

**CHAPTER 170. CORPORATION TAX
PRONOUNCEMENTS—STATEMENTS OF POLICY**

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NONBUSINESS INCOME

§ 170.1. Nonbusiness income—liquidations; effect of *Laurel Pipe Line* decision.

(a) The significant factual elements involved in *Laurel Pipe Line Co. v. Board of Fin. & Revenue*, 642 A.2d 472 (Pa. 1994) are as follows:

- (1) The pipeline operation in issue had been discontinued and was idle for at least 3 years.
- (2) The remaining pipeline operation of the company was independent from the pipeline operation that was sold, including a distinctive geographical separation.
- (3) No proceeds of the sale were used to acquire any assets for future use in the business, nor were any reinvested back into the operations of the business.
- (4) No proceeds of the sale were used to generate income for future use in the business operations, nor were any invested in financial securities that would generate income for the company.
- (5) The entire after-tax net proceeds from the sale were distributed to the shareholders in the form of a dividend.

(b) The law applied in the case is the so called “functional test,” which is derived from the second clause of the statutory definition of “business income:” “and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” 72 P. S. § 7401(3)2.(a)(1)(A). The Supreme Court has interpreted the Commonwealth Court’s opinion in *Welded Tube Co. v. Commonwealth*, 101 Pa. Cmwlth. 32, 515 A.2d 988 (1986) as holding that under the functional test “income meets the functional test if the gain arises from the sale of an asset which produced business income while it was owned by the taxpayer.” *Laurel*, 642 A.2d at 475.

(c) The Supreme Court in *Laurel* notes that in *Welded Tube* the taxpayer had a regular practice of acquiring property in the expansion of its business and reinvesting any gains in its ongoing business. In contrast, *Laurel* engaged in what the Supreme Court describes as a “singular disposition” of property.

(d) In finding that the disposition at issue in *Laurel* was not an integral part of *Laurel*’s business, the Supreme Court focuses on the following facts:

- (1) The “singular” nature of the disposition.
- (2) The pipeline was idle for 3 years.
- (3) The disposition was not made in the course of acquiring new assets.
- (4) This was a liquidation as evidenced by a lack of reinvestment of the proceeds in the business—no assets were acquired and no proceeds were used to generate income or invested in financial securities that would generate income for the company—and the entire net proceeds were distributed to the shareholders.

(5) The pipeline disposed of was a separate and distinct “aspect” of *Laurel*’s business, and the remaining pipeline was independent from the sold pipeline.

(6) *Laurel* divested itself of this “aspect” of its business and the structure of its business has changed as a result.

(e) That no one fact alone controlled the result in *Laurel* is evident by the Court’s statement that “the totality of the circumstances surrounding the sale of the . . . pipeline has persuaded us that the transaction is one that can be characterized as a partial liquidation which has changed the structure of the taxpayer’s business.” 642 A.2d at 477. By citing the *Welded Tube* decision without apparent disagreement, the Supreme Court impliedly has approved that decision; but there are basic factual differences which dictated a contrary result in *Laurel*. These differences are:

(1) *Laurel* involved a partial liquidation while *Welded Tube* was a reorganization.

(2) In *Laurel*, a separate aspect of its business was sold while in *Welded Tube* only a part of the company’s business was sold.

(3) *Laurel* returned the proceeds to its shareholders while *Welded Tube* reinvested its proceeds.

(4) *Laurel*’s business structure changed while *Welded Tube*’s did not.

(f) Unlike *Welded Tube*, *Laurel* deals with the liquidation of a distinct aspect of the taxpayer’s business, which aspect ceases following the liquidation.

(g) The policy implications are as follows:

(1) *Laurel*’s interpretation of *Welded Tube*’s statement of the functional test—that is, “Income meets the functional test if the gain arises from the sale of an asset which produced business income while it was owned by the taxpayer,”—is clarified with respect to liquidations by the decision in *Laurel*. 462 A.2d at 475. A liquidation to which the *Laurel* decision applies is a liquidation where a separate and distinct aspect of the taxpayer’s business ceases

and the proceeds are returned to the shareholders. Such an aspect of the taxpayer's business may be comprised of assets once used in the taxpayer's regular trade or business operations if there is evidence that the assets no longer comprise a part of the operations.

(2) It is the policy of the Department that any disposition of assets for which nonbusiness income is claimed pursuant to a liquidation must have been removed from the relevant apportionment factors prior to the disposition for a period of time consistent with the facts of the individual case. In addition, the taxpayer is required to show by clear and convincing evidence that for the period the assets were not a part of its regular trade or business operations. The proceeds from such a disposition shall be distributed to the shareholders of the corporation and may not be used to acquire assets for future use in business operations or to generate income for use in future business operations.

Source

The provisions of this § 170.1 adopted November 11, 1994, effective November 12, 1994, 24 Pa.B. 5659.

§ 170.2. [Reserved].

Source

The provisions of this § 170.2 adopted November 14, 1997, effective November 15, 1997, 27 Pa.B. 5970; reserved December 4, 1998, effective December 5, 1998, 28 Pa.B. 5986. Immediately preceding text appears at serial pages (236147) to (236148).

§ 170.3. Nonbusiness income—application of *Canteen Corporation* decision.

(a) *Canteen Corp. v. Commonwealth*, 818 A.2d 594 (Pa. Cmwlth. 2003) will not be applied to taxable years beginning after December 31, 1998.

(b) The policy implications are as follows:

(1) It is the policy of the Department of Revenue that the part of the decision in *Canteen Corp. v. Commonwealth*, 818 A.2d 594 (Pa. Cmwlth. 2003), which held that gains or losses from section 338 transactions produce nonbusiness income, does not apply to taxable years beginning after December 31, 1998, because of statutory amendments to the definition of "business income." In accordance with § 153.81 (relating to elections under 26 U.S.C.A. § 338) taxable income generated as a result of a section 338 election will be treated as business income.

(2) The part of the decision which held that the fictional sale of assets by the target corporation must be recognized by the Commonwealth will be followed so that the target corporation's sales factor will include, when required by law, the proceeds assigned to each asset which is deemed to have been sold.

(c) The rationale for this statement of policy is as follows:

(1) The Commonwealth Court in *Canteen* reasoned that the Commonwealth could not include the fictional gain produced by this Federal election in taxable income and then ignore the additional fiction that under this election the company is deemed to have sold all of its assets in a complete liquidation and distribution of assets. Following this reasoning, the Commonwealth Court relied on the Pennsylvania Supreme Court's holding in *Laurel Pipe Line v. Board of Finance and Revenue*, 537 Pa. 205, 642 A.2d 472 (1994) that the gain realized from a partial liquidation of a discrete business segment and distribution of proceeds to shareholders is nonbusiness income.

(2) The Pennsylvania Supreme Court in *Laurel Pipe Line* emphasized that the statutory definition of the functional test of business income is conjunctive in that it required "the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations" to find business income. The court held that the pipeline was not disposed of as an integral part of Laurel's regular trade or business; therefore, the gain was nonbusiness income.

(3) The act of June 22, 2001, (P. L. 353, No. 23) (Act 23), made it clear through the amended definition of "business income" that the functional test of business income is disjunctive in that it merely requires that "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 income is business income.

(i) Therefore, although this type of disposition is not an integral part of taxpayer's regular trade or business, the gain or loss realized from the sale of any asset that was either acquired or managed as an integral part of the taxpayer's regular trade or business operations is business income.

(ii) In addition, Act 23 further provided that "business income . . . includes all income which is apportionable under the Constitution of the United States." As of March 25, 2006, no United States Supreme Court decision has addressed the imposition of a state corporate income tax relative to corporate liquidations.

(d) This section shall be effective immediately and apply to all open cases, tax settlements and appeals.

Source

The provisions of this § 170.3 adopted March 24, 2006, effective March 25, 2006, 36 Pa.B. 1403.

SALES APPORTIONMENT FACTOR

§ 170.11. Documentation requirements to establish out-of-State sales after *Gilmour Manufacturing* decision.

(a) In *Commonwealth v. Gilmour Manufacturing Corporation*, 573 Pa. 143, 822 A.2d 676 (2003), the Supreme Court held that for purposes of calculating its Pennsylvania sales apportionment factor for the Corporate Net Income Tax, a

Pennsylvania corporation is not required to include in the numerator sales of goods to out-of-State buyers who retrieve the goods at the seller's place of business in this Commonwealth and then transport the goods out of this Commonwealth. The Court determined that section 401(3)2(a)(16) of the Tax Reform Code (72 P. S. § 7401(3)2(a)(16)) mandated that conclusion with regard to the "dock sales," regardless of whether the buyer personally retrieves the item using his own means of transport or by engaging the services of a for-hire motor carrier. The Court ruled that the Department regulation on the subject, § 153.26(b)(2) (relating to sales factor), was inconsistent with the statutory requirement insofar as it required the inclusion of the sales in the numerator of the taxpayer's sales factor.

(b) The Court's holding excludes from the Pennsylvania portion of the apportionment factor only sales to out-of-State buyers who transport the goods out of this Commonwealth. Sales to purchasers who do not transport the goods outside of this Commonwealth for use or resale are Pennsylvania sales for purposes of calculating the sales factor numerator. Thus, in the absence of sufficient evidence establishing an ultimate destination to an out-of-State location, sales of goods in which delivery is made to the buyer at a Pennsylvania location must be reported as Pennsylvania sales and included in the numerator of the Pennsylvania sales apportionment fraction.

(c) 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 this Commonwealth.

(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.

(d) Documentation which will be deemed insufficient to establish that the ultimate destination of goods is to an out-of-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.

(e) Examples of documentation are as follows: A taxpayer sells plumbing fixtures to Company X, a New Jersey corporation which has retail stores in New Jersey and Pennsylvania.

(1) *Examples of sufficient documentation:*

Example 1. Company X uses a carrier to pick the goods up at A's warehouse in Pennsylvania. Company X provides documentation it procured from the carrier showing that the merchandise was delivered to X's warehouse in New Jersey.

Example 2. A taxpayer secures a copy of the delivery instructions from Company X to the carrier directing that the fixtures be taken to Company X's warehouse in New Jersey.

Example 3. Company X uses a carrier to pick up the merchandise. The taxpayer secures a copy of the bill of lading showing the fixtures were delivered to the New Jersey location.

(2) *Examples of insufficient documentation:*

Example 1. A taxpayer produces invoices submitted to Company X at its headquarters in New Jersey and a remittance letter accompanying the check from X's New Jersey headquarters.

Example 2. The same as Example 1, except the taxpayer provides an affidavit from its sales manager asserting that the merchandise sold to Corporation X was delivered to X's warehouse in New Jersey.

Source

The provisions of this § 170.111 adopted July 14, 2006, effective July 15, 2006, 36 Pa.B. 3673.

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