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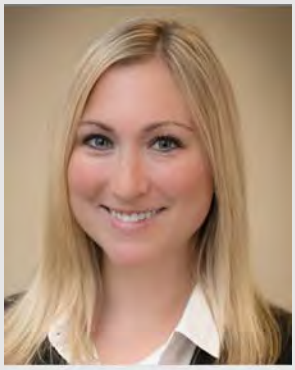

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In this installment of Pennsylvania's SALT Shaker, Karpchuk discusses *Synthes v. Commonwealth of Pennsylvania*.

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If state and local tax cases were films, *Synthes USA HQ Inc. v. Commonwealth of Pennsylvania*[1] would certainly be a drama — pitting parties from the same side against each other in a contentious battle over . . . the correct interpretation of a statute. Before 2014, Pennsylvania law required receipts from services to be sourced based on the location of the "income-producing activity." If the income-producing activity occurred both within Pennsylvania and outside Pennsylvania, receipts were sourced to the state where the greater portion of income-producing activities occurred, based on costs of performance (COP).[2] Thus, before 2014, Pennsylvania employed a traditional COP sourcing statute for apportioning sales from services. During 2014, Pennsylvania enacted market-based sourcing for services but maintained COP sourcing for sales of intangibles.

Despite the legislative change that, to many practitioners and taxpayers alike, seemed to signal a clear change from COP to market-based sourcing, the Pennsylvania Department of Revenue continued to issue assessments for COP years, applying a market-based sourcing interpretation. The DOR's rationale was that the location of the income-producing activity was the location where the benefit was received; that is, the location of the customer. Thus, the DOR interpreted the COP statute to reach a market-based-sourcing result. For years, taxpayers challenged the DOR's interpretation, but all those cases reached settlement agreements, thereby eliminating the need for litigation and providing no case law on the issue. Then, along came *Synthes*.

Synthes was a Pennsylvania-based company that originally filed its returns and paid tax based on a standard COP interpretation of the statute. Then, based on the DOR's interpretation of the statute, Synthes sought a refund of tax paid during a COP year — seeking to source its receipts to the location of its customers, and therefore outside Pennsylvania. Notably, the taxpayer did not argue that the DOR was correctly interpreting the statute. Instead, the taxpayer argued that it was entitled to the benefit of the DOR's interpretation.

In Pennsylvania, state tax cases appealed from the board levels are sent to Commonwealth Court, where the Office of Attorney General represents the commonwealth — with the DOR acting as its client. At Commonwealth Court, all parties agreed that Synthes had established its entitlement to the refund *if* the department's interpretation of the statute was correct. This procedural posture put the attorney general in the untenable position of defending against the

[1] No. 108 F.R. 2016, 07/24/2020.

[2] *See* 72 P.S. section 7401(3)2.(a)(17).

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taxpayer's refund claim and, therefore, the DOR's interpretation of the statute. In so doing, the DOR then sought to intervene, arguing that its interests were not being represented by the attorney general. At oral argument, the attorney general's office was bombarded with questions regarding its position, which ran counter to its client's — that is, the DOR. This circus seemed to irritate the court and distracted from the actual substantive tax issue presented.

In upholding the DOR's interpretation of the statute, the court found that the statute was ambiguous because it did not define "costs of performance" or "income-producing activity." In addition to finding that the terms were ambiguous, the court further opined that both the attorney general's interpretation (which is also many out-of-state taxpayers' interpretation) and the department's interpretation were both "facially reasonable." Ultimately, the court deferred to the DOR's interpretation since it is the "agency charged with interpretation and enforcement responsibilities with respect to the [COP] statute." Thus, the court agreed that the income-producing activity occurs where the customer receives the benefit of the taxpayer's service.

The court's decision raises a number of concerns. As a general rule, the best indication of legislative intent is the plain language of the statute. In construing the language of a statute, "words and phrases are to be construed according to rules of grammar and according to their common and approved usage."[3] Income producing activity and COP are tied together in the statute; one must look to where the greater proportion of income-producing activity occurred, based on costs of performance. "Costs of performance" is not a specifically defined term, but there are several factors that suggest it does not require its own definition. Since it is not a defined term, based on the rules of statutory construction, it should be given its literal meaning. Costs are the expenses incurred; "of performance" is self-defined. As such, the definition should be: the expenses incurred to perform the services. Because this definition becomes so circular, it is not surprising that the term is not defined.

Further, there is certainly a common usage and understanding of what "costs of performance" means, and to claim that the term is ambiguous ignores the history of the Pennsylvania statute and of the Uniform Division of Income for Tax Purposes Act. COP is a concept that has been around for decades and was originally promulgated by the Uniform Law Commission in 1957 as part of UDITPA. While Pennsylvania did not formally adopt UDITPA, in 1971 it did adopt the exact COP language from UDITPA. Since the promulgation of UDITPA and the Pennsylvania legislature's adoption of the COP statute in 1971, the economy has shifted from a manufacturing-based to a service-based economy, with customers increasingly located outside the state where the COP occurs.

During 2014 the Multistate Tax Commission amended the MTC compact and recommended that states adopt market-based sourcing instead of COP. COP and market-based sourcing are two fundamentally distinct concepts; market-based sourcing did not start gaining favor and becoming widely implemented by states until the 2000s. Unless the Pennsylvania legislature in 1971 had a crystal ball, in adopting standard COP language in the statute, it could not have intended to adopt market-based sourcing to deal with an issue and an economy that did not exist at the time. Thus, looking at the history, the court's conclusion that the terms were ambiguous is dubious.

As the economy shifted and states moved toward market-based sourcing, it is understandable that the DOR also desired to change with the times and adopt sourcing that reflected the 21st century. Yet such changes are properly and solely within the control of the legislature — a legislature that expressly chose to address the issue in 2013. Instead, in allowing broad deference to the department, the court in *Synthes* allowed the DOR to alter the intent of a statute written in 1971 when the understanding at the time most certainly did not reflect the diverse service-based economy we have today.

Arguably the most telling fact in opposition to the DOR's interpretation was the 2014 legislative change, which the attorney general argued effectuated the legislature's intent to change the

[3] 1 Pa.C.S. section 1903(a).

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law from a standard COP analysis to market-based sourcing. In disagreeing with the attorney general, the majority opinion claimed that the legislative change "clarified, rather than altered, the application of the benefits-received method the Department was already applying and enforcing." Yet, as the *Synthes* dissent points out, in its 2014 amendment, the legislature left subparagraph 17 (the COP language) fully intact and added subparagraph 16.1, the new market-based sourcing section for services.

The legislature's failure to alter subparagraph 17:

> demonstrates a legislative intent to alter the calculation of [corporate net income tax] for income received for the sale of services from the costs-of-performance method to the benefits-received method by specifically adding this provision to the Tax Code, and by specifically excepting the application of Subparagraph 17 to income within the ambit of Subparagraph 16.1.[4]

Further, if both portions of the statute mean the same thing — as the DOR's interpretation suggests — that would render subparagraph 16.1 and subparagraph 17 redundant. It is undoubtedly the law that the legislature does not intend an absurd or unreasonable result.[5]

In looking at the statute, the court explained that:

> [w]hen the legislature amends a statute that has been the subject of a longstanding administrative interpretation, but does not revise or repeal the agency's interpretation, this is evidence that the legislature has acquiesced in the interpretation and that the interpretation is, in fact, the one the legislature intended.

Yet, there was nothing for the legislature to repeal — the DOR had never issued formal guidance regarding its interpretation. In fact, there is nothing in the legislative record to indicate that the legislature was aware of the issue with the department's interpretation during 2013 when it amended the statute. Instead, evidence points to the fact that the legislature understood the statute to mean standard COP.[6]

Further, the idea that the DOR's position was "longstanding" is questionable, at best. In 2004, then-Gov. Ed Rendell created the Pennsylvania Business Tax Reform Commission to review Pennsylvania's tax structure and recommend changes. Recommendation 16 of the commission's report provides:

> Like most states, Pennsylvania assigns sales of particular services to the state in which the largest share of the costs were incurred to produce the service. This contrasts with the sales factor for the sale of tangible personal property that assigns sales to each state where the output is delivered.[7]

The court deferred to the DOR based on its long-standing interpretation of the statute — and yet, as of 2004, that was clearly not the common understanding of Pennsylvania's COP statute.

As previously mentioned, the DOR never provided notice of its interpretation in a regulation or formal policy statement. Most taxpayers became aware of the department's interpretation only on audit when, after filing based on the standard COP method, they were hit with an assessment based on the department's "benefit received" interpretation. The court's deference to the DOR's unpublished internal interpretation creates substantial due process concerns. With the court's extreme deference to the DOR's unpublished interpretation in spite of the legislative history, it is concerning what other unpublished positions the DOR may take and the court may uphold. Further, the DOR is now in a position of benefiting from its unpublished interpretation, having audited and assessed a number of taxpayers based on a "benefits

[4] *Synthes USA HQ Inc. v. Commonwealth of Pennsylvania*, No. 108 F.R. 2016, 07/24/2020 (Wojcik, J., dissenting).

[5] 1 Pa.C.S. section 1922.

[6] "Under current tax law, the point of taxation is presumed to be the base of operations, usually the headquarters, of the entity being taxed. Under market sourcing, the nexus or taxable event is moved to the location where the service is delivered. The underlying goal of market sourcing is to lure service-providing entities into Pennsylvania." Pa. Legislative Journal — House Remarks on H.B. 440, at 756 (Apr. 24, 2013) (Denlinger).

[7] Pa. Dept. of Rev., "Pennsylvania Business Tax Reform Commission Report" (Nov. 30, 2004).

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received" interpretation, while concomitantly not having to issue refunds to those taxpayers who would have benefited from the department's unpublished interpretation since — for services — such refund requests for COP years are barred by the statute of limitations.

There are still cases pending at the Commonwealth Court in which taxpayers are challenging the DOR's COP interpretation. If *Synthes* is not appealed, it is still likely that other taxpayers waiting in the pipeline will continue to challenge the department's position and, from an adverse Commonwealth Court decision, appeal the issue to the Pennsylvania Supreme Court. Notably, the COP statute still applies to sales of intangibles. Thus, out-of-state taxpayers in particular should be aware of the department's interpretation when conducting business in Pennsylvania. Moreover, Pennsylvania taxpayers with sales of intangibles out of state should review their sourcing and consider whether there is a refund opportunity as a result of the Commonwealth Court's decision upholding the DOR's interpretation of the statute. ■

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