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Recent Developments in Pennsylvania Tax Law

*James A. Horchak**

TAX LAW — CONSTITUTIONAL LAW — PENNSYLVANIA REALTY TRANSFER TAXATION — The Pennsylvania Supreme Court held that the Pennsylvania realty transfer tax does not violate the Supremacy Clause nor the Equal Protection Clause of the United States Constitution, nor the Uniformity Clause of the Pennsylvania Constitution, where a non-exempt party is liable for realty transfer tax in a transaction entered into with a party who is tax-exempt.

Wilson Partners, L.P. v. Commonwealth, 737 A.2d 1215 (Pa. 1999) cert denied, 120 S. Ct. 1171 (Feb. 22, 2000) (No. 99-1076).

Wilson Partners, L.P. and Academic Properties, Inc. (collectively, the "Taxpayers") entered into separate, unrelated agreements with the Federal Deposit Insurance Corporation ("FDIC") for the purchase of various parcels of property located in Pennsylvania.¹ Pursuant to their respective agreements, the Taxpayers took title to property and, in accordance with the Pennsylvania Realty Transfer Act ("Act"), paid realty transfer tax of one-percent of the purchase price to the Department of Revenue.² The Taxpayers subsequently filed separate petitions with the Department of Revenue seeking full or partial refunds on the ground that imposition of the Act constitutes a violation of their rights under both the United States and Pennsylvania Constitutions.³ Specifically, the Taxpayers contended that the Act imposes an unequal tax burden upon nonexempt parties entering into taxable real estate transactions with tax-exempt parties.⁴ "According to [the] Taxpayers, such inequality resulted from the fact that a nonexempt party must bear exclusive liability to the Commonwealth for the taxes, whereas parties transacting with other nonexempt parties share the liability

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1. *Wilson Partners, L.P. v. Commonwealth*, 737 A.2d 1215, 1216 (Pa. 1999).

2. *Id.* at 1216-17; see also 72 PA. CONS. STAT. §§ 8101-C-8113-C (1982).

3. *Wilson Partners*, 737 A.2d at 1217.

4. *Id.*

to the Commonwealth jointly and severally.”⁵ The Taxpayers claimed that this inequality constituted discrimination in violation of the Supremacy Clause and the Equal Protection Clause of the United States Constitution, as well as the Uniformity Clause of the Pennsylvania Constitution.⁶ “The Department of Revenue denied the petitions, and the Board of Finance and Revenue affirmed.”⁷

On appeal, the Pennsylvania Commonwealth Court affirmed and entered judgment in favor of the Commonwealth.⁸ President Judge James Gardner Colins noted that the Act uniformly imposes a single tax upon all transfers, with liability for the full amount of the payment generally being shared jointly and severally among the parties to the transaction, and with the parties being free to discharge such liability in any agreed manner.⁹ Although the scheme imposes exclusive liability upon a party transacting with a tax-exempt entity, the commonwealth court rejected the Taxpayers’ claim that this results in either disparate treatment or inappropriate classification.¹⁰ The commonwealth court concluded that parties who transact with the United States or other tax-exempt parties simply are “no worse off” than parties who transact with nonexempt parties.¹¹ The commonwealth court also held that the Act conformed to principles of uniformity and equal protection

5. *Id.* “Taxpayers characterized this circumstance as ‘doubling’ their tax liability.” *Id.*

6. *Wilson Partners*, 737 A.2d at 1217. The Supremacy Clause requires that “[t]his Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.” U.S. CONST. art. VI, cl. 2. The Equal Protection Clause provides that “[n]o State shall make or enforce any law which shall . . . deny to any person within its jurisdiction the equal protection of the laws.” U.S. CONST. amend. XIV. The Uniformity Clause of the Pennsylvania Constitution provides that “[a]ll taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied and collected under the general laws.” PA. CONST. art. VIII, § 1.

7. *Wilson Partners*, 737 A.2d at 1217.

8. *Id.* *Wilson Partners, L.P. v. Commonwealth*, 723 A.2d 1079 (Pa. Commw. Ct. 1999).

9. *Wilson Partners*, 723 A.2d at 1082.

10. *Id.* at 1083; *see also Wilson Partners*, 737 A.2d at 1217.

11. *Id.* at 1084. The Commonwealth Court drew its conclusion based upon the following logic:

[c]ontrary to the Taxpayers’ contentions, the exempt status of one party to a real estate transfer transaction does not result in the other party paying twice the amount of tax otherwise owed by that party . . . both parties to a transaction are liable for the full amount of the transfer tax, and the classification of governmental parties as exempt does nothing to increase the liability of a nonexempt party. As a practical matter, in most taxable transfers the parties have apportioned the tax liability by agreement. Where the parties have not agreed to apportion the amount of the transfer tax, the liability inevitably falls upon the party that presents the instrument for recording; that party may then seek contribution from the other party.

Id. at 1083.

because any classification resulting under the Act rested upon a reasonable distinction between governmental and non-governmental parties to real estate transfer transactions.¹²

On appeal to the Pennsylvania Supreme Court, Justice Thomas G. Saylor, writing for the court, noted that the Act imposes a one-percent tax upon certain transfers of real estate property in the Commonwealth.¹³ Transfer tax liability is ordinarily shared jointly and severally among the parties.¹⁴ Where the United States or the Commonwealth are parties, they are exempt from the tax.¹⁵ In such instances, transfer tax liability rests exclusively upon the nonexempt party to the transaction, since the tax-exempt status of one party does not relieve the other party from liability for the full amount of the tax.¹⁶

The Taxpayers' first argument was that the Act discriminates against parties dealing with the federal government in violation of the Supremacy Clause.¹⁷ Justice Saylor examined the United States Supreme Court's decision in *Washington v. United States*.¹⁸ In *Washington*, the United States sought to invalidate a state statute which imposed a sales tax on construction materials used by

12. *Id.*

13. *Wilson Partners*, 737 A.2d at 1218. Specifically, the Pennsylvania Realty Transfer Act provides that:

[e]very person who makes, executes, delivers, accepts or presents for recording any document or in whose behalf any document is made, executed, delivered, accepted or presented for recording, shall be subject to pay for and in respect to the transaction or any part thereof, . . . a State tax at the rate of one per cent of the value of the real estate represented by such document, which State tax shall be payable at the earlier of the time the document is presented for recording or within thirty days of acceptance of such document

72 PA. CONS. STAT. § 8102-C (1982); *see also* 61 PA. CODE § 91.111(b) (2000). At the supreme court, attorneys Joseph C. Bright and Kevin J. Moody represented *Wilson Partners, L.P.* and *Academic Properties, Inc.*, and attorney Ronald H. Skubecz, from the Office of Attorney General, represented the Commonwealth of Pennsylvania. Attorney Jill M. Strouss represented the Pennsylvania Department of Revenue. *Id.* at 1216.

Justice Thomas G. Saylor wrote for a unanimous court, including Chief Justice John P. Flaherty, Jr. and Justices Stephen A. Zappala, Ralph J. Cappy, Ronald D. Castille, Russell M. Nigro, and Sandra Schultz Newman. *Id.* at 1216.

14. *Wilson Partners*, 737 A.2d at 1218. *See* 72 PA. CONS. STAT. § 8102-C (1982) and 61 PA. CODE § 91.111 (2000).

15. *Wilson Partners*, 737 A.2d at 1218. *See* 72 PA. CONS. STAT. § 8102-C.2 (1982) and 61 PA. CODE § 91.192 (2000). The federal exemption is consistent the federal government's immunity from state taxation. *See* *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819) (holding that the Bank of the United States was immune from a Maryland tax against it).

16. *Wilson Partners*, 737 A.2d at 1218. *See* 72 PA. CONS. STAT. § 8102-C.2 (1982) and 61 PA. CODE § 91.192 (2000).

17. *Wilson Partners*, 737 A.2d at 1218.

18. *Id.* *See* *Washington v. United States*, 460 U.S. 536 (1983).

owners of construction projects, but, in the case of a federal project, the owner was exempt and the contractor became primarily liable.¹⁹ The United States argued that, because contractors engaged in private construction projects were not directly subject to the sales tax, the statute discriminated against federal contractors in violation of the Supremacy Clause.²⁰ The Supreme Court focused on the economic burden of the tax upon transactions between the federal government and its contractors and not on the fact that federal contractors bore legal responsibility to the state for a tax that other contractors did not bear directly.²¹ The Supreme Court held that there was no discrimination when the state merely shifts the legal incidence of the tax in a non-discriminatory manner, provided that the transaction is subject to an equivalent rate of tax and the state does not deprive the parties of the opportunity to apportion the tax burden among themselves.²²

The Pennsylvania Supreme Court applied the principles from the *Washington* decision and found that the realty transfer tax rate of one-percent is equally applied to all transactions within the Commonwealth.²³ The supreme court further noted that the Act does not direct how the tax liability must be apportioned among the parties and specifically states that such determination is left to the parties.²⁴ Thus, the supreme court held that there is no discrimination when the Act merely removes liability from the federal government, as required by federal immunity from state taxation.²⁵

The Taxpayers' second argument was that the alleged unequal burden imposed by the Act results in a violation of principles of uniformity pursuant to the Pennsylvania Constitution and equal protection under the United States Constitutions.²⁶ Justice Saylor noted that "[i]t is well established that, in matters of taxation, the General Assembly possesses wide discretion, and a tax enactment will not be invalidated unless it 'clearly, palpably, and plainly violates the Constitution.'"²⁷ The supreme court noted that it is the

19. *Washington*, 460 U.S. at 538.

20. *Id.* at 541-41.

21. *Id.* at 544.

22. *Id.* at 544-45.

23. *Wilson Partners*, 737 A.2d at 1219-20.

24. *Id.* at 1220.

25. *Id.* See *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819).

26. *Wilson Partners*, 737 A.2d at 1219-20.

27. *Id.* See *Leonard v. Thornburgh*, 489 A.2d 1349, 1351 (Pa. 1985) (quoting

taxpayer's burden, when challenging a tax statute, to demonstrate that: first, the enactment results in some form of classification, and second, such classification is unreasonable, in that it is not rationally related to any legitimate state purpose.²⁸ Both the Equal Protection Clause of the United States Constitution and the Uniformity Clause of the Pennsylvania Constitution do not require absolute equality nor perfect uniformity in taxation, and any doubts as to the constitutionality of the statute are to be resolved in favor of upholding the statute.²⁹ The supreme court applied the *Washington* Court's rational with respect to the Supremacy Clause challenge to the Taxpayers' uniformity and equal protection challenges.³⁰ Justice Saylor affirmed the commonwealth court's judgment and held that "the taxing scheme under the Act is grounded in a rational basis, as it functions in a non-discriminatory manner to ensure that equal revenues will be collected for all non-excluded transfers of real estate occurring within the Commonwealth."³¹ On appeal, the United States Supreme Court denied certiorari.³²

TAX LAW — STATE IMMUNITY — LOCAL REAL ESTATE TAXATION — The Pennsylvania Supreme Court held that the Pennsylvania State University is not an agency of the Commonwealth, and, therefore, its medical center is subject to local real estate taxation.

Pennsylvania State University v. Derry Township School District, 731 A.2d 1272 (Pa. 1999).

The Pennsylvania State University ("PSU") is the owner and operator of the Milton S. Hershey Medical Center ("HMC") located in Derry Township, Dauphin County, Pennsylvania.³³ HMC encompasses PSU's medical school, dormitories, medical research facilities, and two hospitals.³⁴ In January of 1993, Derry Township School District and the County of Dauphin notified PSU that, as of

Commonwealth v. Life Assurance Co. of Pa., 214 A.2d 209, 214 (Pa. 1965), *appeal dismissed*, 384 U.S. 268 (1966)).

28. *Wilson Partners*, 737 A.2d at 1220. *See also Leonard*, 489 A.2d at 1352.

29. *Wilson Partners*, 737 A.2d at 1220. *See also Leonard*, 489 A.2d at 1351; and *Lee Hosp. v. Cambria County Bd. of Assessment Appeals*, 638 A.2d 344, 351 (Pa. Commw. Ct. 1994), *appeal discontinued*, 648 A.2d 791 (Pa. 1994).

30. *Id.*

31. *Id.* at 1221.

32. 120 S. Ct. 1171 (2000).

33. *Pennsylvania State Univ. v. Derry Township Sch. Dist.*, 731 A.2d 1272, 1273 (Pa. 1999).

34. *Id.*

January 1, 1993, the property of HMC would be subject to local real estate taxation.³⁵ Real estate bills were issued for the years 1993, 1994 and 1995.³⁶ "PSU filed an appeal with the Dauphin County Board of Assessment Appeals ("Board"); however, following hearings, the Board denied PSU's appeal and found the Hershey properties taxable."³⁷ On appeal the Dauphin County Court of Common Pleas reversed the Board's decision.³⁸ The Pennsylvania Commonwealth Court, affirming the court of common pleas decision, held that HMC was immune from real estate taxation on the basis that its owner, PSU, is an agency of the Commonwealth.³⁹

On appeal to the Pennsylvania Supreme Court, Chief Justice John P. Flaherty, Jr. noted that it is well established that real estate owned by the Commonwealth and agencies of the Commonwealth cannot be subject to taxation by political subdivisions absent express statutory authority.⁴⁰ The supreme court had to determine whether PSU is considered an agency of the Commonwealth.⁴¹ Chief Justice Flaherty examined factors that suggested that PSU is no longer considered an agency of the Commonwealth as it had been previously determined in 1939.⁴² PSU's principal means of revenue changed from primarily state and federal appropriations to that of student tuition.⁴³ In addition, the majority composition of

35. *Pennsylvania State Univ. v. Derry Township Sch. Dist.*, 711 A.2d 615, 616 (Pa. Commw. Ct. 1998).

36. *Pennsylvania State Univ.*, 731 A.2d at 1273.

37. *Pennsylvania State Univ.*, 711 A.2d at 616-17.

38. *Id.* at 617.

39. *Id.* Judge Rochelle S. Friedman held that PSU operates as an instrumentality of the Commonwealth, functioning as an integral part of Pennsylvania by carrying out the state's educational, research and public service missions and fulfilling the responsibilities that the Commonwealth has required it to assume. *Id.* at 620.

40. *Pennsylvania State Univ.*, 731 A.2d at 1273. See also Appeal of Bd. of Sch. Directors of Owen J. Roberts Sch. Dist., 457 A.2d 1264, 1265 (Pa. 1983). At the supreme court, attorneys James M. Horne and R. Mark Faulkner from State College represented Pennsylvania State University, attorney John W. Beatty from Erie represented Derry Township School District, attorney Kenneth D. Chestek from Erie represented the County of Dauphin, and attorney Carl G. Wass from Harrisburg represented Dauphin County Board of Assessment Appeals. *Pennsylvania State Univ.*, 731 A.2d at 1272-73.

41. Chief Justice John P. Flaherty, Jr. wrote the opinion for the court, joined by Justices Stephen A. Zappala, Ralph J. Cappy, Ronald D. Castille, Sandra Schultz Newman, and Thomas G. Saylor. Justice Russell M. Nigro concurred in the result. *Id.* at 1273, 1275.

42. *Id.*

43. *Id.* In *Pennsylvania State College v. County of Centre*, (No. 2 Equity November Term 1937, filed August 24, 1939), the Centre County Court of Common Pleas held that Pennsylvania State College, now PSU, was an agency of the Commonwealth.

43. *Id.* (quoting *Pennsylvania State Univ. v. County of Centre*, 615 A.2d 303, 306-07 (Pa. 1992)).

PSU's board of trustees is no longer public or governmental in nature as it had been in the past.⁴⁴ The supreme court found that without a governmental majority on the board of trustees the authority to control and dispose of PSU's property is not within the purview of the Commonwealth.⁴⁵ The supreme court reversed the commonwealth court's decision and held that because the Commonwealth does not control PSU's real property, PSU is not immune from local real estate taxation.⁴⁶ The case was remanded to the court of common pleas for a determination of whether HMC qualifies for exemption as an institution of purely public charity under the General County Assessment Law, title 72, section 5020-204(a)(3) of the Pennsylvania Consolidated Statutes.⁴⁷

TAX LAW — CONSTITUTIONAL LAW — PENNSYLVANIA SALES TAXATION — The Pennsylvania Supreme Court held that the Pennsylvania sales tax exemption for the sale of religious publications, Bibles, and religious articles violates the Establishment Clause of the United States Constitution.

Haller v. Commonwealth, 728 A.2d 351 (Pa. 1999) cert denied, 120 S. Ct. 325 (Oct. 12, 1999) (No. 99-154).

Felice Newman ("Newman") owns and operates Cleis Press, a publishing company located in Pittsburgh, Pennsylvania, whereby all of the books purchased by Newman are subject to the

44. *Id.* (quoting *Pennsylvania State Univ.*, 615 A.2d at 306-07). The board of trustees is composed of thirty-two members, only ten of whom are public officials. *Pennsylvania State Univ.*, 731 A.2d at 1275.

45. *Pennsylvania State Univ.*, 731 A.2d at 1273.

46. *Id.*

47. *Id.* Title 72, section 5020-204(a)(3) of the Pennsylvania Consolidated Statutes provides for an exemption from all county, city, borough, town, township, road, poor and school tax, to:

[a]ll hospitals, universities, colleges, seminaries, academies, associations and institutions of learning, benevolence, or charity, including fire and rescue stations, with the grounds thereto annexed and necessary for the occupancy and enjoyment of the same, founded, endowed, and maintained by public or private charity: Provided, That the entire revenue derived by the same be applied to the support and to increase the efficiency and facilities thereof, the repair and the necessary increase of grounds and buildings thereof, and for no other purpose: And provided further, That any charitable organization providing residential housing services in which the charitable nonprofit organization receives subsidies for at least ninety-five per centum of the residential housing units from a low-income Federal housing program shall remain a "purely public charity" and tax exempt provided that any surplus from such assistance or subsidy is monitored by the appropriate governmental agency and used solely to advance common charitable purposes within the charitable organization.

72 PA. CONS. STAT. § 5020-204(a)(3) (1982).

Pennsylvania sales tax.⁴⁸ Steve Zupcic ("Zupcic") purchased religious books and non-religious books from various stores in Pittsburgh, Pennsylvania.⁴⁹ Zupcic was not required to pay Pennsylvania sales tax on the purchase of a Bible but was required to pay sales tax on other religious and non-religious publications not published by a religious organization.⁵⁰ Pennsylvania sales tax does not apply to sales of religious publications, Bibles and other religious articles sold by religious groups.⁵¹ Newman and Zupcic filed this action in the Pennsylvania Commonwealth Court against the Pennsylvania Department of Revenue, seeking an injunction prohibiting enforcement of the sales tax exemption and a declaratory judgment that the exemption violates: (1) the Establishment Clause of the United States Constitution; (2) Article I, Section 3 of the Pennsylvania Constitution; (3) the Press Clause of the United States Constitution; and, (4) Article I, Section 7 of the Pennsylvania Constitution.⁵² The commonwealth court, en banc,

48. *Haller v. Commonwealth*, 693 A.2d 266, 267 (Pa. Commw. Ct. 1997).

49. *Haller*, 693 A.2d at 267.

50. *Id.*

51. Title 72, section 7204(28) of the Pennsylvania Consolidated Statutes provides that "the [sales] tax imposed by section 202 shall not be imposed upon the sale at retail or use of religious publications sold by religious groups and Bibles and religious articles." 72 PA. CONS. STAT. § 7204(28) (1982). Title 61, section 31.3(22) of the Pennsylvania Code provides that "the [sales] tax does not apply to . . . religious publications sold by religious groups. Sales or use of Bibles and religious articles are exempt." 61 PA. CODE § 31.3(22) (2000) (repealed 2000).

52. *Haller v. Commonwealth*, 728 A.2d 351, 352 (Pa. 1999). Henry Haller was also a plaintiff, but he was subsequently dismissed as a party by the commonwealth court for lack of standing. *Haller*, 693 A.2d at 267 n. 4.

The Establishment Clause of the First Amendment of the United States Constitution provides that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof . . ." U.S. CONST. amend. I.

Article 1, Section 3 of the Pennsylvania Constitution reads as follows:

All men have natural and indefeasible right to worship Almighty God according to the dictates of their own consciences; no man can of right be compelled to attend, erect or support any place of worship, or to maintain any ministry against his consent; no human authority can, in any case whatever, control or interfere with the rights of conscience, and no preference shall ever be given by law to any religious establishments or modes of worship.

PA. CONST. art. 1, § 3.

The Press Clause of the First Amendment of the United States Constitution provides that "Congress shall make no law . . . abridging the freedom of speech, or of the press . . ." U.S. CONST. amend. I.

Article 1, Section 7 of the Pennsylvania Constitution reads as follows:

The printing press shall be free to every person who may undertake to examine the proceedings of the Legislature or any branch of government, and no law shall ever be made to restrain the right thereof. The free communication of thoughts and opinions is one of the invaluable rights of man, and every citizen may freely speak, write and

held that the sales tax exemption violated the Establishment Clause of the United States Constitution and Article 1, Section 3 of the Pennsylvania Constitution for failure to serve a secular purpose since the sales tax exemption is based solely on the religious nature of the items sold or the entity selling them.⁵³

The Pennsylvania Supreme Court noted that according to the *Lemon* test, in order for a governmental action to survive an Establishment Clause challenge, the state must show that: (1) the action serves a secular purpose; (2) the action's principal or primary effect is one that neither advances nor inhibits religion; and (3) the action does not foster an excessive government entanglement with religion.⁵⁴ With respect to the first prong requiring that the exemption have a secular purpose, writing for the court, Justice Sandra Schultz Newman applied the breadth of coverage standard.⁵⁵ Under the breadth of coverage standard, if there is a determination that the Pennsylvania sales tax exemption was aimed at establishing, sponsoring or supporting religion or religious messages, then the exemption does not have a secular purpose.⁵⁶ If, on the other hand, there is a determination that the tax exemption's legitimate purpose was to contribute to the community's moral and intellectual diversity or encourage private

print on any subject, being responsible for the abuse of that liberty. No conviction shall be had in any prosecution for the publication of papers relating to the official conduct of officers or men in public capacity, or to any other matter proper for public investigation or information, where the fact that such publication was not maliciously or negligently made shall be established to the satisfaction of the jury; and in all indictments for libels the jury shall have the right to determine the law and the facts, under the direction of the court, as in other cases.

PA. CONST. art. 1, § 7.

53. *Haller*, 693 A.2d at 274. Judge James R. Kelley wrote the opinion for the commonwealth court. The commonwealth court did not make a ruling on the Press Clause argument.

54. *Haller*, 728 A.2d at 352. See *Lemon v. Kurtzman*, 403 U.S. 602 (1971) (holding that a Rhode Island statute that provided state supplemental payments to religious school teachers violated the Religious Clause of the First Amendment of the United States Constitution).

At the supreme court, attorneys David J. Millstein and Witold J. Walczak from Pittsburgh represented Felice Newman and Steve Zupcic. The Commonwealth of Revenue, Department of Revenue and Robert A. Judge, Sr., Secretary of the Department of Revenue, were represented by John G. Knorr, III, Chief Deputy Attorney General, and Gregory R. Neuhauser, Sr., Deputy Attorney General. *Haller*, 728 A.2d at 351.

Justice Sandra Schultz Newman wrote the opinion of the court, joined by Chief Justice John P. Flaherty, Jr., and Justices Stephen A. Zappala, Ralph J. Cappy, Ronald D. Castille, Russell M. Nigro, and Thomas G. Saylor. *Id.*

55. *Haller*, 728 A.2d at 354.

56. *Id.* See *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1, 12 (1989) (citing *Walz v. Tax Comm'n of New York*, 397 U.S. 664, 674 (1970)).

groups to undertake projects that advance the community's well-being that would otherwise have to be funded by tax revenues. then the exemption has a secular purpose.⁵⁷

The supreme court affirmed the commonwealth court's judgment and held that the Pennsylvania sales tax exemption pursuant to title 72, section 7204(28) of the Pennsylvania Consolidated Statutes violates the Establishment Clause of the United States.⁵⁸ The court noted that according to the breadth of coverage standard the exemption does not have a secular purpose.⁵⁹ In addition, the fact that the Commonwealth offers other sales tax exemptions for different purposes does not save section 7204(28) from violating the Establishment Clause.⁶⁰ On appeal, the United States Supreme Court denied certiorari.⁶¹

Subsequent to the Pennsylvania Supreme Court's holding, the Pennsylvania Department of Revenue amended title 61, section 31.1 of the Pennsylvania Code by deleting paragraph (22) relating to religious publications sold by religious groups.⁶²

TAX LAW — CONSTITUTIONAL LAW — PENNSYLVANIA CORPORATE TAXATION — The Pennsylvania Commonwealth Court held that the three-factor apportionment formula does not violate the Due Process Clause of the United States Constitution as applied to taxpayers with subsidiaries, but such taxpayers are entitled to statutory equitable relief under the special apportionment provision set forth in the Pennsylvania Tax Code.

Unisys Corporation v. Commonwealth, 726 A.2d 1096 (Pa. Commw. Ct. 1999).

57. *Haller*, 728 A.2d at 354. See *Texas Monthly, Inc.*, 489 U.S. at 12 (citing *Walz*, 397 U.S. at 674.)

58. *Haller*, 728 A.2d at 355.

59. *Id.* at 355-56. The court stated that it is not suggesting that the Establishment Clause prohibits the Pennsylvania legislature from exempting religious publications from taxation. *Id.* at 356. An exemption would pass Establishment Clause scrutiny if it benefits non-religious publications equally with religious publications and provides an overall secular purpose. *Id.*

60. *Id.* at 356. For example, caskets and brook trout are exempt from sales tax pursuant to title 72, sections 7204(31) and (42) of the Pennsylvania Consolidated Statutes. See title 72, sections 7204(1)-(57) of the Pennsylvania Consolidated Statutes for complete list of sales tax exclusions.

61. 120 S. Ct. 325 (1999).

62. 30 Pa. Bull. 1654 (2000). The Department of Revenue has authority to "prescribe, adopt, promulgate and enforce, rules and regulations relating to any matter or thing pertaining to the administration and enforcement of the provisions of this article, and the collection of taxes, penalties and interest imposed by this article" pursuant to title 72, section 7270 of the Pennsylvania Consolidated Statutes.

Unisys Corporation (“Unisys”) petitioned the Pennsylvania Commonwealth Court for review of three orders of the Pennsylvania Board of Finance and Revenue (“Board”), which affirmed the Pennsylvania Department of Revenue’s (“Department”) settlement of Unisys’ 1986 franchise tax return and its successor company Sperry Corporation’s 1985 and 1986 franchise tax returns.⁶³ The Pennsylvania franchise tax was designed to tax out-of-state corporations conducting business within Pennsylvania and is imposed on the capital stock value of the corporation.⁶⁴ In

63. *Unisys Corporation v. Commonwealth*, 726 A.2d 1096, 1098 (Pa. Commw. Ct. 1999). Unisys, a Delaware corporation with its principal office in Blue Bell, Pennsylvania, does business in all fifty states. *Id.* at 1099. Unisys owned, directly or indirectly, the stock of more than 100 domestic and foreign subsidiaries doing business in more than 100 countries around the world. *Id.*

Before the commonwealth court, attorney Joseph C. Bright from Philadelphia represented Unisys Corporation, and Kevin A. Moury, Senior Deputy Attorney General from Harrisburg, represented the Commonwealth of Pennsylvania. *Id.*

Judge Bonnie Brigance Leadbetter wrote the opinion for the commonwealth court, joined by President Judge James Gardner Colins, and Judges Doris A. Smith, Rochelle S. Friedman, and James J. Flaherty. *Id.* at 1098. Judge Joseph T. Doyle dissented without opinion. *Id.* at 1105. Judge Dante R. Pellegrini filed a dissenting opinion. *Id.* at 1105-08 (Pellegrini, J., dissenting).

64. *Id.* at 1098. Title 72, section 7602(b) of the Pennsylvania Consolidated Statutes provides that:

Every foreign entity from which a report is required under section 601 hereof, shall be subject to and pay to the department annually, a franchise tax which is the greater of (i) three hundred dollars (\$ 300) or (ii) the amount computed at the rates provided in subsection (h) upon each dollar of the capital stock value as defined in section 601(a), upon a taxable value to be determined in the following manner. The capital stock value shall be ascertained in the manner prescribed in section 601(a) of this article. The taxable value shall then be determined by employing the relevant apportionment factors set forth in Article IV: provided, that the manufacturing, processing, research and development exemptions contained under section 602(a) shall also apply to foreign corporations and in determining the relevant apportionment factors the numerator of the property, payroll, or sales factors shall not include any property, payroll or sales attributable to manufacturing, processing, research or development activities in the Commonwealth: and provided further that except for the imposition of the minimum tax set forth in this section, the provisions of this section shall not apply to the taxation of so much of the capital stock value attributable to student loan assets owned or held by an entity created for the securitization of student loans or by a trustee on its behalf. Any foreign corporation, joint-stock association, limited partnership or company subject to the tax prescribed herein may elect to compute and pay its tax under section 602(a): provided, that any foreign corporation, joint-stock association, limited partnership or company electing to compute and pay its tax under section 602(a) shall be treated as if it were a domestic corporation for the purpose of determining which of its assets are exempt from taxation and for the purpose of determining the proportion of the value of its capital stock which is subject to taxation. The provisions of this article shall apply to the taxation of entities organized for manufacturing, processing, research or development purposes, but shall not apply to such entities as enjoy and exercise the right of eminent domain.

calculating the franchise tax, the corporation must first determine its capital stock value by statutory formula based upon three amounts: (1) the corporation's net worth, (2) the net worth of any subsidiary of the reporting corporation, and (3) the corporation's average net income including dividends received from its subsidiaries.⁶⁵ The corporation must then determine taxable value by multiplying the capital stock value by the apportionment factor.⁶⁶

Because a state may not constitutionally tax a corporation's capital stock value earned outside of the Commonwealth, title 72, section 7602(b) of the Pennsylvania Consolidated Statutes provides corporations with two options of apportioning its capital stock value attributable to business activities conducted within the Commonwealth.⁶⁷ The first method is the single factor method, which is the ratio of the corporation's total real and certain tangible assets located within the Commonwealth over the corporation's total assets located everywhere.⁶⁸ The second method is the three-factor method.⁶⁹ The three-factor method is calculated by taking the average of three ratios: (1) property within Pennsylvania over total property everywhere, (2) payroll incurred in Pennsylvania over total payroll incurred everywhere, and (3) sales within Pennsylvania over total sales everywhere.⁷⁰ When calculating the three-factor apportionment factor it is the Department's practice to use only the reporting corporation's

72 PA. CONS. STAT. § 7602(b) (1982).

65. *Id.* 72 PA. CONS. STAT. § 7601(a) (1982); *see also* 61 PA. CODE §§ 155.26 and 155.27 (2000). Pursuant to title 61, sections 155.27(a) and (b) of the Pennsylvania Code, a corporation's net worth is calculated as follows:

(a) Net worth is the sum of the taxpayer's issued and outstanding capital stock, surplus and undivided profits as per books set forth on the income tax return filed by the taxpayer with the Federal government, or if no return is made, as would have been set forth had a return been made.

(b) In the case of a taxpayer which has investments in the common stock of another corporation, net worth is the consolidated net worth of the taxpayer computed in accordance with generally accepted accounting principles. Book value for investments of stock of other corporations includes original cost plus the investor's share of the investee's earnings or losses. For the purpose of this subsection, investments in the common stock of another corporation means investments which shall be accounted for using the equity method of accounting or which shall be consolidated under generally accepted accounting principles.

61 PA. CODE § 155.27(a) and (b) (2000).

66. *Unisys Corp.*, 726 A.2d at 1099.

67. *Id.*

68. *Id.* *See also* 72 PA. CONS. STAT. § 1896 (1982); 61 PA. CODE § 155.10 (2000).

69. *Unisys Corp.*, 726 A.2d at 1099.

70. *Unisys Corp.*, 726 A.2d at 1099; 72 PA. CONS. STAT. § 7602(b)(1) (1982).

property, payroll and sales and not the property, payroll and sales of any subsidiary of the reporting corporation.⁷¹ Thus, there is an inconsistency in the formula for calculating Pennsylvania franchise tax liability because capital stock value is determined on the consolidated group basis and the apportionment factor is determined using the activity of only the reporting corporation.⁷²

In the years at issue, with respect to the Pennsylvania franchise tax, Unisys reported average net income of the reporting corporation only, less dividend income from its subsidiaries.⁷³ In addition, Unisys reported capital stock value of the reporting corporation only and elected to apportion Pennsylvania operations using the three-factor method.⁷⁴ The Department, however, increased the amount reported by Unisys as average net income by adding dividend income from subsidiaries and also increased net worth to include the value of Unisys' subsidiaries.⁷⁵ The Department recalculated Unisys' three-factor apportionment factor to include the property, payroll, and sales of the reporting corporation only.⁷⁶

The Pennsylvania Commonwealth Court addressed the issue of whether the Commerce Clause and Due Process Clause of the United States Constitution required the Commonwealth to include in the three-factor apportionment factor the property, payroll and sales of the reporting corporation's subsidiaries and, if not, whether the Pennsylvania statutory scheme mandates administrative relief.⁷⁷ Judge Bonnie Brigance Leadbetter noted that the Commerce Clause prohibits a state from taxing value earned outside its borders.⁷⁸ Where earnings attributable to a particular state cannot be determined with precision, the Commonwealth may allocate such earnings using statutorily defined apportionment methods.⁷⁹

The Due Process Clause requires that the apportionment methods adopted by the states must be fair.⁸⁰ The commonwealth court stated that it becomes increasingly difficult to arrive at a precise apportionment method in situations where the reporting

71. *Unisys Corp.*, 726 A.2d at 1099.

72. *Id.*

73. *Id.* at 1100.

74. *Id.*

75. *Id.*

76. *Unisys Corp.*, 726 A.2d at 1100.

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

corporation is part of a multi-state or multi-national organization.⁸¹ Judge Leadbetter noted that the United States Supreme Court held in *Container Corp. of America v. Franchise Tax Board*⁸² that in instances where a taxpayer is part of a multi-jurisdictional organization, the taxable value and apportionment factor should be determined using the entire organization as a whole, also known as the unitary business enterprise.⁸³

Unisys first argued that applying the Department's apportionment method of only using the reporting corporation's property, payroll, and sales activity, and not the activity of the reporting corporation's subsidiaries, is fundamentally unfair and violates the Due Process Clause of the United States Constitution.⁸⁴ Unisys believed that the Due Process Clause mandates that in calculating taxable value a reporting corporation must multiply its consolidated capital stock value by its consolidated apportionment factor.⁸⁵ The commonwealth court then examined four United States Supreme Court cases where the apportionment factors of various state tax codes were challenged under the Due Process Clause. In *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*,⁸⁶ the Court held that the Due Process Clause was violated when there was a 264 percent difference between actual taxable income and apportioned taxable income.⁸⁷ The Court in *Norfolk & Western Ry. Co. v. Missouri State Tax Comm'n*⁸⁸ held that a 166 percent difference

81. *Unisys Corp.*, 726 A.2d at 1100.

82. 463 U.S. 159 (1983). The United States Supreme Court in *Container Corp.* noted that when the taxpayer is part of a multi-jurisdictional organization, the unitary business formula apportionment may be used. *Container Corp.*, 463 U.S. at 165. This method calculates local tax by defining the scope of the "unitary business" of which the taxpayer's activities in the state form one party, and apportioning the total income of that "unitary business" between the state and the rest of the world based on a formula taking into account objective measures of the taxpayer's activities within and without the state. *Id.* "A unitary business is one where there is some sharing or exchange of value not capable of precise identification or measurement which renders unitary business formula apportionment a reasonable method of taxation." *Id.*

83. *Unisys Corp.*, 726 A.2d at 1100.

84. *Id.* at 1101.

85. *Id.*

86. 283 U.S. 123 (1931). In *Hans Rees' Sons*, the taxpayer challenged the constitutionality of the North Carolina's single-factor apportionment method based entirely on ownership of tangible property. *Hans Rees' Sons*, 283 U.S. at 124. The taxpayer proved that under the apportionment factor, 80 percent of the taxpayer's income was subject to tax, while 22 percent of the taxpayer's income was actually generated in the state. *Id.* at 134.

87. *Unisys Corp.*, 726 A.2d at 1102.

88. 390 U.S. 317 (1968). In *Norfolk & Western Ry. Co.*, Missouri calculated the taxpayer's tax by multiplying the ratio derived from taking the number of miles of track within the state divided by the total number of track miles in the United States times the

between the taxable value calculated by the state and the actual taxable value violates the Due Process Clause.⁸⁹ The Court in *Container Corp.* concluded that a fourteen-percent difference between the taxable value using state apportionment factors and the taxpayer's calculated value was not unfair as to violate the Due Process Clause.⁹⁰ Finally, in *Moorman Mfg. Co. v. Bair*,⁹¹ the court held that a forty-eight percent difference was not unfair.⁹²

The commonwealth court concluded that Unisys did not demonstrate a due process violation.⁹³ Unisys claimed that if the unitary business formula was used, its tax liability would be forty-five percent less than the tax calculated by the Department.⁹⁴ The commonwealth court held that a forty-five percent disparity is not ungrossly unfair as to constitute a violation of the Due Process Clause.⁹⁵

Unisys next argued that it was entitled to statutory equitable relief under the special apportionment provision set forth in title 72, section 7401(3)2.(a)(18) of the Pennsylvania Consolidated Statutes ("Subsection (18)").⁹⁶ The Department claimed that Subsection (18) was not applicable to Unisys' situation because it

total value of all the taxpayer's rolling stock. *Norfolk & Western Ry. Co.*, 390 U.S. at 320. The taxpayer was able to offer proof that the actual value of the rolling stock located within the state was three percent, while the track mile apportionment method calculated taxable value of eight percent. *Id.* at 324.

89. *Unisys Corp.*, 726 A.2d at 1102-03.

90. *Id.* at 1103. The taxpayer in *Container Corp.* argued that the application of the three-factor apportionment method was not accurate because the formula utilizes indirect measures of income, i.e., property, payroll and sales.) *Container Corp.*, 463 U.S. at 181.

91. 437 U.S. 267 (1978). In *Moorman Mfg. Co.*, Iowa authorized the use of the single-factor method and not the use of the three-factor method. *Moorman Mfg. Co.*, 437 U.S. at 275. The taxpayer argued its taxes would decrease utilizing the three-factor method. *Id.*

92. *Unisys Corp.*, 726 A.2d at 1103.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* Title 72, section 7401(3)2.(a)(18) of the Pennsylvania Consolidated Statutes provides that:

If the allocation and apportionment provisions of this definition do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition the Secretary of Revenue or the Secretary may require, in respect to all or any part of the taxpayer's business activity: (A) separate accounting; (B) the exclusion of any one or more of the factors; (C) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (D) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. In determining the fairness of any allocation or apportionment, the Secretary of Revenue may give consideration to the taxpayer's previous reporting and its consistency with the requested relief.

72 PA. CONS. STAT. § 7401(3)2.(a)(18) (1982).

is only to be used in "quirky," nonrecurring situations, and to avoid constitutional infractions.⁹⁷ The commonwealth court held that Subsection (18) was applicable to Unisys' situation and that the Department abused its discretion in refusing to adjust Unisys' allocation share under Subsection (18).⁹⁸ Judge Leadbetter noted that although a forty-five percent variance in tax due does not violate the Due Process Clause, it does, however, require relief under Subsection (18).⁹⁹

Judge Joseph T. Doyle dissented without opinion. Judge Dante R. Pellegrini dissented, agreeing with the majority that there was no Due Process Clause violation, but disagreeing that Subsection (18) required the Department to afford relief.¹⁰⁰ Judge Pellegrini stated that Subsection (18) only requires relief where the disparity is unconstitutional, and not where the disparity is something less than unconstitutional.¹⁰¹

97. *Unisys Corp.*, 726 A.2d at 1104.

98. *Id.*

99. *Id.* at 1105.

100. *Id.* (Pellegrini, J., dissenting). Judge Pellegrini was of the opinion that a forty-five percent disparity is not unfair. *Id.* at 1107 (Pellegrini, J., dissenting).

101. *Id.* (Pellegrini, J., dissenting). Judge Pellegrini stated that Subsection (18) applies in situations where the apportionment is unfair, unconstitutional, and does not fairly represent the taxpayer's actual business activity in the Commonwealth. *Id.* at 1108 (Pellegrini, J., dissenting).