



# CORPORATE NET INCOME TAX AUDIT MANUAL

BUREAU OF AUDITS  
PA DEPARTMENT OF REVENUE

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# Introduction

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

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.

# Section I: Imposition of Tax

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## Overview

Corporate net income tax is imposed under Article IV of the Tax Reform Code. Corporate net income tax is paid by all domestic and foreign corporations for the privilege of doing business, carrying on activities, employing or owning capital or property, or having substantial nexus in Pennsylvania. The tax is levied on federal taxable income without the federal net operating loss deduction and special deductions, on a separate company basis with Pennsylvania modifications. Corporate taxpayers with activity in multiple states may be able to apportion taxable income. To apportion income, a corporation must be subject to tax in another state. Corporations report their corporate net income tax liability on the Pennsylvania Corporate Net Income Tax Report (RCT-101).

## Subjectivity

Domestic and foreign corporations, as well as limited liability companies, partnerships, and business trusts that are classified as corporations for Federal income tax purposes and are doing business in the Commonwealth are subject to the tax. Corporations are subject to Pennsylvania Corporate Net Income Tax for conducting any of the following activities:

- Doing business in this Commonwealth
- Carrying on activities in this Commonwealth, including solicitation
- Having capital or property employed or used in this Commonwealth
- Owning property in this Commonwealth
- Having substantial nexus in this Commonwealth

*State Reference* - 72 P.S. § 7402(a)

## Tax Rate

The CNIT rate was 9.99% for tax years 1995 through 2022. Act 53-2022 set a schedule of rate reductions for tax years beginning in 2023.

Year	Rate
1995-2022	9.99%
2023	8.99%
2024	8.49%
2025	7.99%
2026	7.49%
2027	6.99%
2028	6.49%
2029	5.99%
2030	5.49%
2031 and thereafter	4.99%

*State Reference* - 72 P.S. § 7402(b)

## Nexus

Corporations having either economic presence or a physical presence in Pennsylvania are considered to have nexus for corporate net income tax purposes.

Business activities creating nexus include, but are not limited to, the following:

- Owning or leasing property
- Maintaining inventory within the Commonwealth
- Having employees or others soliciting sales or referring customers
- Delivering property into the Commonwealth
- Maintaining a fixed location
- Installing or repairing of property by employees, independent contractors, or others
- Employee leasing services or personnel services
- Approving or accepting purchase orders
- Performing services, managerial or research activities
- Repossessing property
- Having one or more employees performing business activities in Pennsylvania, even occasionally
- Conducting training or seminars
- Providing transportation services
- Hiring, training or supervising personnel

*State Reference* - 72 P.S. § 7402(a)

## Economic Presence

Economic presence applies when out of state corporations are considered to be doing business in this Commonwealth to the extent they are taking advantage of the economic marketplace of the Commonwealth regardless of whether they are physically present in Pennsylvania. As a result, the department will require such taxpayers to begin filing Corporate Tax Reports (Form RCT-101) so long as they meet the minimum thresholds for nexus.

The department will deem that there is a rebuttable presumption that corporations without physical presence in Pennsylvania, but having \$500,000 or more of direct or indirect gross receipts from any combination of the following, sourced to Pennsylvania per year, have a corporate net income tax filing requirement with the Commonwealth:

- Gross receipts from the sale, rental, lease, or licensing of tangible personal property;
- Gross receipts from the sale of services; and/or
- Gross receipts from the sale or licensing of intangibles, including franchise agreements.

*State Reference* - 72 P.S. § 7402(a) & Corporation Tax Bulletin 2019-04

## Public Law 86-272

Public Law 86-272 (15 USC § 381) is a federal law enacted in 1959 to limit the states' ability to tax interstate commerce. It provides that a state cannot impose a net income tax on a business if the business activities within the state are limited to the solicitation of sales of tangible personal property, orders for which are accepted outside the state and delivery of property is made from outside the state.

Generally, taxpayer's that claim the P.L. 86-272 exemption still have nexus with Pennsylvania. If a taxpayer qualifies for protection under the provisions of P.L. 86-272, it is entitled to such protection regardless of whether or not it has Pennsylvania sourced sales in excess of \$500,000.

To the extent protection under this federal law is claimed, taxpayers should continue to file a Pennsylvania Corporate Tax Report (RCT-101) and complete the schedule (Form Rev-986) to claim this exemption from tax.

*State Reference* - Corporation Tax Bulletin 2004-01 & Corporation Tax Bulletin 2019-04

### *Audit Procedures*

- 1) Request a detailed description of business activities conducted in Pennsylvania and have the taxpayer complete a Business Activities Questionnaire (Rev-203D).
- 2) Additional requests for information may be necessary to verify the accuracy of the initial responses. These records may include, but are not limited to:
  - Job descriptions for employees conducting activities in PA
  - Expense reports for employees traveling to PA for business
  - Company policy or procedures manuals regarding sales activities and/or telework
  - Apportionment schedules
  - Sales invoices/contracts
- 3) If nexus with Pennsylvania is established during the audit period:
  - The auditor must request completed Pennsylvania Corporate Net Income Tax Reports (RCT-101s) for the periods under audit, along with the supporting documentation that is typically request in any corporate income tax audit.
  - If documentation is not provided during the audit, an assessment may be calculated using the best information available to the Department.
  - Auditors should consult with their regional specialist to discuss the facts and circumstances of the audit to determine if any additional procedures are necessary.

## Section II: Reports & Statutes of Limitations

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### Pennsylvania Corporate Net Income Tax Report (RCT-101)

Corporations subject to Pennsylvania Corporate Net Income Tax report their tax liability on the Pennsylvania Corporate Net Income Tax Report (RCT-101). Reports must be filed using the same taxable year as reported to the federal government. All corporations incorporated in Pennsylvania are required to file annual reports even if no business activity was conducted during the taxable period. Corporations that have nexus with Pennsylvania are required to file reports even if there was no physical presence within the commonwealth during the tax year.

#### *Filing Deadlines*

The RCT-101 is due on or before the 15th day of the month following the due date of the return to the Federal Government for both calendar and fiscal year filers.

#### *Statute of Limitations for Assessment*

Tax may be assessed within three (3) years after the date the report is filed or the due date of the return, whichever is later. Tax may be assessed at any time if a taxpayer fails to file a report required by law or if the taxpayer is determined to have filed a fraudulent return.

*State Reference* - 72 P.S. § 7403 & 72 P.S. § 7407.3

### Reports of Change (RCT-128C)

A Report of Change (RCT-128C) is used to report changes to an entity's income as result of a federal audit; or report changes to an entity's income as a result of an amended Federal income tax return filed by the entity. If the changes are the result of a federal IRS audit, the taxpayer must attach a copy of the Revenue Agent Report - Income Tax Examination Changes (RAR). If the changes are a result of an amended Federal income tax return (FF1120X) filed by the entity, the amended Federal income tax return must be provided with proof of acceptance by the IRS. When a Report of Change is filed for a period under audit, the report must be reviewed by the auditor for compliance with Pennsylvania law.

Important Note: A Report of Change should only be filed when there are changes to an entity's Federal Taxable Income i.e. RCT-101, Line 1. Generally speaking, Amended Reports (RCT-101) are filed to report changes to Pennsylvania additions/deductions or Pennsylvania apportionment; however, in certain circumstances federal adjustments could trigger changes to Pennsylvania additions/deductions/apportionment.

#### *Filing Deadlines*

For tax years beginning prior to January 1, 2013, changes in federal taxable income must be reported to the Department within 30 days of the change. This has been extended to six months for tax years beginning after December 31, 2012.

#### *Statute of Limitations for Assessment*

Tax may be assessed within three (3) years after the date the report is filed.

*State Reference* - 72 P.S. § 7406.1 & 72 P.S. § 7407.3

## Amended Reports (RCT-101)

Amended reports are filed when a taxpayer is requesting that the Department adjust the corporate net income taxes for a correction to the original report for a particular tax year. Amended reports are filed by using a check box on Page 1 of RCT-101 and including Rev-1175 – Schedule AR, which includes an explanation for filing the amended report. Amended reports cannot be filed for the following reasons:

- Challenges to PA Statute or regulations
- Challenges to department policy or interpretation of statutes or regulations
- For the sole purpose of claiming the report is a final report
- To change the end of the tax year

When an Amended Report is filed for a period under audit, the report must be reviewed by the auditor for compliance with Pennsylvania law.

Important Note: A Report of Change should only be filed when there are changes to an entity's Federal Taxable Income i.e. RCT-101, Line 1. Amended Reports (RCT-101) are filed to report changes to Pennsylvania additions/deductions or Pennsylvania apportionment.

### *Filing Deadlines*

A taxpayer has three (3) years after the due date of the original report to file an amended report. If the original report was properly extended, then the taxpayer has three (3) years after the extended due date to file an amended report.

### *Statute of Limitations for Assessment*

Tax may be assessed within one (1) year from the date of the filing of the amended report or three years from the due date of the original report, whichever period expires later.

*State Reference* - 72 P.S. § 7406 & 72 P.S. § 7407.3

## Extensions of Statute of Limitations

Before the expiration of any limitation for assessment as described above, a taxpayer may consent, in writing, that an open period be extended and the amount of tax due may be assessed at any time within the extended period. The *Consent to Extend Time Limit for Assessment/Determination of Tax and to Extend Period of Time for Record Retention (waiver)* form is used to extend the time limit for record retention and assessment of the specific tax under audit.

The auditor should make every effort to complete the audit before the expiration of the initial statute of limitations. When scheduling is delayed at the taxpayer's request or the taxpayer is not providing records that allow for the timely completion of the audit before statutory periods expire, a waiver must be obtained. A waiver should be obtained at least six months prior to the original deadline date. It is recommended that the extended deadline be at least eight (8) months prior to the supervisor review deadline of the audit to provide ample time for completion of the audit and quality review.

*State Reference* - 72 P.S. § 7407.4

## Section III: Taxable Income

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### Pennsylvania Taxable Income

Taxable Income is partly defined as “taxable income as returned to and ascertained by the federal government before the net operating loss deduction and special deductions.” Accordingly, Pennsylvania starts with Federal Taxable Income on a separate company basis from the Federal Form 1120, Line 28.

If the taxpayer is part of a consolidated group, a pro-forma federal return must be filed on a separate company basis. The amounts from the pro-forma federal return should match to the separate company breakdown of the consolidated schedules. All elections made on the federal consolidated return are binding on the taxpayer for Pennsylvania purposes. Additionally note that the adjustments to income made pursuant to the federal consolidated return regulations are not applicable for purposes of calculating separate company taxable income for Pennsylvania purposes.

*State Reference* - 72 P.S. § 7401.(3)1.(a) & 72 P.S. § 7406

#### *Audit Procedures*

- 1) Review pro-forma federal return and separate company elimination schedules of the consolidated federal return.
- 2) Reconcile RCT-101, Line 1, Income or Loss on a separate-company basis to Federal Form 1120, Line 28. If the primary taxpayer is not filing FF1120, contact headquarters for guidance.
- 3) Review Department records for any Reports of Change filed. When a Report of Change is filed for a period under audit, the report must be reviewed by the auditor for compliance with Pennsylvania law.
- 4) Any differences should be noted and discussed with the taxpayer.

### Charitable Contribution Expense

Pennsylvania follows the federal treatment of charitable contributions under IRC § 170. A charitable contribution deduction is generally limited to 10% of the taxable income without regard to charitable contributions. For 2020, The Coronavirus Aid, Relief, and Economic Security Act (CARES Act, P.L. 116-136, 03/27/2020) temporarily increased the typical 10% contribution deduction limitation to 25% of taxable income for qualified cash contributions and 25% for food inventory contributions. These increases to the contribution limit were extended by The Taxpayer Certainty and Disaster Tax Relief Act of 2020 to 2021 as well.

A taxpayer filing with the Federal government as a member of a consolidated group may be entitled, on a separate company reporting basis, to a larger contribution deduction in arriving at Commonwealth taxable income. Because consolidated reporting is not permitted for Commonwealth purposes, the taxpayer may reflect on a separate company reporting basis the contribution deduction to which it would have been entitled had it filed a separate return with the Federal government.

For Pennsylvania purposes, excess charitable contributions, to the extent they are allowed to be carried over, may be carried forward up to five years until they are fully used. 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. Pennsylvania has not adopted the federal income tax provisions relating to net operating losses. Accordingly, the Pennsylvania net operating loss statutes and regulations do not provide for the conversion of excess charitable contributions into Pennsylvania Net Operating Loss carryovers.

An IRC 163(j) adjustment restricting the amount of current year interest expense that can be deducted resulting in changing a net loss to taxable income, may allow contributions made in the current year, or carryovers from previous years that were not NOL years, to be deducted in arriving at federal taxable income.

*State Reference*- 72 P.S. § 7401.(3)1.(a) & 61 Pa. Code § 153.14.(2)

*Federal Reference* – IRC § 170

### *Audit Procedures*

- 1) Review pro-forma federal return and separate company elimination schedules of the consolidated federal return for charitable contributions, FF1120, Page 1, Line 19.
- 2) Verify that contributions are not in excess of allowable contributions on a separate company basis: (Federal Taxable Income from Line 28 + Charitable Contributions Expense from Line 19) x Limitation Percentage.
- 3) Determine if there any excess contributions that may be carried forward.

## Capital Losses

Pennsylvania conforms to federal law provisions allowing corporations to deduct capital losses only to the extent of their capital gains. Capital gains or losses are reported on Schedule D of the Federal Income Tax Return. The total amount from Schedule D is entered on Form 1120, Page 1, Line 8.

Consistent with IRC § 1212, excess contributions can be carried back three years then carried forward five years. Carry backs cannot increase or produce a net operating loss in the tax year to which it is carried. Losses are applied to the extent of capital gains without causing gains to go into the negative. For Federal purposes, if a taxpayer is offsetting a current capital gain with a carried back/forward capital loss, the taxpayer typically files an FF 1139 – Corporation Application for Tentative Refund or a Form 1120X - Federal Amended Return, with the IRS. For Pennsylvania purposes, capital losses are treated as having been carried back or forward (as applicable) even if the taxpayer has not filed either an FF 1139 or FF 1120X for those periods.

*State Reference* - 72 P.S. § 7401.(3)1.(a) & 61 Pa. Code § 153.11

*Federal Reference* – IRC § 165(f) & IRC §1211-1212

### *Audit Procedures*

- 1) Review applicable periods to determine whether a Report of Change (RCT-128C) was filed with the Department. Reports of Change should be filed for any changes resulting from carry back/forwards of capital losses.
- 2) A capital loss is treated as applied to an available capital gain, even if a Report of Change was not filed with the Department.
- 3) A capital loss schedule should be created to calculate the applicable carryback and/or carryforward for each tax year under audit.

## Adjustments for IRC 163(j) - “Limitation on Business Interest”

IRC Section 163(j), as amended by the Tax Cuts and Jobs Act of 2017, limits the deduction for business interest expense for tax years beginning after December 31, 2017, to the sum of:

1. The taxpayer’s “business interest income,”
2. 30% of the taxpayer’s “adjusted taxable income,” plus
3. The taxpayer’s “floor plan interest.”

The taxpayer will be entitled to claim carryforward amounts in future periods, if eligible. These adjustments should be presented as an adjustment to federal taxable income reported on the proforma FF 1120 and resulting RCT-101, Line 1 when the taxpayer is subject to the limitation; however, there are instances where the taxpayer may report the adjustments as an Other Addition/Deduction on the RCT-101. The Department issued Corporation Tax Bulletin 2019-03 to address the Pennsylvania Corporate Net Income Tax treatment of IRC § 163(j). Note that for years 2019 and 2020 the 30% limit was increased to 50%.

*State Reference* - 72 P.S. § 7401.(3)1.(a) & Corporation Tax Bulletin 2019-03

*Federal Reference* – IRC § 163(j)

### *Audit Procedures*

- 1) For tax years beginning after January 1, 2018, auditors must review the Pennsylvania Corporate Tax Report along with Form 8990 “Limitation on Business Interest Expense Under Section 163(j)” included with the Consolidated Form 1120.
- 2) If the Federal Consolidated Group reports an interest limitation under Code Section 163(j), then each member with a Pennsylvania corporate net income tax filing obligation will need to perform its own set of calculations on a separate company basis to determine if the interest expense limitation applies to it.
  - Request the separate company calculation, such as a proforma Form 8990, and determine if limitation applies.
  - Verify that any disallowed business interest expense is accurately reflected on the RCT-101, Line 1.
  - On the Consolidated Form 8916-A, IRC 163(j) adjustments will be reflected as temporary (timing) differences on Part II. The separate company Form 8916-A may also reflect temporary differences on Part II, but these may represent pro-rated amounts from the consolidated totals.
- 3) Interest expense excluded pursuant to IRC 163(j) may be carried forward to subsequent years for future interest expense deduction without any statutory limit.
  - Request taxpayer schedules to support any IRC 163(j) carryforward and review the application of any carryforward amounts for each tax year;
  - Verify the Federal Consolidated Group is not subject to any limitation on the deduction of its current year interest expenses under Code Section 163(j) (No disallowed business interest expense on Form 8990); AND
  - Confirm taxpayer previously had an interest limitation carryforward under Code Section 163(j) that was previously reported in a prior period.
- 4) Special Considerations:
  - On a separate company basis, the IRC 163(j) limitation may be prorated for “sham transactions” and permanently excluded as a carry forward. Related interest expense or costs for the intangible expense addback may be prorated as well. Refer to Corporation Tax Bulletin 2019-03 Originally Issued April 29, 2019, “Pennsylvania Corporate Net Income Tax Treatment of IRC § 163(j).”
  - IRC 382 can also alter the annual amount of the IRC 163(j) carryforward deduction in situations where a loss corporation already subject to IRC 163(j) is merged into a taxpayer. This may require proration of interest expense previously excluded from the Pennsylvania Net Loss of the corporations that were merged for carryforwards. Refer to Corporation Tax Bulletin 2008-03 (restated), Issued October 11, 2023, “Net Loss Deduction Limitations Under Internal Revenue Code Section 381 and Section 382.”
  - Corporation Tax Bulletin 2019-03 addresses most issues with respect to IRC 163(j) adjustments. If an issue is discovered not specifically covered by the bulletin, the auditor and supervisor should consult with an audit program specialist.

## Sham Transaction Adjustments

Sham transactions reflect deductions that have no business purpose other than the avoidance of taxes and also for lacking economic substance. The Department has the authority to employ the sham transaction doctrine which gives the Secretary the authority ‘to disregard, for taxing purposes, transactions that have no economic substance or business purpose other than tax avoidance.’ Intercompany transactions are sometimes identifiable by eliminations on the federal consolidating schedules. Those that are excessive and incongruent with ordinary and usual expenses relative to all other expenses should be reviewed. For tax years beginning after January 1, 2015, intercompany intangible expense and interest expense related to intercompany intangible expense must be treated as intangible expense addback rather than sham transaction.

*State Reference* - 72 P.S. § 7401(3)(1)(a) & 72 P.S. § 7401(3)(1)(t)(1))

### *Audit Procedures*

- 1) Identify possible sham transactions from the following:
  - a. Separate Company Pro-Forma FF1120
    - Royalty or Interest Income
    - Interest Expense – Line 18 and Form 8916-A, Part III. For tax years beginning after January 1, 2015, interest expense related to intercompany royalty expense must be treated as intangible expense addback rather than sham transaction.
    - Other Income – Line 10 – Service Fees, Royalty, Interest, Management Fee, Miscellaneous, Intercompany.
    - Other Deductions – Line 26 – Royalty, Miscellaneous, Intercompany, Factoring, Administrative, exceptionally large amortization expense. For tax years beginning after January 1, 2015, intercompany royalty expense must be treated as intangible expense rather than sham transaction.
    - Cost of Goods Sold (Other Costs) FF1125A Line 5 – Royalty, Interest, Miscellaneous, Intercompany, Factoring, Administrative.
    - Balance Sheet (Intercompany Accounts) – Notes Receivable, Loans Payable, Other Current Assets.
    - Schedule M-3 – Review for intercompany items.
    - Schedule 8916-A - Review for intercompany items.
  - b. Consolidated FF1120
    - Verify the taxpayer’s separate company column matches the pro-forma
    - Verify taxpayer’s affiliated entities from FF851, organizational chart, etc.
    - Verify what transactions are being reported as eliminations. For instance, royalty and interest income and expense, or intercompany assets and liabilities
  - c. Review Form 10-K for Consolidated Group that Taxpayer is a member.
    - Compare gross profit ratio (gross profit/total revenue) and net profit ratio (net income before taxes/total revenue) on Form 10-K to gross profit/net sales and Line 28 (less dividends)/net sales on both Consolidated FF1120 and separate company FF1120 of Taxpayer under audit. Note: Dividends from Line 28 are excluded in the analysis as most dividend income on the FF1120 may be intercompany and would be eliminated on the Form 10-K.
    - Identify any disparities between the Form 10-K, Consolidated FF1120, and separate company FF1120 margins for additional questioning. The purpose of this analysis is to identify potential profit shifting due to foreign intercompany transactions or domestic intercompany transactions.

- If the margins are higher on the Form 10-K than on the consolidated return, and the margins on the consolidated return and proforma return are comparable, it may indicate foreign intercompany transactions.
- If the margins on the Form 10-K and consolidated FF1120 are comparable with the separate company margins of the Taxpayer significantly lower, it may indicate intercompany transactions with domestic affiliates in the consolidated group.
- If the gross margin is higher on the Form 10-K than on consolidated / separate company FF1120, it may indicate that the intercompany transactions are related to intercompany expenses in COGS, perhaps even purchases.
- If the net margin is higher on the Form 10-K relative to the FF1120s and the gross margins are comparable between Form 10-K, consolidated FF1120 and separate company Taxpayer FF1120, there may be intercompany transactions among the operating expenses.
- The same Form 10-K can be used for PA audit cycles of up to three years, as Form 10-Ks will have comparative income statements for the current year, prior year, and year before the prior. For example, Form 10-K for 2023 will have income statements for 2023, 2022, and 2021 that can be used for margin analysis.

## 2) Additional Information to be Requested

- Question any of the above transactions if they seem out of the ordinary or are not easily identifiable. Request a book to tax trial balance. If the trial balance is insufficient, request a detailed breakdown by account for each questionable item. Note that the Schedule M-3 along with Form 8916-A and other supporting statements for the Schedule M-3 that detail book-to-tax differences are a summary of the book-to-tax general ledger. The difference is Schedule M-3 will group related accounts together, whereas the detailed general ledger shows amounts strictly by account.
- Transfer Pricing Study and a detailed list of all intellectual property, if applicable. The Transfer Pricing Study must be current and inclusive of the covered transactions being questioned. Note that per the federal regulations a Transfer Pricing Study cannot be applied retroactively. This includes a prohibition on taxpayers adjusting or correcting their Transfer Pricing on timely filed amended FF1120X's.
- If any explanations indicate the presence of intercompany transactions not disclosed on the FF1120, provide an applicable request for financial records to the taxpayer as to their exact nature, the parties involved, and who is the purchaser and who is the provider.
- Once the taxpayer responds to the record request, determine if further detail is required. On all intercompany transactions that are questioned, request names/EINs of all the parties involved and the roles that they play in these transactions, as well as supporting agreements, transfer pricing studies, etc. Auditors should completely understand how the intercompany transactions are arranged and reflect this knowledge in the audit narrative.

## 3) The five areas of analysis are:

- Review – Is the intercompany expense proportional to the payroll and other costs of the affiliate that provides the services, as reflected on consolidating FF1120?
- Intercompany Agreements – Determine if the transaction is supported by both intercompany agreements and Transfer Pricing Study.
- Money Flow – Determine if there is actual cash flow vs. bookkeeping entry or if there is a circular flow of funds between the parties involved.
- Day-to-Day Operations – Verify the provider of services is truly run as a going concern, that is, with business locations, own payroll, checking accounts, etc.
- Board Directors' action – Review the current audit period board minutes for language on the treatment of intercompany transactions and distribution of earnings.

4) How to adjust (Determine if addback provision applies or if it is a sham)

- If the transaction involves intangible expenses or costs, the adjustment must be reported as an intangible expense addback in the Statutory Addition section of the CNI tax calculation. The taxpayer may claim an exception for the addback, such as the foreign treaty exception or conduit exception, by filing the REV-802 with the auditor.
- If the transaction involves interest expense or costs directly related to an intangible expense or cost, the adjustment must be reported as an IE addback in the Statutory Addition section of the CNI tax calculation. The taxpayer may claim an exception for the addback, such as the foreign treaty exception or conduit exception, by filing the REV-802 with the auditor.
- If documentation is not provided by the taxpayer or the expense involved does not meet the statutory definition of intangible expense or interest expense from 72 P.S. § 7401(8)-(9) and you cannot determine business purpose other than tax avoidance, the transaction may be considered a sham and is reported as an adjustment to the federal taxable income. The adjustment is shown on the 1120 Income Analysis as a miscellaneous adjustment to Line 28.
  - When describing the treatment of sham transactions, the adjustment should be described as the transaction being eliminated from federal income, and not described as added to federal income.

## Gain/Loss Sale Subsidiary Stock

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.

### *Audit Procedures*

- 1) If not included in tax return filed, request a breakdown of how gain was calculated, showing the reduction in basis of stock for losses used by parent.
- 2) Recalculate the gain or loss on sale of stock for Pennsylvania purposes without the reduction for losses used by the parent.
- 3) Note that the result of this review is typically that the gain will be smaller and the loss larger for Pennsylvania purposes than the amounts reported for federal income tax purposes.

## Calculation for Federal S Corporations Filing as Pennsylvania C-Corp

The taxpayer may opt out from being treated as a Pennsylvania S-Corp by filing Pennsylvania form REV-976 - Election not to be Taxed as a Pennsylvania S Corporation.

### *Audit Procedures*

- 1) Calculate Federal Taxable Income from FF1120S as starting point
  - a. Additions from Schedule K of FF 1120S, unless otherwise noted:
    - i. Net real estate rental income.
    - ii. Other net rental income.
    - iii. Interest.
    - iv. Ordinary dividends.
    - v. Royalties.
    - vi. Other portfolio income.
    - vii. Gain (net of capital gains + Sect. 1231 gain against capital losses). Should not be less than zero.
    - viii. Sect. 1231 (a loss is considered an ordinary loss included in the calculation of taxable income; a gain is included in the capital gains and netted against capital losses).
    - ix. Other income.

- b. Deductions from Schedule K of FF 1120S unless otherwise noted:
  - i. Deductions related to portfolio income.
  - ii. Other deductions.
  - iii. Interest expense on investment debts.
  - iv. Total foreign taxes paid.
  - v. Total expenditures to which section 59(e) election may apply.
  - vi. Domestic production activities deduction IRC section 199.
- c. Total = Total net income before section 179 & charitable contributions.

## Extraterritorial Income Deduction

Extraterritorial income is the gross income of the taxpayer attributable to foreign trading gross receipts, which may be reported as either other deduction or other expense on the federal income tax return. The extraterritorial income is typically included in the calculation of federal taxable income. There is no statutory provision to add back this item when calculating Pennsylvania taxable income. Additional details on extraterritorial income can be found on the instructions for federal form 8873.

## Section IV: Statutory Deductions

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### Dividends

Pennsylvania law allows a deduction for corporations that receive dividends from domestic and foreign corporations. Domestic dividends are deductible to the same extent as allowed to arrive at the federal dividend deduction in IRC Section 243. Taxpayer's must provide form REV-798, Schedule C-2 when reporting the Pennsylvania dividends received deduction.

For tax periods beginning prior to January 1, 2018 - The amount of dividend deduction allowed is based on the percentage of ownership:

- 100% dividend deduction for sum of total deductions on Federal Schedule C.
- 100% dividend deduction for foreign dividend gross-up.
- 70% dividend deduction for less than 20 percent owned foreign corporation, including Subpart F income.
- 80% dividend deduction for greater than or equal to 20 percent owned foreign corporation, including Subpart F income.
- 100% dividend deduction for foreign corporations that meets the 80 percent voting and value test, including Subpart F income.

For tax years beginning on or after January 1, 2018, IRC Section 951A subjects certain U.S. taxpayers to tax on their global intangible low-taxed income ("GILTI") and IRC Section 250 of the Code authorizes a Federal deduction for taxpayers reporting GILTI and taxpayers with foreign-derived intangible income ("FDII"). Pennsylvania issued Corporate Tax Bulletin 2019-02 to provide guidance on how GILTI and FDII are treated for Pennsylvania Corporate Net Income Tax purposes. In general, since GILTI is treated in a manner similar to Subpart F income for Federal income tax purposes, Pennsylvania will treat GILTI income as dividend income for Corporate Net Income Tax purposes. However, since both the GILTI deduction and the FDII deduction are reported on line 29 of Federal Form 1120, neither deduction amount is permitted to be taken for Pennsylvania purposes. As a consequence, the dividend received deduction is applied against the gross GILTI income amount rather the net GILTI amount which includes the GILTI deduction taken pursuant to IRC 250.

For tax periods beginning on or after January 1, 2018 - The amount of dividend deduction allowed is based on the percentage of ownership:

- 100% dividend deduction for sum of total deductions on Federal Schedule C
- 100% dividend deduction for foreign dividend gross-up
- 50% dividend deduction for less than 20 percent owned foreign corporation, also applicable to Subpart F Income and Global Intangible Low-Taxed Income (GILTI).
- 65% dividend deduction for greater than or equal to 20 percent owned foreign corporation, also applicable to Subpart F Income and Global Intangible Low-Taxed Income (GILTI).
- 100% dividend deduction for foreign corporations that meets the 80 percent voting and value test, also applicable to Subpart F Income and Global Intangible Low-Taxed Income (GILTI).

The Repatriation Transition Tax (RTT) was a one-time deduction on untaxed earnings of foreign corporations accumulated prior to 2018. For additional guidance refer to Information Notice 2018- 01.

**State Reference** - 72 P.S. § 7401(3)1.(b) & Corporate Tax Bulletin 2019-02

**Federal Reference** – IRC §243, §951A, & §250

## *Audit Procedures*

- 1) Review pro-forma FF1120, Schedule C and compare to amounts reported on REV-798, Schedule C-2.
- 2) Obtain a detailed schedule of all dividends listing the name and percentage ownership to verify the proper amount of dividend deduction was reported.
- 3) If records are not provided, the Federal Form 851, the FF1120 Consolidating Spreadsheets, and Form 5471s may be utilized for tracing the flow of domestic and foreign dividends to the Taxpayer.

## Interest on US Securities

Interest income is reported on FF1120, Line 5. As a general rule, interest earned on municipal and state obligations are already excluded from interest income reported on FF1120 Line 5. Interest income from securities issued by the United States government or any of its agencies is deductible from Pennsylvania taxable income to the extent it is included in Federal taxable income and exempt income under Federal Law.

Interest income must be reduced by the following:

- Interest expense on indebtedness incurred to carry security.
- Expenses incurred in the production of such interest income.
- Other expenses deducted on the Federal Income Tax return that would not have been allowed under 26 USC section 265 if the interest were exempt for Federal Income Tax.

Corporation Tax Bulletin 2024-02 lists securities determined to be obligations of the U.S. Government. Interest from repurchase agreements is not considered interest from US securities; therefore, it is not deductible. A repurchase agreement (repo) is a form of short-term borrowing for dealers in government securities. A dealer sells government securities to an investor, usually overnight, and buys them back the following day at a slightly higher price. The small price difference represents an implicit overnight interest rate. It is an exchange of a security (acting as collateral) for cash. The implied interest rate is the difference between the sale and repurchase prices.

**State Reference** - 72 P.S. § 7401(3)1.(b.1)) & Corporation Tax Bulletin 2024-02

## *Audit Procedures*

- 1) Verify that the taxpayer owns the securities and/or the securities are managed on behalf of the taxpayer. Documentation may consist of Form 1099 Interest or annual brokerage statements.
- 2) Obtain a detailed schedule showing the calculation of net interest deduction, which should include a listing of investments that generated the exempt interest income.
- 3) Confirm amount claimed is included on FF1120, Line 5.
- 4) Verify that the securities for which the interest income exemption is being claimed are listed as US Obligations on Corporation Bulletin 2024-02.
- 5) Verify that none of the interest income is derived from repurchase agreements.

## Current Year Additional Pennsylvania Depreciation

Pennsylvania corporate tax law *does* not conform with the Internal Revenue Code (IRC) Section 168(k). Pennsylvania corporate taxpayers are required to add back all bonus depreciation claimed under Section 168(k) when computing taxable income. See Section V. Statutory Additions – Current Year Bonus Depreciation for additional information regarding the addback adjustment for 168(k) bonus depreciation.

Pennsylvania law allows the corporate taxpayer to recover, or deduct, the amount of depreciation previously added back until the total amount included as taxable income in prior years has been claimed. The bonus

depreciation carryforward balance should not be less than zero (negative). If the taxpayer reported an addition for 168(k) bonus depreciation, they are entitled to take the appropriate deduction as follows:

- Property placed in service prior to 9/28/2017 – The 3/7ths fraction is used to recapture bonus depreciation disallowed over the life of an asset. An additional deduction is also allowed to recapture the amount of depreciation claimed under section 168(k) that has not been recovered through the 3/7ths deductions. The additional deduction must take place in the earlier of the taxable year in which qualified property is fully depreciated for Federal income tax purposes or is sold or otherwise disposed of by a taxpayer.
- Property placed in service on or after 9/28/2017 – The Modified Accelerated Depreciation System (MACRS) calculation is typically used to recapture bonus depreciation disallowed over the life of the asset. An additional deduction is also allowed to recapture the amount of depreciation claimed under section 168(k) that has not been recovered on qualified property which is sold or otherwise disposed of during a taxable year by a taxpayer and for which depreciation was included as taxable income.

Schedules C-3 and C-4 are used as an ongoing historical reference for all bonus depreciation calculations for property placed in service prior to 9/28/2017.

For tax periods with property placed in service on or after 9/28/2017, REV-1834, Schedule C-8 “Adjustment for Bonus Depreciation” is used to report bonus depreciation adjustments for both depreciation calculations for tax periods 2017 and forward. (Prior to 9/28/2017 and on or after 9/28/2017). REV-1834, Schedule C-9 “Adjustment for Deduction for Property which is fully Depreciated, Sold or Otherwise Disposed” is used to report additional bonus depreciation additional deductions for a fully depreciated, sold, or otherwise disposed assets.

### *481(a) Adjustments*

Section 481(a) of the Internal Revenue Code requires taxpayers to compute adjustments to federal taxable income for any changes in either an overall accounting method or the accounting treatment of any item. Changes in accounting method are reported on Federal Form 3115 and any resulting changes to taxable income may appear as a 481(a) Adjustment within the taxpayer books and records. Some examples of changes that may affect depreciation include changes in:

- Depreciation method or recovery period
- Treatment of salvage proceeds or costs of removal
- Method of accounting for dispositions of depreciable property
- Treatment of depreciable property from a single asset account to a multiple asset account (pooling), or vice versa.
- Opting into or out of bonus depreciation

For Pennsylvania purposes, the recognition of any 481(a) adjustments relating to Pennsylvania bonus depreciation depends on the facts and circumstances of the information obtained during the audit.

*State Reference* – 72 P.S. § 7401(3)1.(r)(1) and (2)

*Federal Reference* – IRC 168(k)

## *Audit Procedures*

- 1) Auditor must request a detailed list of all 168(k) property to determine the proper addback and deduction. The detail should also include disposition information.
- 2) Reconcile the federal depreciation amounts on bonus assets to the Additional PA Bonus Depreciation Deduction to determine if the reported amount is accurate. The PA Bonus Depreciation cannot exceed the Federal Bonus Depreciation previously reported as an addition to Pennsylvania Taxable Income.
- 3) When determining the carryforward balance for bonus depreciation, the auditor must use the additions and deductions based on the last adjusted action per department records.
- 4) For property placed in service on or after 9/28/2017, auditors may estimate the current year MACRS depreciation to determine a reasonable estimate of audited amounts.
- 5) Taxpayers are entitled to a bonus depreciation deduction from partnerships based on their ownership percentage, if bonus depreciation from partnership interests was added back in prior years. A separate schedule showing the partnership amounts and their reconciliation to the taxpayer's reported/audited figures should be included with the audit package.
- 6) Taxpayers are entitled to bonus depreciation carry-in balances from merged or acquired entities. Prior to allowing the PA Bonus Depreciation Deduction, verify with the taxpayer the merged/acquired entity's EIN and review historical balances for that entity in the Department's records.

## **Intangible Income or Related Interest Income**

Effective for tax years beginning after December 31, 2022, certain taxpayers may make an election on their originally filed Form RCT-101 Corporate Tax Reports to exclude an intangible expense or cost or an interest expense or cost, which were added back to a related entity's corporate net income tax base for the same tax year. The following are required by corporate taxpayers to deduct the intangible expense or cost or an interest expense or cost:

- The election must be made by the taxpayer on an originally filed report.
- The taxpayer shall identify the name and Federal EIN of the taxpayer to which the election applies.
- The exclusion may not exceed the intangible expense or cost, or the interest expense or cost, paid, accrued or incurred by the taxpayer related entity's corporate net income tax base for the same tax year.
- If such an election is made, the taxpayer that made the adjustment required by 72 P.S. § 7401(3)1.(t)(1) shall not be entitled to receive any credit against tax due in this Commonwealth as calculated under phrase (t)(1)(A) or (B).

***State Reference*** - 72 P.S. § 7401(3)1.(u)

## *Audit Procedures*

- 1) Review REV-798, Schedule X to identify the name and FEIN of the Affiliated Entity(s) paying Intangible Income and/or Interest to the taxpayer under audit.
- 2) Verify that the Affiliated Entity(s) paying Intangible Income and/or Interest to the taxpayer are adding back the Intangible expense or cost as required by 72 P.S. § 7401(3)1.(t)(1) and the amounts do not exceed the intangible expense or cost incurred by the taxpayer related entity's corporate net income tax base for the same tax year.
- 3) Confirm the election was made by the taxpayer on an its originally filed Pennsylvania Corporate Tax Report. If such an election was not made, the taxpayer is not entitled to the intangible income deduction upon audit.

## Other Deductions

Taxpayers may claim any other allowable deductions on RCT-101, Line 2E and Schedule OD. Examples include Federal wages disallowed as a result of tax credits under IRC Section 45B (FICA tax obligations on employee tips) or IRC Sec 51(Work Opportunity Credit). There are instances where the taxpayer may report an IRC 163(j) interest limitation adjustment as an Other Deduction on the RCT-101; however, these adjustments should be presented as an adjustment to federal taxable income. For tax periods commencing after December 31, 2023, an other deduction may also be claimed for ordinary and necessary business expenses of certain medical cannabis businesses, as defined in 72 P.S. § 7401(3)1.(b.2), which were not taken by the corporation on its federal Form 1120.

*State Reference* - 72 P.S. § 7401(3)1.(b.2) & 72 P.S. § 7401(3)1.(c))

*Federal Reference* – IRC 45B & IRC 51

### *Audit Procedures*

- 1) For tax credits claimed under IRC 45B and 51, verify the amounts to the FF8846 and the FF5884, respectively.
  - Examples of credits not allowed is the empowerment zone employment credit, welfare to work credit, renewal community employment credit, Indian employment credit and employee retention credits.
- 2) Review any other deductions claimed for compliance with Pennsylvania Law. If there is no statutory or regulatory provision for the reported amounts, the deduction should be disallowed.

## Section V: Statutory Additions

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### Taxes Imposed on or Measured by Net Income

In arriving at Pennsylvania taxable income, no deduction shall be allowed for taxes imposed on or measured by net income. To the extent that such taxes have been deducted for Federal income tax purposes, they must be added back to Federal taxable income before apportionment for Pennsylvania Corporate Net Income Tax purposes. For Federal income tax purposes, deductions for taxes paid (not including federal taxes) are reported on FF1120, Line 17. All taxpayers reporting expenses for taxes on federal income tax returns must complete REV-860, Schedule of Taxes, even if no taxes are imposed on or measured by net income.

#### Important Considerations:

If a corporation pays a tax to a state which is a combination of taxes imposed on net income and some other element (*i.e.*, gross receipts or net worth), the portion based on net income must be added back in calculating Pennsylvania taxable income.

If a corporation is required to pay a tax which could be based on either net income or some other item (*i.e.*, gross receipts or net worth), and the tax paid for the period is based on net income, the total tax is added back in the calculation of Pennsylvania taxable income.

If a corporation overpays or over accrues income taxes in a prior year and adjusts the income tax expense for this overpayment or over accrual in a subsequent year, then the taxpayer may decrease the tax addback for the amount of this adjustment. However, the amount of the decrease is limited to the amount of these taxes added back in the year of the overpayment or over accrual.

**State Reference** - 72 P.S. § 7401(3)1.(o) & Corporation Tax Bulletin 2008-05

**Federal Reference** – IRC §164

#### **Audit Procedures**

- 1) Obtain a schedule listing the income tax expense by-state.
- 2) Verify completeness of the by-state schedule, by reconciling to:
  - FF1120, Line 17, Income Taxes (Or Taxes based on income)
  - REV-860, PA Schedule C-5
- 3) Verify the reported amounts only include states that impose an income tax.
- 4) Negative tax addbacks should be reviewed and supported with records that substantiate any overpayments or over accruals:
- 5) Prior year tax addback detail should be reviewed (if available) to determine whether current year negative can be offset by prior year addbacks on a by-state basis
- 6) An audited negative tax is permitted to the extent that a prior year positive addback can be verified for that specific state
- 7) For negative tax addbacks that do not offset against known prior year positive amounts:
  - Taxpayer's representative should be requested to provide proof of:
    - Proof of refund for prior period, such as a copy of a refund check and/or
    - Documentation of prior period tax accrual reported on the Pennsylvania return
    - A written explanation for the negative amounts
- 8) Negative tax amounts that cannot be validated through proof of refund, documentation of prior period tax accrual and reporting, offset by previously reported positive amounts as documented by available records, or other adequate explanation should be disallowed

## Current Year Bonus Depreciation

Pennsylvania corporate tax law decoupled from the Internal Revenue Code (IRC) Section 168(k). Accordingly, Pennsylvania corporate taxpayers are required to add back all bonus depreciation claimed under Section 168(k) when computing taxable income. Taxpayers must file the appropriate Pennsylvania Schedule to show the full depreciation calculation. For assets placed in service prior to 9/28/2017, all amounts are contained in the REV-799 (Schedule C-3 and Schedule C-4). For assets placed in service on or after 9/28/2017, summary amounts are reported on the REV-1834 (Schedule C-8 and Schedule C-9).

Federal 168(k) qualifying property generally includes new property with a recovery period of 20 years or less and qualified leasehold improvement property. Property amortized under Section 197 does not qualify. Bonus Depreciation applies after any reduction for a Section 179 allowance.

Since Pennsylvania has elected not to adhere to the timing of Federal bonus depreciation, corporate taxpayers must adjust their depreciation expense when filing their corporate income tax returns. This involves a two-step process.

1. The amount of Federal bonus depreciation must be added back to income. Federal bonus depreciation amounts are reported on the FF4562, Line 14 and Line 25
  - For assets acquired after 9/8/2010 and before 1/1/2012, the Department permitted full recovery of disallowed 100% bonus depreciation in the year that such depreciation was claimed and allowable for federal tax purposes. The net result was that no adjustment was necessary.
2. Taxpayer is entitled to a Pennsylvania deduction (See Section IV. Statutory Deductions – Current Year Additional PA Depreciation)
  - For assets placed in service prior to 9/28/2017 – The deduction is equal to a fraction of 3/7 times the amount of depreciation calculated under normal rules with the remaining basis.
  - For assets placed in service on or after 9/28/2017 – The deduction is equal to the regular MACRS depreciation calculation on the property without regard to the bonus depreciation amounts.
  - 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.
    - The *Adjustment for Disposition* must be reported on the proper schedule.
    - *Other Adjustments* are only applicable to assets placed in service prior to 9/28/2017, as the MACRS calculation would not create a balance.

### *Mergers and Conversions*

In the case of mergers, where the acquired corporation had unrecovered bonus depreciation, the balance is transferred to the survivor. In the case of conversions, where a corporate subsidiary becomes a single member LLC (disregarded entity), the balance is transferred to the owning member corporation. In either case for the balance to be transferred the merger target or the entity converted to a disregarded LLC must have been filing in Pennsylvania and added back bonus depreciation on a previously filed corporate tax report in order to have a balance to transfer to the surviving taxpayer.

**State Reference** – 72 P.S. § 7401(3)1.(q)

**Federal Reference** – IRC 168(k)

## *Audit Procedures*

- 1) Verify the addback of Federal bonus depreciation from the FF4562, Lines 14 and 25.
- 2) Review Department records for bonus depreciation history to verify the balance carry-in for the taxpayer and any merged or converted entities, if applicable.
- 3) Review partnership returns for bonus depreciation reported by partnership on Form 4562 and include an amount proportional to the profit / loss ownership percentage as an addback. If, as filed, the bonus depreciation added back is greater than what is reflected on the Corporate Form 4562, the difference could be due to the inclusion of partnerships.

## Intangible Expense or Related Interest Expense

Act 52 of 2013 requires, for tax years beginning after 12/31/2014, an addback of intangible expenses to income for intercompany expense deductions for royalties, licensing, or leasing fees on intangible property, including those embedded with other expenses or misclassified as other expenses, or as amortization expense on intangible property purchased from an affiliate. In addition to disallowing intangible expenses or costs, the addback also disallows interest expenses that are directly related to an intangible expense or cost. Taxpayers must complete REV-802, Schedule C-6 to report all intangible expense and related interest expense or claim any applicable exceptions to the addback.

There are three exceptions that a taxpayer may claim to override the disallowance of the intercompany intangible expenses. See Information Notice Corporation Taxes 2016-1.

1. Principle Purpose & Arms-Length - The principal purpose must be a valid business purpose, other than the avoidance of CNI tax. The terms are considered arm's length where the terms of the transaction under consideration are such as would have been arrived at in independent transactions with or between unrelated parties under similar circumstances.
2. Foreign Treaty - An affiliated entity domiciled in a foreign nation which has in force a comprehensive income tax treaty with the United States providing for the allocation of all categories of income subject to taxation.
3. Conduit - The affiliated entity pays expenses to an unaffiliated entity for the same intangible asset.

*State Reference* - 72 P.S. § 7401(3)1.(t) & Information Notice Corporation Taxes 2016-1

## *Audit Procedures*

### How to review when the taxpayer has filed the REV-802

- 1) Verify the total intercompany intangible expense and related interest expense from various sections of the FF1120, including but not limited to other deductions, cost of goods sold or other income. The intercompany interest expense should match the FF8916-A, Part III, Line 3a or 3b.
- 2) If the taxpayer claims the principal purpose/arms-length exception both elements must be substantiated for the exception to be approved. Examples of documentation to support the claim for the exceptions include: a contemporaneous business or marketing plan, corporate minutes and memoranda and/or section in the Transfer Pricing Study that shows reasonable projections of the anticipated economic benefits. Request a summation as to the principal purpose as well the appropriate transfer pricing studies.
  - For tax years beginning after January 1, 2023, consideration should be given to the potential of the corporate affiliate having economic presence within the Commonwealth pursuant to 72 P.S. § 7402(a).

- 3) If the taxpayer claims the foreign treaty exception the auditor must confirm that the US has a foreign treaty with the foreign nation cited. The auditor may also request the FF 5471/5472 to confirm the transaction cited was reported.
- 4) If the taxpayer claims the conduit exception the auditor should request a copy of the licensing agreement that the affiliated entity has with the outside party to verify that the taxpayer's portion of the intangible expense was properly computed.

#### How to review if the taxpayer has not filed the REV-802

- 1) If the auditor observes that the return contains intangible expenses and related interest expense with affiliates as explained above, the following information should be reviewed:
  - The Complete Consolidated FF 1120
  - The General Ledger Trial Balance for the Taxpayer
  - Transfer Pricing Studies for all domestic and foreign intercompany transactions within the Consolidated Group that pertain to the observed intercompany expenses.
  - The Assignment Agreement for the assignment of intangible property to the affiliated entity
  - The Licensing Agreement between the Affiliated Entity and Taxpayer.
  - A statement, from the Taxpayer, as to the business purpose or principal purpose for the intangible expense apart from the minimization of CNI Tax, with supporting documentation from contemporaneous marketing studies, board meetings, etc.
  - The Promissory note between the Taxpayer and all domestic and foreign affiliates for Intercompany Debt that pertain to the observed intercompany expenses.
  - A Written Statement from the Taxpayer explaining the business purpose of the loan(s)
  - Form 10-K "financial notes" sections that deals with indebtedness and mergers
- 2) Analyze Intangible Expense: Are the royalties paid to a foreign entity or a domestic entity? For foreign - review FF5471 / 5472. For domestic – does it also file in PA?
- 3) Analyze Related Interest Expense: Are the royalties paid to a foreign entity or a domestic entity? For foreign - review FF5471 / FF5472. For domestic – does it also file in PA?
- 4) If the transaction does not qualify for the addback, is it a sham transaction, impacting income (Line 28)? An example is if the interest expense does not relate to an intangible asset and the transaction lacks economic substance.
- 5) The auditor must provide workpapers to the taxpayer showing the preliminary findings for the intangible expense and related interest expense being added back. The taxpayer may file the REV-802 to claim any exception. See b above to verify the exceptions.
- 6) It is possible that intangible expenses or costs could also be amortization of intellectual property that was sold to the Taxpayer by an affiliate or even fees for management services, but this possibility should only be considered for deductions that significantly reduce taxable income and appear out of the ordinary.
- 7) For tax years beginning after January 1, 2023, consideration should be given to the potential of the corporate affiliate having economic presence within the Commonwealth pursuant to 72 P.S. § 7402(a).

## Other Additions

Taxpayers may claim any other allowable additions on RCT-101, Line 3D and Schedule OA. IRC 163(j) adjustments, excess capital losses, and excess charitable contributions are some examples that may be reflected as “Other Additions,” but should be reclassified as direct deductions to federal taxable income upon audit.

Wherein a corporate taxpayer made an intercompany sale of tangible or intangible business property that is deferred for federal tax purposes pursuant to U.S. Treas. Reg. § 1.1502-13 “Intercompany Transactions,” Pennsylvania requires the full recognition of intercompany gains in the year of sale, as PA taxable income is required to be computed on a separate company basis apart from any consolidating adjustments required by the federal government. To the extent the deferred gains for subsequent years are not removed from the taxpayer’s pro-forma 1120 they will be offset by Pennsylvania corporate net income “Other Deductions.”

### *Audit Procedures*

- 1) Review any other additions claimed for compliance with Pennsylvania Law.
- 2) Verify that the reported amounts are properly classified as an “Other Addition”

## Section VI: Business & Non-Business Income or Loss

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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.

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. Amounts constituting nonbusiness income or loss are allocated if it can be specifically assigned to a particular state. Rents and royalties from real or tangible personal property, gains, interest, patent, or copyright royalties are allocable to Pennsylvania to the extent that they constitute nonbusiness income.

If the taxpayer reports nonbusiness income on the RCT-101, the supplemental form, REV-934, must be completed.

*State Reference* – 72 P.S. 7401(3)2.(a)(1-8)

### *Audit Procedures*

- 1) The auditor should review all claims of nonbusiness income to determine the source of the income and the relationship of that source to the taxpayer.
- 2) Inquire about the taxpayer's rationale for treating income as business or nonbusiness in nature.
- 3) Review for consistency or inconsistency with which the taxpayer has reported such treatment to other states. I.e. Was the income reported to Pennsylvania as total nonbusiness income allocated to only one other state or apportionable in any other states?
- 4) Does the income meet the transactional or functional test for business income?
  - a. Transactional Test. Does the property that produces the income arise from transactions or activities conducted in the course of the taxpayer's trade or business operations?
  - b. Functional Test. Is the property functionally related to the taxpayer's unitary business, i.e., was the acquisition, management and disposition of the property accomplished as an integral part of the taxpayer's business?
- 5) Information gathered as a result of the taxpayer responding to the questions set forth in the REV-934 should be forwarded to a specialist within the Bureau of Audit's headquarter's staff for assistance upon review.

## Section VII: Apportionment

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### Overview

Apportionment is the process of dividing the corporation's business income among the states in which it conducts business using a formula. Corporate taxpayers with activity in multiple states may be able to apportion taxable business income. To apportion income, a corporation must be subject to tax in another state. For tax years beginning on or after Jan. 1, 2013, unless the taxpayer is required to use a special apportionment method, the apportionment factor used in the calculation of the Pennsylvania taxable income will consist only of a single sales factor.

### Jurisdiction to Subject

For purposes of allocation and apportionment of income, 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 if that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not. Note that the Ohio Commercial Activity Tax (CAT), the Nevada Commerce Tax, the Washington Business & Occupations (B&O) Tax and the Texas Franchise/Margins Tax are all gross receipts taxes, not income taxes. Consequently, merely filing and paying one or more of these taxes does not in and of itself constitute sufficient grounds for a showing that the taxpayer is subject to tax in another state.

A particular state has "jurisdiction to subject" the taxpayer to a net income tax, if the taxpayer's business activity in the state is sufficient to give the state jurisdiction to impose at least a net income tax under the constitution and statutes of the United States. Whether the state does in fact impose such a tax is not relevant. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of 15 U.S.C.A. §§ 381-385.

The determination of whether the state has "jurisdiction to subject" the taxpayer to a net income tax shall be made upon the same rules that are applied in determining whether a taxpayer has sufficient activity in this Commonwealth to subject the taxpayer to the Pennsylvania Corporate Net Income Tax.

**State Reference** - 72 P.S. § 7401(3)2.(a)(3) & 61 Pa. Code § 153.23

### Audit Procedures:

1. Review the by-state breakdown of income taxes for taxes paid to states besides PA.
2. If the by-state breakdown discloses tax being paid to only a few other states besides PA, and the Taxpayer is domiciled in PA, request a description of business activities in those states, and evaluate whether or not those activities are or are not protected under P.L. 86-272, using Corporate Tax Bulletins 2004-01 and 2019-04 in your evaluation.
3. If the taxpayer is not subject to tax in any other state, the taxpayer does not have the right to apportion income, and all receipts shall be apportionment to PA.

### Apportionment Calculation

The sales factor is a fraction, calculated to 6 decimal places, the denominator of which is the total sales of the taxpayer with the numerator being the sales of the taxpayer in Pennsylvania. Taxable income or loss with Pennsylvania Adjustments is multiplied by the sales factor to compute the income or loss apportioned to Pennsylvania for corporate net income tax purposes. For tax years beginning on or after January 1, 2013, the weighting is 100% of the sales factor.

**State Reference** - 72 P.S. § 7401(3)2.(a)(9)(A)(v) & 72 P.S. § 7401(3)2.(a)(15)

## Sales Factor Receipt Types

Corporate Taxpayer must complete the form, RCT-106, for the determination of the sales factor apportionment percentage. The sales factor encompasses five types of sales receipts, as described on the RCT-106:

### Sales (Net of Returns and Allowances)

Sales means all gross receipts of the taxpayer not allocated under the definition of non-business income other than:

- Dividends.
- Interest on United States, state or political subdivision obligations.
- 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.
- Gains on certain government obligations are considered securities and excluded

Receipts reported on RCT-106, Line 1 are generally a result of receipts from the sales of goods or services generated in the normal course of a taxpayer's trade or business. Sales should be reported net of returns and allowances. Gross sales are permitted to be reduced by customer returns/refunds and discounts (also called allowances) given to customers in the normal course of business. Generally, receipts reported on RCT-106, Line 1 shall reconcile to the Federal 1120, Line 1c – Gross Receipts or Sales, less Returns and Allowance. For Pennsylvania purposes, the sales are apportioned to Pennsylvania based of the type of business activity that the receipts were generated from, such as sales of Tangible Personal Property, Services, and/or Intangibles.

*State Reference* - 72 P.S. § 7401(3)2.(a)(1)(E)

### Interest, Rents, and Royalties

Receipts reported on RCT-106, Line 2 include receipts from interest, rents and royalties generated in the normal course of a taxpayer's trade or business.

#### *Interest*

Interest may include receipts earned on U.S. obligations and on loans, notes, mortgages, bonds, bank deposits, corporate bonds, tax refunds, etc. Generally, interest receipts reported on RCT-106, Line 2 shall reconcile to the Federal 1120, Line 5 – Interest. For Pennsylvania purposes, all interest receipts shall be sourced as a sale of intangible property, i.e. a sale of something other than tangible property or service.

#### *Rents*

Rents may include receipts earned from the rental of real or tangible personal property. Generally, rent receipts reported on RCT-106, Line 2 shall reconcile to the Federal 1120, Line 6 – Rents. For Pennsylvania purposes, all rent receipts shall be sourced as sales from the sale, lease, rental or other use of tangible personal property or real property

#### *Royalties*

Royalties may include receipts earned from the lease or license of intangible property. Generally, royalty receipts reported on RCT-106, Line 2 shall reconcile to the Federal 1120, Line 7 – Royalties. For Pennsylvania purposes, royalty receipts shall be sourced as a sale of intangible property, i.e. a sale of something other than tangible property or service.

## Gross Receipts from the Sales of Other Business Assets

Gross receipts from the sales of other business assets generally include receipts from the sale or exchange of real property, tangible property, and/or intangible property used in the taxpayer's trade or business. For Federal Income Tax purposes, sales of assets are computed at net, as reflected on Lines 8 and 9 of the FF1120. For apportionment purposes, asset sales should be reported at gross, and the proceeds from the sales are includable in the sales factor. Generally, gross receipts from the sales of other business assets receipts reported on RCT-106, Line 3 shall reconcile to the proceeds on Federal 1120, Form 4797 and Schedule D. For Pennsylvania purposes, gross receipts from the sales of other business assets shall be sourced based of the type of business property that the receipts were generated from, such as Tangible Personal Property, Real Property, and/or Intangibles.

### *Sale of Stock Treated as a Sale of Assets under 26 U.S.C. 338(h)(10)*

Corporate taxpayer's may reflect gains and losses on FF1120, Line 8 or Line 9 for the sale of stock in a corporation treated as a sale of their business assets, pursuant to IRC § 338(h)(10). The Department treats IRC 338(h)(10) sales as business income and follows the tax fiction that assets were sold when legally the actual transaction was a sale of stock. Gross proceeds from the sale would be in the sales factor. Gross proceeds from the allocated sale of tangible personal property and real property should be apportioned to situs of the property, and gross proceeds from the allocated sale of intangible property should be sourced according to 72 P.S. § 7401(3)2.(a)(17). For tax years beginning after December 31, 2022, any proceeds allocated to "goodwill" and certain other intangibles should be excluded from both the numerator and denominator of the sales factor.

### *Sales of partnership interest*

A corporation's interest in a partnership is considered ownership of the underlying assets. 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. The proceeds from the sale must be allocated to the types of assets considered sold by the corporation, such as securities, intangible assets, and real and tangible personal property. Auditors should request information as to how the taxpayer allocated the selling price of the partnership interest to their share of the tangible property, real property, and intangible property of the partnership. If workpapers are unavailable, the following guidelines may be used to ascertain a reasonable estimate of the Taxpayer's allocations:

1. Multiply the proceeds by the value 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.
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 amount represents the allocation for the sale of intangible assets.
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 as amount represents the allocation for the sale of real and tangible personal property.

Once the allocated selling price of the partnership interest to the taxpayer's share of the tangible property, real property, and intangible property of the partnership is determined, the auditor should determine the appropriate sourcing methodology used to source each type of receipt when calculating the PA and Everywhere receipts for the sales factor. Note: If the allocated amount for intangible assets cannot be assigned to a specific type of intangible property as described in 72 P.S. § 7401(3)2.(a)(17)(C-J), the receipts received from intangible property shall be excluded from the numerator and the denominator of the sales factor.

## Other Sales (Receipts Only)

Other sales are all other receipts that were not reported on Lines 1 through 3 of the RCT-106. Receipts reported on RCT-106, Line 4 typically consist of receipts reported on Federal 1120, Line 10 – Other Income. For Pennsylvania purposes, Line 10 - Other Income is includable in the sales factor to the extent the amounts represent business income to the taxpayer. The sales receipts are apportioned to Pennsylvania based on the type of business activity that the receipts were generated from, such as Tangible Personal Property, Services, and/or Intangibles.

Examples of Other Sales that are generally included in sales factor:

- Scrap sales
- Sales tax discounts (commissions for timely filings)
- Proceeds from a life insurance policy
- Management fees or intercompany sales/revenue that include a related markup
- Other receipts/sales where income was received in exchange for something of value

Examples of Other Sales that are generally NOT included in sales factor:

- Bad debt recovery
- Rebates/refunds of money already paid (usually related to taxpayer's own purchases)
- Refund of premiums from a life insurance policy
- Partnership income/losses – Note that partnership receipts should be represented in the taxpayer's sales factor on a gross basis, not as a net income/loss amount
- Hedging and foreign currency transactions (Note: For tax years 2023 and later, these would never be included in the sales factor)
- Intercompany reimbursements or cost allocations for expenses (usually displayed as negative amounts on FF1120, Line 10)
- Receipts or negative amounts reported on Line 10 should be evaluated on a case-by-case basis to determine whether they should be included in the sales factor

## Partner's Share of Sales from Partnerships

Interests in an unincorporated entity, such as a 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 sales, which is typically based on the profit/loss percentages as reflected on the Schedule K-1 issued to the corporate taxpayer. The profit / loss percentage is used to maintain consistency with the flow-through of income from the partnership to the Taxpayer's corporate return. A Partnership Agreement may be necessary when there is no fixed profit / loss percentage of ownership reflected on the Schedule K-1 or when the proportionate share of ownership is calculated using other specific percentages derived from the Agreement.

The corporation's distributive share of income/loss (reported either on FF1120, Line 10 - Other Income / Line 26 – Other Deductions) is excluded for sales factor purposes, as the Taxpayer's partnership share in the gross receipts that give rise to the amount on Line 10 / Line 26 are to be reflected in the partnership sales factor. Partnership flow-through for dividends, interest income, rents and royalty income should already be reflected on Lines 4, 5, 6 & 7 of the FF1120.

Information to determine partnership flow-through receipts can be obtained from the partnership's Federal Form 1065, including the corporate partner's Schedule K-1, and state tax return, PA-65, including Schedule H Corp.

### *Intercompany sales between taxpayer and partnership interest.*

Sales between the partnership and the taxpayer shall be eliminated from the denominator and numerator of the taxpayer's sales factor as follows:

1. Sales by the taxpayer to the partnership to the extent of the interest in the partnership
2. Sales by the partnership to the taxpayer not to exceed the taxpayer's interest in partnership sales.

Sales made by the taxpayer or the partnership to non-partners shall be included in the taxpayer's sales factor in an amount equal to the taxpayer's interest in the partnership.

### *LLCs/Business Trusts.*

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 corporate net income sales factor. The proportionate share is based on profit/loss ownership as reflected on the Schedule 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.

*State Reference* - 72 P.S. § 7402.2 & 61 Pa. Code § 153.29

## Rules of Apportionment

### Sales of Tangible Personal Property

Sales of tangible personal property are considered Pennsylvania sales if the property is delivered or shipped to a purchaser within the state, regardless of the f.o.b. point or other conditions of the sale.

Sales from the rental, lease or licensing of tangible personal property are Pennsylvania sales if the customer first obtained possession of the tangible personal property in the state. If the tangible personal property is subsequently taken out of Pennsylvania, the taxpayer may use a reasonably determined estimate of Pennsylvania usage to determine the portion of the sale to apportion to Pennsylvania.

### *Dock Sales*

All sales are sourced based on destination, regardless of how the goods are transported. Sales to purchasers who pick up the goods at the taxpayer's location and transport the goods to a location in Pennsylvania are Pennsylvania sales, regardless of the taxpayer's location. These sales are included in the numerator.

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.

Taxpayer must be able to provide documentation sufficient to establish an out-of-state sale. Documentation sufficient to establish an out-of-state sale includes:

1. Bills of Lading of the carrier establishing that the goods were destined for or delivered to an out of state location.
2. Delivery instructions from the purchaser to the carrier establishing that the goods were to be transported out of Pennsylvania.
3. Warehouse receipts of the purchaser showing that the goods were delivered to an out of state location.
4. Invoices issued by the taxpayer/seller to the purchaser showing an out-of-state delivery address.

Documentation which will be deemed insufficient to establish that the ultimate destination of goods to an out of a state location:

1. Invoices issued by the taxpayer/seller to the purchaser showing an out-of-state mailing address.
2. Affidavits or other declarations from the seller, its employees or agents that the ultimate destination of goods was an out of state location.

### *Sales of Electricity*

For Pennsylvania corporate net income purposes, the sale of electricity shall be treated as a sale of tangible personal property for purposes of apportioning receipts, as it more closely resembles a saleable commodity, than it does a service or the use of an intangible. As such, receipts from the sale of electricity will be sourced pursuant to 72 P.S. § 7401(3)2.(a)(16), the associated regulations and applicable interpretations of the Pennsylvania courts. In the case of partnerships that are engaged in the sale of electricity and have one or more corporate partners, the partnership's receipts from the sale of electricity will flow up to its corporate partner(s) in the same manner as any other sale of tangible personal property. See Corporation Tax Bulletin 2023-01.

*State Reference* - 72 P.S. § 7401(3)2.(a)(16) & 61 Pa. Code § 153.26 & Corporation Tax Bulletin 2023-01

### *Sales from the Sale, Lease, Rental or Other Use of Real Property*

Sales from the sale, lease, rental or other use of real property are Pennsylvania sales, if the real property is located in this state. If a single parcel of real property is located both in and outside this State, the sale is in this State based upon the percentage of original cost of the real property located in this State.

*State Reference* - 72 P.S. § 7401(3)2.(a)(16.1)

### *Sale of Services*

For tax periods beginning on or after January 1, 2014, sales from the sale of a service are Pennsylvania sales if the service is delivered to a location in this state.

1. If the service is delivered both to a location in and outside Pennsylvania, the sale is in this state based upon the percentage of total value of the service delivered to a location in this state.
2. If the state or states of assignment under #1 cannot be determined for a customer who is an individual that is not a sole proprietor, a service is deemed to be delivered at the customer's billing address.
3. If the state or states of assignment under #1 cannot be determined for a customer, except for a customer under #2, a service is deemed to be delivered at the location from which the services were ordered in the customer's regular course of operations. If the location from which the services were ordered in the customer's regular course of operations cannot be determined, a service is deemed to be delivered at the customer's billing address.

*State Reference* - 72 P.S. § 7401(3)2.(a)(16.1) & Information Notice 2014-01

### *Sales Other Than Tangible Personal Property and Services*

#### *Income Producing Activity & Cost of Performance*

For tax years beginning before January 1, 2023, Sales, other than sales tangible property and services are in this state if income-producing activity is performed in this State.

The Department of Revenue viewed the location where the "income producing activity was performed" as being where the benefit of the income producing activity was received. This position was upheld by the Pennsylvania Supreme Court in the matter of *Synthes, USA HQ, Inc. v. Commonwealth*, 289 A.3d 846 (Pa. 2023).

## *Market-Based Sourcing*

For taxable years beginning after December 31, 2022, the Commonwealth adopted specific sourcing rules for receipts from sales other than tangible personal property and services. Corporation Tax Bulletin 2024-01 “Sourcing Sales Other than Tangible Personal Property and Services” provides the Department’s interpretation of key terms and concepts necessary to properly apply the statutory rules for sourcing sales other than tangible personal property and services.

### *Gross receipts from the Sale, Lease, or License of intangible property*

Gross receipts from the lease or license of intangible property, including a sale or exchange of property where the receipts from the sale or exchange derive from payments that are contingent on the productivity, use or disposition of the property, if and to the extent the property is used in Pennsylvania.

Gross receipts from the sale of intangible property where the property sold is a contract right, government license or similar property that authorizes the holder to conduct a business activity in a specific geographic area, if and to the extent the property is used in or otherwise associated with Pennsylvania.

Gross receipts from the sale, redemption, maturity or exchange of securities, held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business, are sourced to Pennsylvania if the customers are in Pennsylvania.

- Greater than 50% of the total receipts must be derived from such sales to be considered held by the taxpayer primarily for sale to customers
- If the securities are not held by the taxpayer for sale to customers, they would not be included in the sales factor calculation (numerator or denominator).

### *Gross Receipts from interest, fees, and/or penalties imposed in connection with loans to Unaffiliated Entities*

Real Property - Interest, fees, and penalties imposed in connection with loans secured by real property will be sourced to jurisdictions based on the location of collateral property per the original loan agreement.

- If more than fifty per cent of the fair market value of the real property is located within Pennsylvania, the receipts are sourced to the state.
- If more than fifty per cent of the fair market value of real property is not located within any single state, the receipts are sourced to the location of the borrower.
- For individuals, the locations of the borrower will be their residential address. For corporations, it will depend on relevant facts and circumstances. It could be a headquarters location, billing address, activities of the corporation, or the location of the office from which the transaction was negotiated in the regular course of business.

Tangible Personal Property - Interest, fees, and penalties imposed in connection with loans secured by tangible personal property are sourced to Pennsylvania if the property was delivered or shipped to a purchaser in Pennsylvania.

- Exceptions:
- Transportation property - Receipts are sourced to Pennsylvania the extent the property is used in Pennsylvania
- Aircrafts – Based on the number of landings of the aircraft in Pennsylvania over the total number of landings of the aircraft everywhere
- Motor vehicles - Receipts are sourced to Pennsylvania if the motor vehicle is registered in Pennsylvania.

Unsecured Loans (No collateral) - Interest, fees, and penalties associated with the loan is sourced to the jurisdiction of the borrower.

- For individuals, the locations of the borrower will be their residential address.
- For corporations, it will depend on relevant facts and circumstances. It could be a headquarters location, billing address, activities of the corporation, or the location of the office from which the transaction was negotiated in the regular course of business

### *Gross Receipts from interest, fees, and/or penalties imposed in connection with loans to Affiliated Entities*

The interest, fees, and/or penalties received from the loan is sourced to the commercial domicile of the lender.

### *Gross Receipts from interest, fees, and/or penalties earned by entities that do not regularly lend funds*

The interest, fees, and/or penalties received from the loan is sourced to the commercial domicile of the lender.

### *Gross Receipts from interest, fees and penalties in the nature of interest from credit card receivables and gross receipts from fees charged to cardholders*

The interest, fees, and/or penalties are sourced to the billing address of the cardholder

### *Gross Receipts from Other Intangible Property*

Receipts from intangible property, that were not previously described, are excluded from the sales factor numerator and denominator.

Examples include, but are not limited to, sale of goodwill, the sale of patents, the sale of copyrights, customer lists etc.

*State Reference* - 72 P.S. § 7401(3)2.(a)(17) & Corporation Tax Bulletin 2024-01

## Special Apportionment

### *Railroad, Truck, Bus, Airline or Qualified Air Freight Forwarding Companies*

All business income of railroad, truck, bus, airline and qualified air freight forwarding companies shall be apportioned to this Commonwealth by multiplying the income by a fraction, the numerator of which is the taxpayer's total revenue miles within this Commonwealth during the tax period and the denominator of which is the total revenue miles of the taxpayer everywhere during the tax period.

A revenue mile shall mean the average receipts derived from the transportation by the taxpayer of persons or property one mile. Where revenue miles are derived from the transportation of both persons and property, the revenue mile fractions attributable to each such class of transportation shall be computed separately, and the average of the two fractions, weighted in accordance with the ratio of total receipts from each such class of transportation everywhere to total receipts from both such classes of transportation everywhere, shall be used in apportioning income to this Commonwealth.

Department Guidance confirms that the special apportionment formula used for rail, bus and air corporations must comply with the court's holding in *FedEx Ground Packaging Systems*, 898 A.2d 22 (Pa. Commw. Ct. 2006).

## *Pipeline or Natural Gas Companies.*

### *Pipeline Companies*

All business income of pipeline companies shall be apportioned to this Commonwealth by multiplying the income by a fraction, the numerator of which is the revenue ton miles, revenue barrel miles or revenue cubic feet miles within this Commonwealth during the tax period and the denominator of which is the total revenue ton miles, revenue barrel miles or the revenue cubic feet miles of the taxpayer everywhere during the tax period.

A revenue ton mile, revenue barrel mile or a revenue cubic foot mile shall mean respectively the receipts derived from the transportation by the taxpayer of one ton of solid property, one barrel of liquid property or one cubic foot of gaseous property transported one mile.

### *Natural Gas Companies*

All business income of natural gas companies subject to regulation by the Federal Power Commission or by the Pennsylvania Public Utility Commission shall be apportioned to this Commonwealth by multiplying the income by a fraction, the numerator of which shall be the cubic foot capacity of the taxpayer's pipelines in this Commonwealth, and the denominator of which shall be the cubic foot capacity of the taxpayer's pipelines everywhere, at the end of the tax period. The cubic foot capacity of a pipeline shall be determined by multiplying the square of its radius (in feet) by its length (in feet).

## *Water Transportation Companies*

### *Water Transportation Companies Operating on High Seas.*

All business income of water transportation companies operating on high seas shall be apportioned to this Commonwealth by multiplying the business income by a fraction, the numerator of which is the number of port days spent inside the Commonwealth and the denominator of which is the total number of port days spent inside and outside of the Commonwealth. The term "port days" does not include periods when the ships are not in use because of strikes or withheld from service for repair or because of seasonal reduction of services. Days in port are computed by dividing the aggregate number of hours in all ports by twenty-four.

### *Water Transportation Companies Operating in Inland Waters.*

All business income of water transportation companies operating on inland waters shall be apportioned to this Commonwealth by multiplying the business income by a fraction, the numerator of which is the taxpayer's total revenue miles within this Commonwealth during the tax period and the denominator of which is the total revenue miles of the taxpayer everywhere during the tax period. In the determination of revenue miles, one-half of the mileage of all navigable waterways bordering between the Commonwealth and another state shall be considered Commonwealth miles. For purposes of this paragraph, revenue miles shall mean the revenue receipts derived from the transportation by the taxpayer of persons or property one mile

## *Satellite Television Services Providers*

All business income of providers of satellite television services shall be apportioned to this Commonwealth by multiplying the income by a fraction, the numerator of which is the value of equipment located in this Commonwealth that is owned or rented by the taxpayer or owned by an entity that is included with the taxpayer in a controlled group, as defined in section 267(f) of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. § 166), and used by the taxpayer in generating, processing or transmitting satellite television services, whether or not such equipment is affixed to real estate, and the denominator of which is the value of all such equipment located everywhere. The value of property owned by the taxpayer or owned by an entity included with the taxpayer in a controlled group and used by the taxpayer shall be its cost less depreciation per the books and records of the owner.

## *Split-Factor Apportionment*

Taxpayers involved in both an activity subject to one or more of the special apportionment formulas under 72 P.S. § 7401(3)2.(b)-(e), as well as separate activities subject to standard single sales factor apportionment under 72 P.S. § 7401(3)2.(a)(15)-(17) shall utilize an apportionment methodology whereby the taxpayer's taxable income is subject to "split apportionment" according to the proportion of gross receipts derived from business activities subject to special apportionment compared to the proportion of gross receipts derived from business activities subject to standard apportionment. This issue was previously addressed by the Commonwealth Court in the matter of *Buckeye Pipeline Co. v. Commonwealth* and the Department has consistently applied the split factor methodology adopted by the court. Application and examples of this approach can be found in Corporation Tax Bulletin 2022-01.

*State Reference* - 72 P.S. § 7401(3)2.(b-e) & Corporation Tax Bulletin 2022-01

## Audit Procedures

### Everywhere Receipts (Inside and Outside PA)

#### *General Procedures*

- 1) Identify each revenue stream. Compare each type of sales receipt shown on the RCT-106 to the Federal 1120.
- 2) Review source documents (including, but not limited to, by-state breakdown, general ledger, trial balance, system generated sales reports and/or downloads traceable to sales invoices) to verify completeness
  - Determine how the by-state breakdown was prepared, i.e. the methodology the taxpayer used to apportion receipts to PA.
  - Trace back to original records. A random check of sales records is required to verify the accuracy of any summary reports.
- 3) If no by-state breakdown and/or original records is provided, determine in favor of the Commonwealth.

#### *Partnership Procedures*

- 1) Obtain partnerships' federal returns (FF1065) (should be included with PA-20/PA-65) along with by state apportionment schedules for all partnerships.
  - If the FF1065 and the PA-20/PA-65 is unavailable, request the Corporate Partner have the partnership fill out the Schedule H Corp.
  - Minimum documentation requirements should be for the PA-65, Schedule H Corp filed by the Taxpayer's Partner, a statement that identifies the partnerships trade or business, the commercial domicile of the partnership, if there are intercompany transactions between the Corporate Taxpayer and the partnership with a breakdown of the transactions as to the type and amounts involved, and a by-state breakdown of net sales.
  - For partnerships that are organized only for the distribution of investment income, only the Corporate Taxpayer's Schedule K-1 is required for documentation. If there are a number of such partnerships and the investment income is not material, verify the Schedule K-1s for the largest distributors of income.
- 2) Compute taxpayer's distributive share of sales based on the taxpayer's ownership percentage. Percentage of ownership is based upon profit / loss percentage as reflected on the taxpayer's schedule K-1. If the ownership percentage is changed during the year use a daily or monthly average.
- 3) Reconcile the taxpayer's distributive share of sale to the FF1065 and Schedule H Corp.
  - Obtain the Partnership Agreement if the taxpayer's distributive share of sales varies from the ownership percentage as reflected on the Schedule K-1.

## Pennsylvania Receipts (Inside PA)

### *General Procedures*

- 1) Review source documents (including but not limited to by-state breakdown, general ledger, trial balance, system generated sales reports and/or downloads traceable to sales invoices) to verify accuracy.
  - Determine how the by state breakdown was prepared i.e. the methodology the taxpayer used to apportion receipts to Pennsylvania.
  - Trace back to original records. A random check of sales records is required to verify the accuracy of any summary reports.
- 2) The auditor should determine the sourcing methodology used to assign each type of receipt in calculating the sales factor.

### *For Sales of tangible personal property:*

- 1) 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.
- 2) Trace the shipping address from the invoices to the destination sales reports to determine they are being properly reported.
- 3) Confirm that the destination sales reports include the destination of the goods on the sale from the taxpayer to its customer and not where the customer may resell it to a 3<sup>rd</sup> party.

### *For Sales of Services:*

- 1) A random check of sales records is required to determine if the taxpayer is properly reporting sales on to where the service is delivered. Verify that sales are apportioned using the service address and not the billing address.
- 2) Confirm that the sales apportionment reports properly reflect Pennsylvania sales in accordance with PA Law and Information Notice 2014-01

### *For Sales Other Than Tangible Personal Property and Services:*

- 1) Determine the source and nature of the intangible receipts (i.e. receipts from the Sale, Lease, or License of intangible property, such as royalties or license fees or interest, fees, penalties associated with loans, etc.)
- 2) Confirm that the sales apportionment reports properly reflect Pennsylvania sales in accordance with PA Law and Corporation Tax Bulletin 2024-01

# Section VIII: Net Loss Deduction

## Overview

Corporations can carry forward a Pennsylvania net operating loss (NOL) for taxable years beginning on or after January 1, 1981. The losses carried into a given taxable year can be used to offset positive taxable income. Taxpayers are required to complete the RCT-103 – Net Loss Schedule reflecting the net loss carryforward, the current period net loss deduction, and the net loss carryforward to subsequent years. The schedule below shows the number of years a loss may be carried forward and the limit on the deduction by tax year.

Taxable Year	Limitations	Carryover
1998	\$1,000,000	20 taxable periods
1999-2006	\$2,000,000	20 taxable periods
2007-2008	Greater of 12.5% or \$3,000,000	20 taxable periods
2009	Greater of 15% or \$3,000,000	20 taxable periods
2010-2013	Greater of 20% or \$3,000,000	20 taxable periods
2014	Greater of 25% or \$4,000,000	20 taxable periods
2015-2016	Greater of 30% or \$5,000,000	20 taxable periods
2017	30%	20 taxable periods
2018	35%	20 taxable periods
2019 -2025	40%	20 taxable periods
2026	50%*	20 taxable periods
2027	60%*	20 taxable periods
2028	70%*	20 taxable periods
2029	80%*	20 taxable periods

\*Losses generated in tax year 2024 and prior can still only reduce taxable income up to the prior cap of 40% of taxable income for taxable years 2026-2029. Losses generated in tax year 2025 and thereafter may then be used to further reduce taxable income.

## Application of Losses

A net operating loss arises when the Pennsylvania taxable income after apportionment is less than zero in a given year. Pennsylvania permits the carryover of NOLs incurred in one taxable period to offset income in future tax periods also referred to as a carryforward. The carryforward period for net losses is based on the starting date of the tax period. The NOL must be carried to the earliest taxable year in which it may be carried. There is no provision to forgo the use of a net loss in order to use a credit against the tax liability. Short periods are considered one taxable period.

## Federal Audits and Net Losses

When the result of the Report of Change affects the tax liability in a subsequent year that is closed to assessments, and was not part of the federal audit, the Department has no authority to adjust the Corporate Net Income Tax for the closed periods. However, this does not prevent the Department from changing the application of the net losses for years which are still within the statutory timeframe for adjustment, if appropriate.

## Changes in Ownership

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 for any 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.

### *General Application of Net Loss Deductions Limited by IRC § 381*

In addition to dictating the types of transactions in which existing net operating losses may be transferred from one corporation to another, IRC § 381 also determines the amount of net operating losses which may be deducted by the acquiring corporation in the first taxable year of the acquiring corporation ending after the date of transfer. It dictates that the losses 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.

#### Example

'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:

$$\frac{\text{\# of days from merger date to the end of year}}{\text{Total days in Year}} * \text{PA Taxable Income}$$

The rules for net loss carryforward applicable to that date should be used and the statutory deduction limitations apply. When merging two or more corporations with different fiscal year ends the survivor will combine the net losses of the merging corporation with the net losses generated by the survivor based on the beginning of the merging corporation's fiscal year. For more information regarding net loss deduction limitations under IRC 381, refer to Corporation Tax Bulletin 2008-03.

### *General Application of Net Loss Deductions Limited by IRC § 382*

When there is a change of ownership of a loss corporation, including a merger, the limitations on the Net Loss Deduction under IRC § 382 may also apply. The determination as to whether IRC § 382 applies to the Net Loss Deduction available to be used is based on the application of this section and applicable Treasury Regulations in effect at the time of the change of ownership on a separate company basis. Under IRC § 382, when there is a change of ownership of a loss corporation the net losses from years prior to the change in ownership available to be used in years following the change of ownership are limited to the value of the loss corporation on the date of the change of ownership times the long-term tax-exempt rate. The long-term tax-exempt rate is the highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change occurs. These rates are published by the Internal Revenue Service and can be found on their website at [www.irs.gov](http://www.irs.gov).

In calculating this limitation for Pennsylvania Corporate Net Income Tax purposes, the portion of the value of the loss corporation attributable to Pennsylvania is the value of the corporation times the CNI apportionment for the tax period immediately prior to the change of ownership. Typically, the tax period in question will be the short tax year ending on the date of the sale. However, if no tax return is required for the short period prior to the change, the taxpayer should use apportionment from the last filed tax return before the change of ownership for purposes of this calculation.

#### Example

The stock of 'X' Corporation, a loss corporation, is sold to 'Y' Corporation on April 1, 2017. In order to determine the limitation of 'X's loss that would be able to be used during the year of acquisition and thereafter:

$$\text{Value of Loss Corporation} * \text{Long term tax exempt rate} * \text{Apportionment \%} = \text{NOL Limitation}$$

For more information regarding net loss deduction limitations under IRC 382, refer to Corporation Tax Bulletin 2008-03. In the event the merging or acquired entity had an IRC 163(j) adjustment to federal taxable income in a loss year, it may be necessary to prorate the excess interest from the net loss in accordance with Corporate Tax Bulletin 2008-03. If this scenario arises during an audit, the auditor should refer the matter to a specialist within the Bureau of Audit's headquarter's staff.

*State Reference* - 72 P.S. § 7401(3)4.(g), 61 Pa. Code § 153.15.(e), Corporation Tax Bulletin 2008-03

*Federal Reference* – IRC § 381 & IRC § 382

### *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 its assets in a complete liquidation under 26 U.S.C. § 381. 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 Corporate Net Income Tax. Under a 338(h)(10) election, the target corporation would recognize any net losses on the deemed sale of assets and any net operating loss carryforward would remain with the corporation.

### *Net Losses and Limited Liability Companies (LLC)*

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 by the member. For federal income tax purposes, the net operating losses in this situation belongs to the member under IRC Section 332.

If a corporation reorganizes into a multi-member LLC any Pennsylvania net loss generated by the entity prior to the reorganization may not be used by any member. For federal income tax purposes, the LLC would either be a partnership or a corporation and the survival of the net losses depends on the nature and detail of the transaction.

### *Audit Procedures*

- 1) Review Department records to verify the amounts on the taxpayer's NOL schedule are accurate.
- 2) Verify that the NOLs claimed from prior tax years have not expired and the amounts claimed do not exceed the current year limitation.
- 3) Review taxpayer information to determine if the taxpayer had any mergers/acquisitions.
  - Request information for any all mergers or acquisitions that took place during the tax period including the name and EIN of the merged or acquired corporation(s), as well as any supporting merger/acquisition agreements.
  - Review Department records to verify the amounts for any merged/acquired entities included on the taxpayer's NOL schedule are accurate.
- 4) If there were any mergers or acquisitions, verify application of any IRC Section 381/382 limitations for Pennsylvania purposes.
  - Request the taxpayer provide an explanation regarding the transaction that occurred and if an analysis was conducted for any IRC 381/382 limitations.
  - For mergers/ acquisitions where there is a 50% or greater change in overall ownership control, request the taxpayer provide an IRC 382 Study. If the IRC 382 Study was conducted for the Federal Consolidated Group, an explanation must also be provided to as to how the taxpayer applied the study on a Separate Company basis.
- 5) Information must be provided for any mergers/acquisitions during the audit period for the merged/acquired entity's NOL carryforward to be included in the taxpayer's NOL carryforward.