or

- (c) Some of the individual's services are performed in Pennsylvania:
 - (1) And the individual's base of operation is in Pennsylvania; or
- (2) If there is no base of operations in any state in which some part of the service is performed, but the place from which the individual's service is directed or controlled is in Pennsylvania; or
- (d) If the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the individual's service is performed but the individual's residence is in Pennsylvania.
- (e) An individual's payroll is either all in Pennsylvania or all outside Pennsylvania, and cannot be split, except when an employee's place of work changes from one state to another.

CTM402.5. Management fees.

- (a) May or may not be included in the factor dependent on the details of each case.
 - (b) Applicable court decisions
 - (1) Cmwlth v. American Gas (42 A.2d 161(Pa. 1945))
- (i) Taxpayer had written agreement with an out-of-state affiliate to provide employee services.
 - (ii) Employees in question were officers of the taxpayer.
 - (iii) Taxpayer reimbursed subsidiary for services of these employees.
- (iv) PA Supreme Court ruled these payments were payroll and included in the payroll factor.
- (2) (UPS Worldwide Forwarding, Inc. v. Commonwealth of Pennsylvania. 62 F.R. 2001, 63 F.R. 2001, 64 F.R. 2001, and 65 F.R. 2001, (2004). Taxpayer relied on the decision of the PA Supreme Court in the American Gas case in its appeals.

- (i) Taxpayer had agreement with an out-of-state affiliate to provide employee services.
 - (ii) Taxpayer reimbursed subsidiary for services of these employees.
 - (iii) Agreement was not written.
 - (iv) Employees were not officers of the taxpayer.
- (v) Commonwealth Court ruled in favor of the Commonwealth, disallowing the payroll factor. Decision was upheld by the PA Supreme Court.

SUBCHAPTER B

CTM402.11. Audit procedures.

- (a) For statutory and regulatory guidance (see (72 P.S. § 7401.(3)2.(a)(13) and (14)/ 61 Pa. Code § 153.25).
- (b) The taxpayer has the option to file the payroll on the accrual or cash basis, just so it is consistently filed from year to year and for PA and everywhere payroll.
 - (c) Indicate whether factor is computed on a cash or accrual basis of accounting.
- (d) List within Pennsylvania and total accrual basis payroll totals. If this is not the method employed by the taxpayer use these numbers for comparison purposes.
- (1) Verify the accrual figures with the payroll account records when available. If the accrual method is used, verify total everywhere to Federal Form 1120 gross (before jobs credit) payroll.
- (2) If the taxpayer files the factor on a cash basis, it is not necessary to adjust to the accrual basis of accounting.
- (e) Determine how by-state breakdowns were compiled. Verify that the by-state breakdowns were compiled correctly by tracing back to original source documents (such as general ledger, payroll journal, payroll register, wage tax reports, payroll tax returns, UC-2s, W-3s, FF 940, FF 941).

- (f) Obtain documentation of any non-USA payroll included to confirm this is compensation to employees.
- (g) Must exhibit or prepare a schedule showing the by state breakdown. Must identify all source documents reviewed to verify the by state detail.
 - (h) Detailed explanations of proposed changes are required in the narrative.
- (1) Identify dollar amounts, fully detail reason for adjustments and the impact on both the numerator and denominator.
 - (2) Must exhibit documentation to support all changes.
- (i) Perform a review of employer withholding of PA personal income taxes, if information is available at location. If discrepancies occur, pursue.

CTM402.12. Review of Federal and State documentation.

- (a) Review FF 940, Employer's Annual Federal Unemployment (FUTA) Tax Return and FF 941, Employer's Quarterly Federal Tax Return reports.
- (1) Obtain a by-state breakdown of the FF 940. This is the best basis for the payroll factor as all wages are on a consistent basis.
- (2) Federal forms and publications can be found at: http://www.irs.ustreas.gov/businesses/small/content/0,,id=98942,00.html
 - (b) Review state PA UC-2, Employer's Report for Unemployment Compensation.
- (1) Calculate Pennsylvania wages based on employer withholding taxes paid. These totals should be used for comparison purposes. If not comparable, question.
- (2) State forms and publications can be found at: http://www.dli.state.pa.us
- (3) Per PA UC-2: wages include not only salary, commissions, bonuses and tips, but also sick or accident disability payments (except workers' compensation payments) made by an employer or third party (insurance company) and certain fringe

benefits. Additionally, the cash value of payments made in a medium other than cash, such as lodgings, meals, etc. are also considered wages.

CTM402.13. Partnership/joint venture payroll.

- (a) Obtain FF 1065 and by state apportionment schedules for all partnerships.
- (b) Distributive share of payroll based on the taxpayer's percentage (ownership of capital reflected on the taxpayer's schedule K-1).
- (c) Use payroll sub-schedule for each entity unless a detailed schedule, which must be exhibited, is presented by the taxpayer to summarize all entities. When using summary sub-schedules, use a separate sub-schedule for each partnership.

CTM402.14. Limited liability company payroll.

- (a) A multimember LLC filing as a partnership will be included in the partners' PA tax returns just as any other partnership.
- (b) A single member LLC that is a disregarded entity is included in the fraction the same as a branch or division.
- (c) Be sure to separately identify all LLC payroll by using the audit application payroll sub-schedule as it will not be included in the factor for CS/FF purposes.
- (d) Use payroll sub-schedule for each entity unless a detailed schedule, which must be exhibited, is presented by the taxpayer to summarize all entities When using summary sub-schedules, use a separate sub-schedule for each LLC.

CTM402.15. Management fees.

- (a) Obtain copies of all documents concerning management fees.
- (b) Determine if there is direct supervision of employees supplied in the management agreement.
 - (c) Determine if they work solely for this taxpayer or several companies.
- (d) When the taxpayer reimburses another entity for services performed by employees the decision as to whether this is payroll is based on the facts of the case.

The taxpayer is required to provide a copy of the agreement to support their position as to whether these payments are included in the payroll factor.

CTM402.16. Audit procedures – CS/FF.

(a) Indicate factor(s) as filed/amended/determined/(re)settled on accompanying. Do not include factor in narrative.

(b) Denominator:

- (1) Will be the same as CNI tax except if taxpayer had an investment in an LLC that is a disregarded entity.
- (2) Adjustments, if necessary should be the same as CNI tax. Make statement that adjustments are the same as CNI tax, do not repeat adjustments.

(c) Numerator:

- (1) Submit schedules (PA property manufacturing apportionment) showing computation of manufacturing and nonmanufacturing property owned and rented by location. Include partnerships in this computation if they are involved in manufacturing activities.
- (2) Submit schedule of Pennsylvania payroll by location broken down between taxable, exempt and partially exempt.
- (d) Detailed explanations of proposed changes are required in the narrative and on the audit schedules. Documentation to support the changes must be included as exhibits.
- (e) The factor as revised per audit should be shown on accompanying schedules. Do not include factor in narrative.

CHAPTER 403. SALES FACTOR.

SUBCHAPTER A

CTM403.1. General information.

- (a) Sales means all gross receipts of the taxpayer not allocated under the definition of non-business income (see 72 P.S. § 7401(3)2.(a)(1)(D)) other than:
 - (1) Dividends.
- (2) Interest on United States, state or political subdivision obligations. See Taxing Bulletin 94.
- (3) Gross receipts received from the sale, redemption, maturity or exchange of securities. Exception: Proceeds from the sale of securities held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Securities held by a security dealer for own purposes would not be in factor.
- (4) Gains on certain government obligations are considered securities and excluded. They are still excluded even though the gains from the sale of securities issued after 2/4/94 (Act 68 of 1993, PA Tax Update No. 48) are now taxable.
- (b) The sales factor is a fraction, the denominator of which is the total sales of the taxpayer with the numerator being the sales of the taxpayer in Pennsylvania.
- (c) Taxpayers claiming three-factor apportionment are required to complete tables supporting apportionment. A completed table (RCT-106) is required to support three-factor apportionment claim.
 - (d) The factor is computed to 6 decimal places.
- (e) The sales factor is single weighted in the calculation of the CS/FF tax apportionment.
- (f) When calculating the CNI tax apportionment sales factor is weighted. The weight of the factor has changed through the years. See below:

Weight	Effective Dates	Authority
70%	After 12/31/06 to current	Act 116 of 2006
triple weighted	after 12/31/98 and before 01/01/07	Act 4 of 1999
Double weighted	after 12/31/94 and before 01/01/99	Act 21 of 1995
single weighted	before 01/01/95	

CTM403.2. Sales of tangible personal property are assigned on a destination basis.

- (a) For statutory and regulatory guidance (see 72 P.S. § 7401(3)2.(a)(16) and 61 Pa. Code § 153.26.
- (b) The sale is assigned to Pennsylvania if the final destination of property is delivered or shipped to a purchaser within Pennsylvania.
- (c) Dock sales (see Commonwealth v. Gilmour Manufacturing Corporation, 573 Pa. 143, 822 A.2d 676 (2003).
- (1) All sales are sourced based on destination, regardless of how the goods are transported.
- (2) Sales to purchasers who pick up the goods at the taxpayer's location and transport the goods to a location in PA are PA sales, regardless of the taxpayer's location. These sales are included in the numerator.
- (3) Sales to purchasers who pick up the goods at the taxpayer's location and transport the goods to a location outside of PA are sourced outside of the Commonwealth, regardless of the taxpayer's location. These sales are not included in the numerator.
- (4) Taxpayer must be able to provide documentation sufficient to establish an out-of-state sale. (See Corporate Tax Statement of Policy 2004-02).
- (i) Documentation sufficient to establish an out-of-state sale includes:
- (A) Bills of Lading of the carrier establishing that the goods were destined for or delivered to an out of state location.
- (B) Delivery instructions from the purchaser to the carrier establishing that the goods were to be transported out of Pennsylvania.
- (C) Warehouse receipts of the purchaser showing that the goods were delivered to an out of state location.

- (D) Invoices issued by the taxpayer/seller to the purchaser showing an out-of-state delivery address.
- (ii) Documentation which will be deemed insufficient to establish that the ultimate destination of goods to an out of a state location:
- (A) Invoices issued by the taxpayer/seller to the purchaser showing an out-of-state mailing address.
- (B) Affidavits or other declarations from the seller, its employees or agents that the ultimate destination of goods was an out of state location.

CTM403.3. Receipts from other than the sale of tangible personal property.

- (a) Sales, other than sales of tangible personal property, are in this state if:
 - (1) The income-producing activity is performed in this state; or
- (2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.
 - (b) Gross rents.
- (1) Rents from real estate and equipment are sourced to the location of the property.
 - (2) Mobile property should be based on a mileage basis.
 - (3) Airplane for corporate use assign by hanger days.
 - (c) Gross royalties.
- (1) Real tangible personal property –assigned to the site where the property is located.

- (2) Intangible personal property-assigned based on the income producing activity performed.
 - (d) Gross proceeds from the sale or disposition of assets.
- (1) Real and tangible personal property sourced based on location of property or destination.
- (2) Intangible property examples of intangibles that are included and assigned based on the income producing activity.
 - (i) Goodwill.
 - (ii) Trademarks.
 - (iii) Sale of technology.
 - (iv) Patents.
 - (v) Futures other than securities (net proceeds).
 - (vi) Options.
- (vii) Foreign currency exchange contracts are included at net gains not proceeds.
- (e) Other income. Other income is categorized by type of income and assigned accordingly.
 - (1) Management fees where service is performed.
 - (2) Scrap sales situs.
- (3) Sales tax discounts are includable in the factor, as this is a commission for timely filing and remitting of sales tax. Situs where return prepared.
- (4) Bad debt recovery (receipts were originally included in prior period) and discounts (reduction in purchase price) are not receipt items and should not be included in the factor.

- (5) Rebates (return of money), either at the time of sale or mail in rebates are not included in the factor.
- (6) Refunds are not included in the factor. These are a return of the taxpayer's money that reduces expenses generated in a prior year. Examples include tax refunds, insurance refunds, insurance dividends if actually a return of expenses).
- (7) Sale of Stock treated as a sale of assets under 26 U.S.C. 338(h)(10), (Canteen Corporation v. Commonwealth of PA, 818 A 2d 594 (PA Commonwealth 2003)).
- (i) Taxable years beginning after 12/31/98 338(h) deemed sales would be treated as business income. Gross proceeds from the sale would be in the sales factor.
- (ii) Taxable years beginning prior to 01/01/99 338(h) deemed sales would be non-business income. No proceeds would be in the sales factor.
 - (f) Safe harbor leases (61 Pa. Code 153.30).
- (1) Only when the real title rather than the tax title passes under Pennsylvania law from the seller/lessee to the purchaser/lessor will the transaction be given safe harbor treatment.
 - (2) If real title does not pass to the purchaser/lessor:
- (i) The purchaser/lessor will not include the rental or interest income attributable to the safe harbor agreement in the factor.
- (ii) The seller/lessee will not include the down payment or the installment payment relating to the safe harbor lease transaction in the factor.
 - (3) If real title does pass to the purchaser/lessor:
- (i) The purchaser/lessor will include in the factor all rental or interest income attributable to such property.
- (ii) The seller/lessee will include in the factor the down payment and all installment payments attributable to the safe harbor agreement.

(4) Review Federal M-1s for safe harbor lease adjustments.

CTM403.4. Underlying unincorporated entities.

- (a) Partnership/joint venture sales.
- (1) Per 72 P.S. § 7402.2, and 61 Pa. Code § 153.29, interest in an unincorporated entity (partnership, joint venture or similar association) shall be considered a direct ownership interest in the assets of the underlying unincorporated entity. The "corporate" owner should include the proportionate share based on capital ownership as reflected on the Schedule K-1 of the underlying entity's sales factor for CNI tax and capital stock/franchise tax if applicable.
- (2) The corporation's distributive share of income/loss (usually reported on page 1, line 10 other income on the Federal Form 1120) is excluded for factor purposes.
 - (b) LLCs/business trusts.
- (1) The proportionate share of the underlying LLC/business trust's (if not classified federally as a corporation) sales will be included in the corporate owner's CNI sales factor. The proportionate share is based on capital ownership as reflected on the Schedule K-1. The proportionate share of the LLC/business trust's sales factor is not included in the corporate owner's CS/FF sales factor because the LLC/business trust is statutorily classified as a corporation and would report for CS/FF on its own activity.
- (2) If the underlying LLC/business trust is classified federally as a corporation, the proportionate share of the sales factor is not included in the corporate owner's sales factor.
 - (c) Intercompany sales between taxpayer and partnership interest.
- (1) Sales between the partnership and the taxpayer shall be eliminated from the denominator and numerator of the taxpayer's sales factor as follows:
- (i) Sales by the taxpayer to the partnership to the extent of the interest in the partnership.
- (ii) Sales by the partnership to the taxpayer not to exceed the taxpayer's interest in partnership sales.

(2) Sales made by the taxpayer or the partnership to nonpartners shall be included in the taxpayer's sales factor in an amount equal to the taxpayer's interest in the partnership.

CTM403.5. Sales of partnership interest.

- (a) A corporation's interest in a partnership is considered ownership of the underlying assets.
- (b) When a corporation sells its interest in a partnership it is treated as a sale of the underlying assets, not a sale of an investment or intangible asset.
- (c) The proceeds from the sale must be allocated to the types of assets considered sold by the corporation; securities, intangible assets, and real and tangible personal property. This is calculated as follows:
- (1) Multiply the proceeds by the amount of securities reported on the balance sheet of the partnership divided by the total assets of the partnership. This is the amount of the proceeds received from the sale of securities and will be excluded from both the numerator and the denominator.
- (2) Multiply the proceeds by the amount of intangible assets reported on the balance sheet of the partnership divided by the total assets of the partnership. This is included in the denominator of the sales factor as the sale of intangible assets. The amount sourced to PA is then determined as if the intangible were actually held by the corporation. If it is determined that an intangible is sourced to a particular state, other than the state of domicile, the proceeds associated with the sale of that particular asset would be the proceeds allocated to the sale of intangible assets multiplied by the value of the that particular asset divided by the total intangible assets. Otherwise, the proceeds allocated to intangible assets are sourced to the state of commercial domicile of the corporation.
- (3) Multiply the proceeds by the amount of real and tangible personal property reported on the balance sheet of the partnership divided by the total assets of the partnership. This is included in the denominator of the sales factor as the sale of real and tangible personal property. The amount of the proceeds sourced to by PA is based on the percentage of the partnership's real and tangible property located in the state. This is done by multiplying the proceeds allocated to the sale of real and tangible personal property by the real and tangible personal property owned by the

partnership in PA and divide by the total real and tangible personal property owned by the partnership.

CTM403.6. Synthetic leases.

The following table shows the difference between accounting for a "synthetic lease" for book purposes and tax purposes. Company A maintains legal title to the property in question.

	Co A Lessor	Co. B Lessee
Financial Statement -	Owns Property	Reports Rental Expense
Lease	Expense Depreciation	
	Reports Rental Income	
Federal Income Tax -	Reports Interest Income	Owns Property
Financing Agreement		Depreciation Expense
		Reports Interest Expense
Nexus	Yes - holds legal title	Yes - using the property
Three factor apportionment	Interest income	n/a
Sales Factor	n/a	included at federal income tax
Property Factor		cost base
Single factor proportion of	Would include property	Would not include property
taxable assets		

SUBCHAPTER B

CTM403.11. Auditing procedures.

- (a) For statutory and regulatory guidance (see (72 P.S. § 7401.(3)2.(a))(1)(E), (15), (16) and (17)/ 61 Pa. Code § 153.26).
- (b) Indicate factor(s) as filed/amended/determined/(re)settled as appears on accompanying schedules. Do not include factor in the narrative.
- (c) Must exhibit or prepare a schedule showing the by state breakdown. Must identify all source documents reviewed to verify the by state detail (such as sales journals, general ledger, sales invoices, sales reports sorted by state).
 - (d) Detailed explanations of proposed changes are required in the narrative.

- (e) Identify issues, fully detail reason for adjustments and the impact on both the numerator and denominator.
 - (f) Must exhibit documentation to support all changes.
 - (g) By-state breakdowns.
 - (1) Determine how by-state breakdowns were prepared.
- (2) Trace back to original records. Must go beyond apportionment schedules (for example sales journals, by state sales reports, computer file of sales).
- (3) If no by-state breakdown and/or original records provided, determine in favor of the Commonwealth. One method is by using average Pennsylvania assets over average everywhere assets from the CNI property factor to prorate the tangible assets.

CTM403.12. Interest on United States, state or political subdivision obligations.

If interest on United States, state or political subdivision obligations is in factor, remove it from the factor. See Taxing Bulletin 94.

CTM403.13. Verification that the sales of tangible personal property are reported on a destination basis.

- (a) Sales of tangible personal property are assigned on a destination basis. A random check of sales records is required to determine if the taxpayer is properly reporting sales on a destination basis. Verify that sales are recorded using the shipping address and not the billing address.
- (b) If taxpayer has computerized records, computerized audit assistance must be pursued. Have taxpayer complete the CORPORATION TAX COMPUTER AUDIT FEASIBILITY QUESTIONNAIRE.
- (c) Trace the shipping address from the invoices to the destination sales reports to determine they are being properly reported.

CTM403.14. Partnership/joint venture sales.

- (a) For statutory and regulatory guidance (see (72 P.S. § 7402.2 and 61 Pa. Code § 153.29).
- (b) Interest in a partnership, joint venture or similar association shall be considered a direct interest and included in the fraction.
- (1) Obtain Federal Form 1065 and by state apportionment schedules for all partnerships.
- (2) Compute taxpayers distributive share of sales based on the taxpayers percentage (ownership of capital reflected on the taxpayers schedule K-1). This computation is calculated using the audit application sales sub-schedule.
- (c) The partnership's distribution of income to the corporation (usually reported on page 1, line 10 other income on the Federal Form 1120) is <u>excluded</u> for factor purposes. Make sure that flow thru items are not included twice.
- (d) The percentage of ownership is the percentage of capital to use for apportionment. If capital ownership percentage is changed during the year use a daily or monthly average.
 - (e) Corporate Partners Reporting of Partnership Activity.
- (i) Sale of investment in partnership when the partner receives property rather than cash. This transaction does not affect the sales factor until the property received by the partner is sold.
- (ii) Taxpayer received distributions from the partnership above its basis in the partnership. The amount received above the basis is reported as a gain on the taxpayer's federal income tax return. This is considered a partial sale of underlying assets and the proceeds included in the sales factor in the same manner as a total liquidation.
- (iii) Distributions received from the partnership that change the partner's ownership percentage are not included in the sales factor.

CTM403.15. Limited liability company.

- (a) Be sure to separately identify all LLC sales by using the audit application sales sub-schedule, as they will not be included in the factor for CS/FF purposes.
- (b) A sale of a multiple member LLC is treated the same as a sale of a partnership.
 - (c) A sale of a single member LLC is treated the same as a sale of assets.

CTM403.16. Intercompany sales.

- (a) Determine if there are any intercompany sales between related companies or partnerships. Ask the taxpayer for details on any intercompany transactions.
- (i) Review the balance sheet to determine if there are any intercompany receivables or payables.
 - (ii) Review sales records.
- (b) Verify that on a separate company basis all intercompany sales were reported on the FF1120.
- (i) For consolidated purposes, sales between members of the consolidated group are not reported until sold outside of the group.
- (ii) For separate company purposes, sales between members of the consolidated group are reported at the time of sale.
- (c) For sales to a partnership or from a partnership by the taxpayer to the extent of the interest in the partnership is eliminated from the sales factor.

CTM403.17. Audit procedures – CS/FF.

- (a) LLCs are treated as disregarded entities or partnerships for CNI. LLCs are considered as corporations for franchise tax effective with years starting on or after 1/1/1998.
 - (b) Effective 1/1/99 and thereafter there is no exemption for the sales.

- (c) Indicate factor(s) as filed/amended/determined/(re)settled on accompanying schedule. Do not include factor in narrative.
- (d) Detailed explanations and documentations or proposed changes are required in the narrative.
- (e) The factor as revised per audit should be shown on accompanying schedule. Do not include factor in narrative.
 - (f) Adjustments, if necessary, should be the same as CNI tax.
 - (1) Make statement that adjustments are the same as CNI tax.
- (2) If adjustments are different than CNI tax, detailed explanation of reasons for adjusting should be included in the narrative.

CHAPTER 500. SINGLE FACTOR APPORTIONMENT

CTM500.1. Generally.

- (a) For regulatory guidance (see 61 Pa. Code § 155.10).
- (b) All corporations except regulated investment companies that are subject to CS/FF may elect to use the single factor fraction.
 - (c) May be used by both domestic and foreign corporations.
- (d) Foreign corporation electing to use single fraction is treated as a domestic corporation.
- (e) Taxpayer is not required to be subject to tax in another state to use single fraction.
- (1) Must be subject to tax outside of the Commonwealth, in order to exempt tangible assets based on situs.
- (2) Does not have to be subject tax outside of the Commonwealth to exempt assets if exempt by:

- (i) Commonwealth statute.
- (ii) Reason of public policy.
- (iii) Reason of constitutional interpretation.

CTM500.2. Statutory changes to exemption - impact on factor.

In Gilbert Associates, Inc. v. Commonwealth of Pennsylvania, 418 A.2d 783 (Pa. Cmwlth. 1980) the court ruled that foreign corporations that are entitled to apportionment can use the single fraction; however, intangibles are treated as if they were a domestic corporation.

CTM500.3. Use of single fraction is an election.

- (a) Since the use of the single fraction is an election made by the taxpayer the Department does not have the authority to calculate the tax using three-factor apportionment without the approval of the taxpayer.
- (b) If the taxpayer qualifies to use three-factor apportionment the taxpayer must be given the opportunity to amend the report when the adjusted single fraction results in a higher tax than the three-factor apportionment.
- (c) If the taxpayer does not amend the report Department must calculate the tax using the adjusted single fraction.

CTM500.4. Taxable assets fraction.

The taxable assets fraction is a fraction:

- (1) The numerator of which is the average book value of taxable assets owned by the taxpayer during the taxable year and
- (2) The denominator of which is the average book value of the total assets owned by the taxpayer during the taxable year.
 - (3) Monthly or daily averaging:

- (1) May be required where the averaging is reasonably required to reflect the average value of the taxpayer's property.
- (2) If substantial property is acquired or disposed of during the taxable year.
- (3) If the value of asset is adjusted in arriving at the denominator the adjusted value is also used in calculating the numerator.

CTM500.5. Average total assets.

- (a) Average total assets. Should always tie into the total average net book value of assets (both tangible and intangible) as reported on the Federal Form 1120 balance sheet as adjusted for:
 - (1) Negative assets and negative liabilities.
 - (2) The actual value (but not less than zero) of investee companies.
- (3) Daily average balance of exempt intangibles purchased or sold during the year.
- (b) Adjustment to total assets. Total assets reported on the beginning and ending balance sheets shall be adjusted as follows:
- (1) Add back any negative assets which have to be reclassified as liabilities.
- (2) Add back any negative liabilities which have to be reclassified as assets.
 - (3) Deduct the book value of investee companies.
 - (4) Add net positive net worth of investee corporations.
- (5) Deduct the book value of exempt intangible purchased or sold during the year.
- (6) Calculate the daily average of the exempt intangibles and add this number to both beginning and ending total assets.

- (7) Adjust the total assets beginning and ending for each of the above adjustments.
- (8) Add adjusted beginning and ending assets and divide by 2. This will be the average total assets. This is your denominator.

CTM500.6. Average taxable assets.

To calculate the average taxable assets, begin with the total beginning and ending total assets as calculated above.

- (1) Deduct exempt tangible and intangible assets.
- (2) If the asset is not specifically listed as exempt it is taxable and included in the numerator.

CTM500.7. Tangible assets.

- (a) Tangible assets may be exempt.
 - (1) Based on situs (location).
- (2) If actually and exclusively employed in manufacturing, processing or research and development in this Commonwealth, except if employed by a corporation which enjoys the right of eminent domain.
- (b) Tangible assets located outside of Pennsylvania are exempt assets if the corporation is subject to tax outside this Commonwealth.
- (c) Movable property may be partially exempt to the extent utilized outside of PA. The assets shall be allocated on an equitable and reasonable basis, such as, on a time used or mileage basis.
- (d) Tangible assets are similar to the assets used in the property factor except that:
 - (1) The assets owned are at net book value
 - (2) Does not included leased or rented property

- (3) There is no requirement that the assets be used only owned.
- (4) Includes construction-in-progress unlike the property factor which excludes it.

CTM500.8. Qualified pollution control devices 72 P.S. § 7602.1 / 61 Pa. Code § 155.11.

- (a) Property employed or utilized within the Commonwealth of Pennsylvania for water and air pollution control or abatement devices which are being employed or utilized for the benefit of the general public shall be exempt from the tax.
- (b) To qualify as an exempt asset the taxpayer must have the certificate issued by the Pennsylvania Department of Environmental Protection.

CTM500.9. Exempt intangible assets.

- (a) Are not exempt by situs.
- (b) Taxable unless exempted by statute, public policy or constitutional interpretation.
 - (c) Certain assets are specifically exempt by Commonwealth statute:
- (1) Obligations of the Commonwealth, a public authority, commission, board or other agency created by the Commonwealth or a public authority created by the Commonwealth.
- (2) Stocks of foreign corporations more than 50 percent owned (includes limited liability companies and business trusts).
 - (3) Student loan assets--years beginning after December 31, 1998.
 - (i) Student loan notes.
- (ii) Federal, state or private subsidies or guarantees of student loans.

		(iii)	Instru	ıments	that i	repres	ent a	a guar	antee	of (debt,	certif	ficates	or
other	securities	issued	by an	entity	creat	ed for	the	securi	tizatio	on c	of stud	dent I	oans,	or
by a t	rustee on	its beh	alf.											

- (iv) Contract rights to acquire or dispose of student loans and interest rate swap agreements related to student loans.
- (v) Interests in or debt obligation of other student loan securitization trusts or entities.
- (vi) Cash or cash equivalents representing reserve funds or payments on or with respect to student loan notes, the securities issued by an entity created for the securitization of student loans or the other student loan related assets. Solely for purposes of this definition, "cash or cash equivalents" shall include direct obligations of the United States Department of the Treasury, obligations of federal agencies which obligations represent the full faith and credit of the Unite States investment grade debt obligations or commercial paper, deposit accounts, federal funds and banker's acceptances, prefunded municipal obligations, money market instruments and money market funds.
 - (d) Certain assets are specifically exempt by public policy:
- (1) Stocks of Pennsylvania corporations (includes limited liability companies and business trusts).
- (2) Stock of banks, title insurance companies, trust companies and other companies subject to a tax on shares.
 - (3) Stock of nonprofit corporations.
- (4) Stock and obligations of cooperative agricultural associations and agricultural credit associations.
 - (5) Stock of credit unions.
 - (e) Certain assets are specifically exempt by constitutional interpretation.
- (1) Obligations of the United States government, its agencies, instrumentalities, possessions and territories unless taxation is specifically authorized. This exemption, reflected in 31 U.S.C.A. § 3124, does not apply to obligations of the

United States which are secondary, indirect, contingent or mere guarantees. Certain other obligations issued under Federal statutes are specifically exempted from state taxation by the Federal statute authorizing issuance of the obligation.

(2) National bank shares (only for banks filing national bank shares in Pennsylvania).

CTM500.10. Taxable intangible assets.

This list is for informational purposes and is not all inclusive.

- (1) Average value of stocks of foreign corporation less than 50 percent owned.
 - (2) Other investments.
 - (3) Advances to individuals.

CTM500.11. Taxable or exempt intangible assets.

This list is for informational purposes and is not all inclusive. The following may be exempt or partially exempt based on if an exemption is claimed:

- (1) All cash accounts:
 - (i) Cash.
 - (ii) Time deposits.
 - (iii) Demand deposits.
 - (iv) Notes receivable, net of reserves.
- (2) Accounts receivable from customers, net of reserves.
- (3) Advances to other companies, regardless of the relationship between the taxpayer and the other company, is not an investment in that company.
 - (4) Cash surrender value of officers' life insurance.

(5) Prepayments and accruals.

CTM500.12. Interests in unincorporated entities.

- (a) LLCs and business trusts are considered to be corporations for capital stock/ foreign franchise and would be handled like an investment in a corporation for single fraction purposes.
 - (b) Investment in partnerships is a line item on the balance sheet.
- (1) For each partnership, review the balance sheet to determine if there are any exempt assets.
- (2) For each partnership with exempt assets, a proportional share of the investment will be exempt.
- (i) A separate single fraction calculation will be performed for each partnership using the prorate share of the assets of the partnership.
- (ii) The fraction will be multiply by the investment in partnership to arrive at the taxable portion of the partnership.
- (iii) Can not use three factor apportionment if partner is using single fraction.

CHAPTER 501. SINGLE FACTOR APPORTIONMENT - NON-MANUFACTURING

CTM501.1. Generally.

For companies not claiming a manufacturing, processing or research and development exemption, RCT-106 insert sheet page 1 must be filed.

CTM501.2. Tangible assets.

(a) Tangible assets are either taxable or exempt based on situs (location).

- (b) Tangible assets located outside of Pennsylvania are exempt.
- (c) Tangible assets located inside of Pennsylvania are taxable.

CTM501.3. Taxable intangible assets.

This list is for informational purposes and is not all inclusive. All intangible assets not specifically exempted by statute, public policy or constitutional interpretation as listed in CTM500.08 are taxable.

- (1) Average value of stocks of foreign corporation less than 50 percent owned.
 - (2) Other investments.
 - (3) Advances to individuals.
 - (4) All cash accounts:
 - (i) Cash.
 - (ii) Time deposits.
 - (iii) Demand deposits.
 - (iv) Notes receivable, net of reserves.
 - (5) Accounts receivable from customers, net of reserves.
- (6) Advances to other companies, regardless of the relationship between the taxpayer and the other company, is not an investment in that company.
 - (7) Cash surrender value of officers' life insurance.
 - (8) Prepayments and accruals.

CTM501.4. Audit procedures.

(a) Obtain taxpayers' workpapers used to compile fraction.

- (b) Review the beginning and ending balance sheet of the taxpayer.
 - (1) Determine that the balance sheet is on a separate company basis.
- (2) Obtain breakdown of line items as needed to determine that there are no negative assets or negative liabilities on the balance sheet.
 - (3) Obtain a breakdown of all investment accounts.
- (i) For investment in corporations, obtain the corporation name, % ownership, state of incorporation and balance sheets for each corporation. For Capital Stock/ Foreign Franchise, LLCs and Business Trusts are considered corporations by statue.
- (ii) For investments in unincorporated entities such as partnerships, obtain K-1s and balance sheets for each entity.
- (iii) For investments in securities, obtain the name of the security, identifying it as federal, state or local security, and date purchased and date sold if applicable.
- (iv) Obtain documentation on student loan assets and any investments in National Bank Shares.
- (4) Determine if there was any substantial fluctuation in value of assets between beginning and end of year. If so, monthly or daily averaging should be used.
- (i) Determine if assets were acquired or disposed of during the taxable year.
- (ii) If securities were not held for a full year calculate the daily average value of each security.
- (iii) If the value of asset is adjusted in arriving at the denominator the adjusted value is also used in calculating the numerator.
- (c) Average total assets. Using the separate company beginning and ending balance sheets adjust for the following:

- (1) Add back any negative assets which have to be reclassified as liabilities.
- (2) Add back any negative liabilities which have to be reclassified as assets.
 - (3) Deduct the book value of investee companies.
 - (4) Add net positive net worth of investee corporations.
- (5) Deduct the book value of exempt intangible purchased or sold during the year.
- (6) Calculate the daily average of the exempt intangibles and add this number to both beginning and ending total assets.
- (7) Adjust the total assets beginning and ending for each of the above adjustments.
- (8) Add adjusted beginning and ending assets and divide by 2. This will be the average total assets. This is your denominator.
 - (d) Tangible assets.
- (1) Real and tangible personal property includes such items as land, buildings, machinery and equipment, furniture, fixtures, automobiles, trucks, inventories and other like interests.
- (2) Start with the beginning and ending year net book value of the tangible assets as determined for the total assets.
- (3) Review schedule 1 on the insert sheet for exempt tangible assets claimed.
- (4) Review the books and records of the taxpayer to determine the situs of the property.
- (i) Determine that taxpayer is subject to tax outside of the Commonwealth, if not no exemption can be claimed for tangible assets.

- (ii) Situs outside PA is the only exemption permitted for tangible assets.
 - (5) Total adjusted beginning and ending exempt assets and divide by 2.
- (i) If monthly or daily average assets are used enter this number in the beginning and ending totals before averaging.
 - (ii) This will be the average exempt tangible assets.
 - (e) Intangible assets.
- (1) Start with the beginning and ending year net book value of the intangible assets as determined for the total assets.
- (2) Review schedule 2 on the insert sheet for exempt intangible assets claimed.
- (3) Determine that all exemptions claimed are exempt by statute, public policy or constitutional interpretation. No other intangible assets are exempt.
- (4) Review documentation obtained from the taxpayer to determine the investment in any corporations.
 - (i) Exhibit a list or prepare a schedule of all corporations owned.
- (A) This should include LLCs and business trusts as these are corporations for CS/FF under statute.
- (B) List or schedule should include % ownership or shares owned, date acquired and date sold (if applicable), book value and equity value of each corporation.
 - (ii) All investments in PA corporations are exempt.
- (A) Verify on the Department of State website that the company in a PA domiciled corporation.
- (B) Verify on the Department's system that the corporation is registered.

- (iii) All investments in foreign corporations more than 50% owned are exempt.
 - (A) Verify that the ownership percentage is greater than 50%.
- (B) For all the foreign corporations that have nexus in PA, verify that they are registered and filing taxes.
- (5) Student loan assets. Review documentation provided to determine if all investments in student loan assets are valid.
 - (6) United States securities.
- (i) Verify that the securities are owned by the taxpayer and are not repurchase agreements.
- (ii) Verify that the securities are US securities and not secondary, indirect, contingent or mere guarantees by the government.
- (iii) Request documentation from the taxpayer for proof of ownership and validity of claim as US security. If documentation is not provided deny exemption.
- (iv) The internet can also be used to search for information on the securities. Enter the name of the security using any of the search engines.
 - (7) National bank shares.
 - (i) Verify that the national bank shares are owned by the taxpayer.
- (ii) Obtain a copy of the national bank's annual report, review the report to determine that it is a national bank.
- (iii) Verify on the Department's system that the bank is registered and filing a PA bank shares return. (Report Code for National Bank is LA).
- (iii) If documentation is not provided to determine if this is a national bank or there is no bank shares report filed for the tax period, the exemption should be denied.

- (8) Total the average value all of the exempt intangible assets audited and determined.
 - (f) Pollution control devices.
- (1) Review the description schedule and DEP certificates provided with the return.
- (2) Assets must be employed or utilized in PA for water and air pollution control or abatement devices which are being employed or utilized for the benefit of the general public shall be exempt from the tax.
 - (g) Option to amend report.
- (1) If the audit of the single fraction results in a larger apportionment percentage than the three factor apportionment give the taxpayer the option to amend the return using the 3 factor apportionment.
- (2) As use of single fraction is an election a signed amended return must be received from the taxpayer in order to use the three factor apportionment.
- (h) Detailed explanations and documentations of the proposed changes are required in the narrative.
 - (i) The fraction as revised per audit should be shown on accompanying schedule.

CHAPTER 502. MANUFACTURING.

For companies claiming manufacturing, processing or research and development exemption, RCT-102 must be filed. All lists provided below are for informational purposes and are not all inclusive.

CTM502.1. The RCT-102.

(a) There are numerous line item descriptions of assets that are placed in to various subcategories and categories.

- (b) There are also a number of columns to further break out the line items.
- (1) Column A is to show the net book value of assets for (1) beginning of year, (2) end of year and (3) average.
- (2) Column B is used to list those exempt assets that are claimed on RCT– 106.
 - (3) Column C lists the PA assets not used in manufacturing.
 - (4) Column D lists the PA assets used exclusively in manufacturing.
- (5) Column E lists the PA assets used both in manufacturing and nonmanufacturing.
- (6) Column F lists those assets listed in Column E not used in manufacturing.
 - (7) Column G lists those assets listed in Column E used in manufacturing.
 - (8) Column H lists the total taxable assets from Column C and F.

CTM502.2. Total assets (Column A).

- (a) The beginning and ending assets will be adjusted for negative assets and liabilities, replacing actual value for book value of investee companies and daily averaging as needed. See the prior chapters for more detail.
- (b) The average column will be the simple mathematical computation of the sum of column 1 and 2 divided by two. If daily averaging is used the number will be entered in both the beginning and ending columns for those items before dividing by two.

CTM502.3. Assets exempt by situs and statute (Column B).

These are all the assets that are claimed as exempt on the RCT 106 page 1 insert sheet. Refer to chapter 501.

CTM502.4. PA assets not used in manufacturing (Column C).

This list is for informational purposes and is not all inclusive.

- (a) Tangible assets.
- (1) Real and tangible personal property located in PA and not used in the exempt activity.
- (2) The building used to store these inventories of products purchased for resale.
 - (3) Equipment used to handle or deliver nonmanufactured inventories.
- (4) Inventories of goods warehoused in Pennsylvania which were not produced by the taxpayer as a result of the exempt activity. This includes goods purchased for resale.
 - (b) Investments.
 - (1) Investment in stocks of foreign corporations 50% or less owned.
- (2) Investment in stocks of securities of state and local jurisdictions other than PA.
- (3) National bank share if bank is not a national bank or does not file a PA bank shares report. (Report Code for national bank is LA).
 - (4) Bonds, mortgages or notes held as an investment.
 - (c) Current assets.
 - (1) Notes receivable other than customer accounts.
- (2) Accounts receivable from sales of goods not produced by the taxpayer as a result of the exempt activity.
- (3) Advances to individuals and other companies, regardless of the activity of the other company or the relationship between the taxpayer and the other company.

- (i) Advances and loans to other companies are not considered an investment in that company and would not be exempt as an investment.
- (ii) Advances to other companies are not used in Manufacturing, Processing, or Research and Development of the taxpayer, even if the other company is engaged in an exempt activity.
- (iii) The exception would be when the advance is for the purchase of materials to be used in the taxpayer's exempt activity. In that case the taxpayer must provide a schedule of the amount reported as advances to individuals or advances to other companies, showing the amount related to advance payment of materials to be used in the taxpayer's exempt activity.
- (iv) Note: In Chrysel Corporation v. Commonwealth of, 295 A.2d 624 (Pa. Cmwlth. 1972) , the court ruled that funds advanced to a parent company by its wholly-owned subsidiary and carried on the subsidiary's books as an asset (an advance) are included in the value of the subsidiary's capital stock even though, instead of paying off the debt, the parent company purchased equipment that it uses in manufacturing. The advances are not actually and exclusively used in manufacturing by the subsidiary and, therefore, are not exempt from the capital stock tax. In addition, the advances do not qualify for the manufacturing exemption as a reasonable reserve of cash or working capital because the subsidiary ceased its manufacturing operation prior to the tax year in question.
- (4) Cash surrender value of life insurance if not used as collateral for a manufacturing loan.
 - (5) Long-term portion of prepayments and accruals (over one year).

CTM502.5. PA assets actual and exclusively used in manufacturing (Column D).

- (a) Tangible assets.
- (1) Real and tangible personal property located in PA and used exclusively in an exempt activity.
- (2) The building and equipment used exclusively in an exempt activity is entered in this column. If used in both exempt and nonexempt activity, it would be included in column E.

- (3) Inventories of goods warehoused in Pennsylvania which were produced by the taxpayer as a result of the exempt activity.
- (b) Investments. No investments would be exempt as manufacturing, processing or research and development.
 - (c) Current assets.
- (1) Advances to a company for the purchase of materials to be used in the taxpayer's exempt activity would be granted the exemption.
- (2) Cash surrender value of life insurance if used as collateral for a manufacturing loan.
- (3) Unless taxpayer is 100% manufacturing, processing or research and development, most of the other current assets are usually used both in manufacturing and no manufacturing activities. See the next section for further discussion on these assets.

CTM502.6. PA assets used both in manufacturing and non-manufacturing (Column E).

- (a) Tangible assets.
- (1) Real and tangible personal property located in PA and used in both exempt and nonexempt activity.
- (2) The building and equipment used in both exempt and nonexempt activity.
- (3) The building and equipment used in the warehousing inventories of goods which were produced by the taxpayer as a result of the exempt activity or as sales for resale of non-manufactured goods.
- (b) Investments. If there are investments in unincorporated entities, no investments would be exempt as manufacturing, processing or research and development.
 - (c) Current assets.

- (1) Demand deposits, cash, time deposits, and all other interest generating accounts (Corporation Taxing Bulletin 2008-4).
 - (i) Interest bearing accounts.
- (A) The taxpayer must provide a schedule showing end of month balances for all interest bearing and non-interest bearing accounts.
- (B) Lowest end of month balance of interest generating accounts is taxable as an asset not used in the exempt activity.
- (C) Based on the total balance of all interest generating accounts at the end of each month.
- (D) When the monthly schedule reflects a "0" balance for one month, the exemption will be allowed.
- (E) After the lowest monthly balance is determined, subtract from average to arrive at balance to be apportioned for nonmanufacturing.
- (F) Funds were not used during the taxable period for any purpose directly related to the operator's manufacturing business. Per Fry Communications, Inc. v. Commonwealth of Pennsylvania , 433 A.2d 601, (Pa. Cmwlth. 1981) , the taxpayer was not entitled to an exemption for funds invested in certificates of deposit that were later used to pay for an expansion of the operator's physical plant, the purchase of three printing presses, and the payment of federal income taxes.
 - (ii) Non-interest bearing accounts.
- (A) Review the accounts to determine if funds were transferred from interest bearing accounts to affect the monthly balances.
- (B) If so, can add to total monthly balances of interest accounts to correct for fraud, evasion or error.
- (2) Accounts receivables from customers must be reviewed to determine what sales of goods were and were not produced by the taxpayer as a result of the exempt activity.

- (i) If actual amounts are known enter in the appropriate column.
- (ii) If no actual amounts, one method of allocating the receivables is to: multiply by the sales of goods not produced by the taxpayer as a result of the exempt activity divided by the total sales.
- (d) Cash, accounts receivables, inventories, and prepayments and accruals associated with work performed by a subcontractor. Total book values of these assets which would otherwise be exempt and multiply them by the subcontracting costs reported as part of cost of goods sold, divided by total cost of goods sold.
- (1) If taxpayer has sales of goods not produced as a result of the exempt activity, the taxable portion of assets is calculated first and then removed from the average value when calculating the book value of assets associated with subcontracting costs.
- (2) No adjustment for subcontracting cost is required if taxpayer exercises close and constant supervision over subcontractor.

CTM502.7. Gross receipts.

- (a) Complete the gross receipts schedule at the bottom of page 2A of the RCT-102.
 - (b) This breaks out the gross receipts of sales on line 1a. from the FF 1120.

CTM502.8. Investments in partnerships.

- (a) A separate single fraction manufacturing exemption schedule will be prepared for each partnership claiming an exemption. The percentage calculated will be applied against the value of the partnership as carried on the taxpayer's balance sheet.
- (b) This is calculated in the manner as the single fraction manufacturing exemption is calculated for a corporation.

CTM502.9. Audit procedures.

(a) Obtain taxpayers' workpapers used to compile fraction.

- (b) Review the books and records of the taxpayer such as, general ledger, accounts receivable, sales records.
- (c) Generally describe assets by locations, and divisions stating how it is used in the operations, to determine if it is taxable or exempt.
- (d) If an asset is apportioned between manufacturing and nonmanufacturing, determine if the taxpayer properly apportioned.
- (e) Follow the same procedures as for the single fraction non-manufacturing. However, on this schedule include the detail for beginning, ending and average net book value of assets.
- (f) Determine which assets that are exempt by situs and statue (see chapter 500 & 501). This will leave the PA assets.
 - (g) The remaining PA assets will classified as follows:
 - (1) Totally exempt. These are assets used 100% in the exempt activity.
 - (2) Taxable. These are assets not used in the exempt activity.
- (3) Mixed assets. These are assets that are partially used in the exempt activity.
- (h) Review assets by location to determine which tangible assets will be classified as exempt taxable or mixed.
- (i) If there is construction-in-progress located in Pennsylvania and is going to be directly used in exempt activities you exclude that portion from the numerator.
- (j) Demand deposits, cash, time deposits, and all other interest generating accounts (Corporation Taxing Bulletin 2008-4).
- (1) Where a disparity exists between the beginning and ending balances, prepare a schedule reflecting monthly balances.
- (2) When the monthly schedule reflects a "0" balance for months, the exemption will be allowed.

- (3) When the monthly balance does not reflect a "0" balance, the lowest monthly balance will be considered taxable.
- (4) After the lowest monthly balance is determined, subtract from average to arrive at balance to be apportioned for nonmanufacturing. Funds were not used during the taxable period for any purpose directly related to the operator's manufacturing business.
 - (k) Suggested apportionment methods if actual figures are not available.
- (1) Method used must be appropriate for the asset to be apportioned and the information available.
- (2) Square feet of building for storage of nonmanufactured goods over total.
- (3) Inventory of nonmanufactured goods over total inventory stored in the building.
- (4) Pennsylvania sales from nonmanufactured articles to total Pennsylvania sales. (Refer to page 2-A of Capital Stock Tax Manufacturing Exemption Schedule RCT-102.)
- (I) Investments in Partnerships. A separate single fraction manufacturing exemption schedule will be prepared for each partnership claiming an exemption. The percentage calculated will be applied against the value of the partnership as carried on the taxpayer's balance sheet.
- (m) Detailed explanations and documentation of proposed changes are required in the narrative.
- (n) The fraction as revised per audit should be shown on accompanying schedule 6C.

CHAPTER 601. SPECIAL APPORTIONMENT.

CTM601.1. Railroad, truck, bus, airline, pipeline, natural gas and water transportation companies.

- (a) CNI tax.
- (1) Those companies listed in 72 P.S. § 7401.(3)2.(b) & (c) & (d) must use the special apportionment.
 - (2) They cannot use three factor apportionment.
- (3) Must be expressed in revenue miles, revenue cubic feet or whichever the appropriate measurement is.
- (b) Capital stock/franchise tax. (61 Pa. Code §155.10) For franchise purposes they can use special apportionment fraction or RCT 106 page 1 single factor apportionment.

CHAPTER 701. LOANS TAX (72 P.S. §§3250-10).

CTM701.1. Corporate loans tax.

- (a) Corporate loans tax is due if:
- (1) Treasurer or other fiscal officer of the corporation residing in Pennsylvania.
 - (2) Pays interest on indebtedness of the corporation to:
 - (i) Individual residents of Pennsylvania.
 - (ii) Partnerships resident in Pennsylvania.
- (iii) Has indebtedness outstanding that is held by a trustee, agent, or guardian for a resident individual taxable in its own right or by an executor or administrator of an estate where the decedent was a resident of Pennsylvania.
 - (b) If all criteria are met above then proceed as follows:
- (1) Examine taxpayer's notes and loans payables to determine if the treasurer or other fiscal officers of the corporation residing in Pennsylvania were paying

interest on indebtedness of the corporation to the individuals, partnerships trustees, agents, guardians, executors, or administrators mentioned above.

- (2) Identify the type of indebtedness (e.g., promissory notes, mortgage) and the interest rate paid by examining the individual loan agreements.
 - (3) Confirm the actual interest paid.
- (c) Compute the taxable indebtedness. Divide the audited interest paid by the audited interest rate.
 - (d) Compute net loans tax.
 - (1) Multiply the taxable indebtedness by the tax rate of .004.
 - (2) Subtract the treasurer's commission to derive the net loans tax due.
 - (e) The treasurer's commission is computed as follows:
 - (1) 5% on the first \$1,000 of gross loans tax.
- (2) 1% on the amount of gross loans tax over \$1,000 but not exceeding \$2,000.
 - (3) .05% on the amount of gross loans tax over \$2,000.