

PENNSYLVANIA STATE BUDGET: CHANGES TO CAPITAL STOCK/FOREIGN FRANCHISE TAX AND CORPORATE NET INCOME TAX FOR FISCAL YEAR 2009-2010

On October 9, Governor Edward G. Rendell signed into law House Bill 1531 (“Act 48”) as part of Pennsylvania’s 2009-2010 budget process. Act 48 includes, among other things, several business tax changes that affect both the capital stock – foreign franchise tax and the corporate net income tax.

The capital stock tax is a property tax applicable to all domestic corporations (i.e. those incorporated in Pennsylvania). The foreign franchise tax is a tax upon the privilege of foreign corporations (i.e. those incorporated outside of Pennsylvania) to conduct business in Pennsylvania. Both taxes are computed based upon the capital stock value of the corporation.

“Capital stock value” is determined by using the following statutory formula: the product of 1/2 the sum of the five year average net income capitalized at the rate of 9.5% plus 75% of net worth, from which product shall be subtracted \$150,000 or, expressed algebraically, $(.5 (\text{average net income}/.095 + (.75)(\text{net worth}))) - \$150,000$. Act 48 increases the valuation deduction from \$150,000 to \$160,000 or, expressed algebraically, $(.5 (\text{average net income}/.095 + (.75)(\text{net worth}))) - \$160,000$.

While the capital stock – foreign franchise tax has been subject to a gradual phase out, Act 48 extends the period of time for the phase out and increases the applicable tax rates during the phase out. Previously, the rates had been reduced to 2.89 mills (.00289) for

tax years beginning during 2008; 1.89 mills (.00189) for tax years beginning during 2009; and 0.89 mills (.00089) for tax years beginning during 2010. The capital stock and franchise tax would be repealed for tax years beginning during 2011. However, Act 48 changes these rates as follows: 2.89 mills (.00289) for tax years beginning during 2008 through 2011; 1.89 mills (.00189) for tax years beginning during 2012; and 0.89 mills (.00089) for tax years beginning during 2013. The capital stock and franchise tax will be repealed for tax years beginning during 2014.

The corporate net income tax is imposed upon corporations, joint stock associations, business trusts, limited liability companies and other entities that are treated as corporations for federal income tax purposes at a flat rate of 9.99%. The following privileges are subject to the tax: doing business in Pennsylvania; carrying on activities in Pennsylvania; having capital or property employed or used in Pennsylvania or owning property in Pennsylvania. Taxable income for purposes of the tax is federal taxable income before net operating loss and special deductions with Pennsylvania modifications. In addition, Pennsylvania allows a limited net operating loss deduction. For taxable years beginning after December 31, 2006, the loss is limited to the greater of 12.5% or \$3,000,000. Act 48 increased the net operating loss deductions as follows: for taxable years

(continued on page 2)

(continued from page 1)

beginning after December 31, 2008, the loss is limited to the greater of 15% or \$3,000,000 and for taxable years beginning after December 31, 2009, the loss is limited to the greater of 20% or \$3,000,000. All of the net operating loss deduction limits above are applied after modifications and apportionment.

If a taxpayer is subject to a corporate net income tax in other states, the taxpayer is permitted to apportion business income between Pennsylvania and the other state(s). Pennsylvania generally provides for a three-factor apportionment formula, the factors being property, payroll and sales. For taxable years beginning after December 31, 2006, the apportionment percentages have been weighted: sales - 70%, payroll - 15%, and property - 15%. Act 48 changes the apportionment as follows: for taxable years beginning after December 31, 2008, the apportionment percentages are: sales - 83%, payroll - 8.5%, and property - 8.5%, and for taxable years beginning after December 31, 2009, the apportionment percentages will be: sales - 90%, payroll - 5% and property - 5%. Act 48 did not change the apportionment percentages with respect to the capital stock - foreign franchise tax, which remain equally weighted at 1/3 each. ♦

This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking legal action.

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