

TaxNewsFlash

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Pennsylvania: “Benefits-received” interpretation of income-producing activity test upheld (Supreme Court decision)

The Pennsylvania Supreme Court on February 22, 2023, upheld a “benefits-received” interpretation of the income-producing activity test for sourcing receipts from sales of services.

The case is: *Synthes USA HQ, Inc. v. Commonwealth of Pennsylvania*.

Summary

Under Pennsylvania law in effect through tax years beginning in 2013, receipts from the sale of services were apportioned to Pennsylvania if the income-producing activity was performed in Pennsylvania or, if the income-producing activity was performed both in and outside Pennsylvania and a greater portion of the income-producing activity was performed in Pennsylvania than any other state, based on costs of performance.

The taxpayer, a Pennsylvania-based corporation, provided research, development, and management services to its customers. In applying the costs of performance methodology on its original tax report, the taxpayer sourced its service receipts to Pennsylvania, the location where the taxpayer incurred a greater portion of the costs in performing those services. The taxpayer subsequently sought a corporate net income tax (CNIT) refund based on looking to where the taxpayer's customers received the benefit of the taxpayer's services.

The Board of Appeals denied the refund claim for lack of evidence and on appeal, the Board of Finance and Review upheld the denial for the same reason. The taxpayer then petitioned the Commonwealth Court for review where the taxpayer and the Department of Revenue (DOR) stipulated that the taxpayer had provided the evidence necessary to support its refund claim. The Office of the Attorney General

(OAG) argued that the Board of Finance and Revenue's denial of relief was correct on the basis that the department's "benefits-received" method was not the correct interpretation of the cost of performance method. The DOR intervened in the proceeding, arguing that as the agency in charge of administering the Commonwealth's tax laws, its interpretation should be given deference. The Commonwealth Court concluded that the DOR's interpretation was consistent with the legislative intent of the statute, and the taxpayer was accordingly entitled to a refund. This appeal to the Pennsylvania Supreme Court followed.

In the case before the Supreme Court, both the taxpayer and the DOR again advocated for a customer-based interpretation of the income-producing activity test that was in effect for the sourcing of sales "other than sales of tangible personal property" for the 2011 tax year at issue. The majority opinion of the Supreme Court upheld their customer-based interpretation, reasoning that:

- The term "income-producing activity" was not defined by statute or regulation and the meaning of the term is "far from clear" as evidenced by the lack of uniformity in other states' application of the term.
- In line with precedent, the CNIT apportionment provisions are aimed to "measure the amount of commercial activity that an entity engages in during a given year and tax it accordingly." Moreover, as the court had previously opined, "the numerator of the sales factor represents the contribution of Pennsylvania consumers and purchasers to the entity's sales."
- Subparagraph 17 (addressing sales of other than tangible personal property) must be interpreted in the context of other CNIT provisions addressing the apportionment of income. It would be incongruous to apply diametrically opposed sourcing methods in determining the sales factor—e.g., destination sourcing for sales of tangible personal property versus origin sourcing for sales of services. Reading the law in conjunction with the provisions governing the sales factor generally and the court's prior decision regarding destination-based rule for sales of tangible personal property, the DOR's interpretation was most "compelling." This interpretation sourced sales of services to where the service was fulfilled and the income finally produced, which was at the customer's location. Such treatment was also in conformity with the court's previous interpretation of the provisions sourcing sales of tangible personal property.
- Not all products can be easily categorized as a product or a service and the "difficulty in classifying these mixed transaction[s]" favored an interpretation that was the same as sourcing sales of tangible property.
- The 2013 amendment to the law to adopt specific rules for sourcing service receipts was not an attempt to alter the general framework for sourcing sales but was to clarify the sourcing of sales of services to the point of delivery to the consumer.

This case was unusual in that the taxpayer and the DOR were on the same side, but the OAG argued for a different interpretation of the law. The first issue addressed in the majority opinion was whether the OAG may represent the Commonwealth separately from the DOR and advocate for an interpretation of the law that conflicts with the DOR's interpretation. The court concluded that the OAG may represent the Commonwealth separately from an executive agency, but that the rules of professional conduct required the OAG to advise the DOR, its former client, that it was pursuing an objective antithetical to the DOR's position. The DOR might then request that the Governor allow General Counsel to take over the case on its behalf or exercise its right of automatic intervention. The court determined that although the statutory process was not followed precisely in this case, a result that conformed to the statute was achieved when the Commonwealth Court allowed the DOR to intervene, and the OAG continued to represent the Commonwealth.

KPMG observation

Up until recently, receipts other than receipts from sales of services and sales of tangible personal property (e.g., sales from intangible property) continued to be sourced in Pennsylvania using the income-producing activity test that was interpreted in this case. Effective January 1, 2023, a new complex web of sourcing rules apply to these "other" types of receipts. Taxpayers may wish to consider

whether the court's holding in this case—including that it would be inconsistent to apply different sourcing rules to different types of receipts—has implications for sourcing “other” receipts for years prior to 2023.

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