

12/16/96

Regulatory Analysis Form

This space for use by IRRC

(1) Agency

Revenue

(2) I.D. Number (Governor's Office Use)

15-381

McKinley

IRRC Number: 1882

(3) Short Title

Definitions; Net Profits and Regulated Investment Companies

(4) PA Code Cite

61 Pa. Code §§ 101.1, 103.12 and 155.30

(5) Agency Contacts & Telephone Numbers

Primary Contact: Anita M. Doucette (717) 787-1382

Secondary Contact: Douglas A. Berguson (717) 787-1382

(6) Type of Rulemaking (check one)

- Proposed Rulemaking
- Final Order Adopting Regulation
- Final Order, Proposed Rulemaking Omitted

(7) Is a 120-Day Emergency Certification Attached?

- No
- Yes: By the Attorney General
- Yes: By the Governor

(8) Briefly explain the regulation in clear and nontechnical language.

Section 101.1 (relating to definitions) is being amended by replacing the existing definitions of "employee" and "employer" with new definitions consistent with the requirements of Act 110 of 1989 (72 P.S. § 7301(g) and (h)). The definition of "income" is being expanded to implement the provisions of section 602(f)(2)(A) of the TRC (72 P.S. § 7602(f)(2)(A)) also to reflect holdings in Morgan v. Commonwealth, 400 A.2d 1384 (Pa. Cmwlth. 1979) and Wettach v. Commonwealth, 620 A.2d 730 (Pa. Cmwlth. 1993). Section 103.12 (relating to net profits) is also being amended to reflect Morgan and Wettach. The definition of "personal income tax income" set forth in § 155.30(b)(4) (relating to regulated investment companies) is being amended to provide that the term means income computed in the same manner and on the same basis as the income of an individual under Article V. Personal Income Tax.

(9) State the statutory authority for the regulation and any relevant state or federal court decisions.

Statutory authority for the regulation is contained in sections 3 §§ 7354 and 7408).

PROPOSED

IRRC #	1882
PAB	8/30/97
CPC	9/29/97
CRD	10/29/97
MONITOR	McGINLEY
ANALYST	CAT
SUPPORT	WBL

Cindy 8/21

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(10) Is the regulation mandated by any federal or state law or court order, or federal regulation? If yes, cite the specific law, case or regulation, and any deadlines for action.

The regulation is not mandated by federal or state law, court order, or federal regulation.

(11) Explain the compelling public interest that justifies the regulation. What is the problem it addresses?

The regulation will bring existing regulations into conformity with the laws of this Commonwealth and make them consistent with current Federal requirements. It will also provide a concise and nontechnical definition of "income" and "net profits" that will help business owners, investors, tax practitioners and regulated investment companies properly classify and compute their income, losses and deductions.

(12) State the public health, safety, environmental or general welfare risks associated with nonregulation.

There are no public health, safety, environmental or general welfare risks associated with nonregulation.

(13) Describe who will benefit from the regulation. (Quantify the benefits as completely as possible and approximate the number of people who will benefit.)

One of the most common questions and concerns is "Am I subject to Pennsylvania withholding requirements even though I am not subject to Federal requirements (and vice-versa)?" This regulation will benefit pension and profit-sharing trusts, persons who hire home workers or domestics, and many others who are not required to withhold Federal income tax from "wages." The income definitions will benefit business owners, investors, tax practitioners and regulated investment companies who or that are required to classify and compute their income, losses and deductions by helping them to avoid interest and penalty charges and minimize costs of litigation.

Regulatory Analysis Form

(14) Describe who will be adversely affected by the regulation. (Quantify the adverse effects as completely as possible and approximate the number of people who will be adversely affected.)

No parties should be adversely affected by the regulation.

(15) List the persons, groups or entities that will be required to comply with the regulation. (Approximate the number of people who will be required to comply.)

Regulated investment companies that are subject to the capital stock/foreign franchise tax and business owners, investors and tax practitioners will be required to comply with the regulation.

(16) Describe the communications with and input from the public in the development and drafting of the regulation. List the persons and/or groups who were involved, if applicable.

A copy of the regulation was forwarded to the Pennsylvania Bar Association; the Pennsylvania Institute of Certified Public Accountants and the Pennsylvania Chamber of Business and Industry. The regulation was listed in the Department's Agenda of Regulations published at 26 Pa.B. 3170 (July 6, 1996) and was forwarded to interested parties upon request.

(17) Provide a specific estimate of the costs and/or savings to the regulated community associated with compliance, including any legal, accounting or consulting procedures which may be required.

No additional cost can be associated with compliance.

Regulatory Analysis Form

(18) Provide a specific estimate of the costs and/or savings to local governments associated with compliance, including any legal, accounting or consulting procedures which may be required.

This regulation does not increase costs or savings to local governments. No legal, accounting or consultant procedures are required by the regulation.

(19) Provide a specific estimate of the costs and/or savings to state government associated with the implementation of the regulation, including any legal, accounting, or consulting procedures which may be required.

This regulation does not increase costs or savings to state government. No legal, accounting or consultant procedures are required by the regulation.

Regulatory Analysis Form

(20) In the table below, provide an estimate of the fiscal savings and costs associated with implementation and compliance for the regulated community, local government, and state government for the current year and five subsequent years.

	Current FY Year	FY +1 Year	FY +2 Year	FY +3 Year	FY +4 Year	FY +5 Year
SAVINGS:	\$	\$	\$	\$	\$	\$
Regulated Community						
Local Government						
State Government						
Total Savings	N/A					
COSTS:						
Regulated Community						
Local Government						
State Government						
Total Costs	N/A					
REVENUE LOSSES:						
Regulated Community						
Local Government						
State Government						
Total Revenue Losses	N/A					

(20a) Explain how the cost estimates listed above were derived.

N/A

Regulatory Analysis Form

(20b) Provide the past three year expenditure history for programs affected by the regulation.

Program	FY -3	FY -2	FY -1	Current FY
N/A	N/A	N/A	N/A	N/A

(21) Using the cost-benefit information provided above, explain how the benefits of the regulation outweigh the adverse effects and costs.

There are no adverse effects or costs.

(22) Describe the nonregulatory alternatives considered and the costs associated with those alternatives. Provide the reasons for their dismissal.

There are no nonregulatory alternatives associated with the regulation.

(23) Describe alternative regulatory schemes considered and the costs associated with those schemes. Provide the reasons for their dismissal.

There are no alternative regulatory schemes associated with the regulation.

Regulatory Analysis Form

(24) Are there any provisions that are more stringent than federal standards? If yes, identify the specific provisions and the compelling Pennsylvania interest that demands stronger regulation.

Federal standards are made applicable for withholding tax purposes. The other provisions vary from Federal standards because Article III of the Tax Reform Code incorporates only a handful of Federal income tax provisions.

(25) How does this regulation compare with those of other states? Will the regulation put Pennsylvania at a competitive disadvantage with other states?

Article III of the Tax Reform Code, as originally enacted, was consistent with the Federal income and the tax laws of almost every other state that imposes an income tax. That tax was declared unconstitutional in 1971 by the Pennsylvania Supreme Court. Notwithstanding the fact that it adopts only a handful of Federal income tax provisions, the current law with its low, fixed rate and limited deductions and exemptions is considered by many to be preferable.

(26) Will the regulation affect existing or proposed regulations of the promulgating agency or other state agencies? If yes, explain and provide specific citations.

This regulation does not affect any other existing or proposed regulations of the Department or any other state agencies.

(27) Will any public hearings or informational meetings be scheduled? Please provide the dates, times, and locations, if available.

The regulation will be presented to the House and Senate Finance Committees and the Independent Regulatory Review Commission. The Committees may hold public hearings or informational meetings to consider the regulation. The date, time and location of such hearings or meetings can be ascertained by contacting the Committee. The Commission may hold informational meetings to consider the regulation. The date, time and location of such meetings can be ascertained by contacting the Commission.

At the same time the regulation is presented to the Committees and the Commission, the regulation will be published in the Pennsylvania Bulletin and the public will be invited to comment.

Regulatory Analysis Form

(28) Will the regulation change existing reporting, record keeping, or other paperwork requirements? Describe the changes and attach copies of forms or reports which will be required as a result of implementation, if available.

The regulation will not change existing reporting, record keeping, or other paperwork requirements.

(29) Please list any special provisions which have been developed to meet the particular needs of affected groups or persons including, but not limited to, minorities, elderly, small businesses, and farmers.

No special groups are affected by the regulation.

(30) What is the anticipated effective date of the regulation; the date by which compliance with the regulation will be required; and the date by which any required permits, licenses or other approvals must be obtained?

This regulation will be effective upon final publication in the Pennsylvania Bulletin. Compliance with the regulation is required upon publication. There are no permits, licenses or other approvals required by this regulation.

(31) Provide the schedule for continual review of the regulation.

This regulation is scheduled for review within five years of final publication. No sunset date has been assigned.

FACE SHEET
FOR FILING DOCUMENTS
WITH THE LEGISLATIVE REFERENCE BUREAU

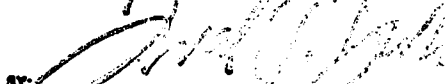
(Pursuant to Commonwealth Documents Law)

RECEIVED
LEGISLATIVE REFERENCE BUREAU
JUL 22 1997

DO NOT WRITE IN THIS SPACE

12/16/96

Copy below is hereby approved, as to form and legality, Attorney General

BY: 

(DEPUTY ATTORNEY GENERAL)

JUL 22 1997

DATE OF APPROVAL

Check if applicable
Copy not approved. Objections attached.

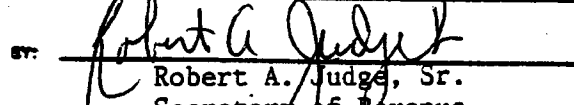
Copy below is hereby certified to be a true and correct copy of a document issued, prescribed or promulgated by:

Department of Revenue

(AGENCY)

DOCUMENT/FISCAL NOTE NO. 15-381

DATE OF ADOPTION: _____

BY: 

Robert A. Judge, Sr.

TITLE: Secretary of Revenue
(EXECUTIVE OFFICER, CHAIRMAN OR SECRETARY)

Copy below is hereby approved as to form and legality, Executive or Independent Agency

BY: 

(Deputy General Counsel)
(Chief Counsel, Independent Agency)
(Strike inapplicable title)

7/2/97
DATE OF APPROVAL

Check if applicable. No Attorney General approval or objection within 3 days after submission.

NOTICE OF PROPOSED RULEMAKING

DEPARTMENT OF REVENUE

61 Pa. Code §§ 101.1, 103.12 and 155.30

Personal Income and Corporate Taxes

Definitions; Net Profits and Regulated Investment Companies

PREAMBLE

Notice is hereby given that the Department of Revenue, under authority contained in sections 354, 408, and 603 of the Tax Reform Code of 1971 (Code) (72 P.S. §§ 7354, 7408, and 7603), proposes amendments to 61 Pa. Code by amending Chapter 101. General Provisions, section 101.1 (relating to definitions), Chapter 103. Imposition and Determination of Tax, section 103.12 (relating to net profits) and Chapter 155. Capital Stock Tax and Foreign Franchise Tax, section 155.30 (relating to regulated investment companies), as set forth in Annex A.

Explanation of Regulatory Requirements

Section 101.1 (relating to definitions) is being amended by replacing the existing definitions of "employee" and "employer" with new definitions consistent with the requirements of Act 110 of 1989 (72 P.S. § 7301(g) and (h)).

The definition of "income" is being expanded to implement the provisions of Section 602(f)(2)(A) of the Tax Reform Code (72 P.S. § 7602(f)(2)(A)) and to reflect the holdings of the Commonwealth Court in Morgan v. Commonwealth, 400 A.2d 1384 (Pa. Cmwlth. 1979) and Wettach v. Commonwealth, 620 A.2d 730 (Pa. Cmwlth. 1993). The revisions provide that the term "income" includes income received by a taxpayer directly or through partnerships, associations, Pennsylvania S corporations or estates or trusts. The revisions also specify that:

(1) The taxable income of a partnership or Pennsylvania S corporation is to be computed in the same way and on the same basis as the taxable income of an individual.

(2) The taxable income of an individual is the total of the eight classes of income enumerated and classified in Section 303 of the Tax Reform Code, each class computed without setoff between or among any other class and, unless a net taxable class, without deductions.

Section 103.12 (relating to net profits) is also being amended to reflect the holdings in Morgan and Wettach.

The definition of "personal income tax income" set forth in § 155.30(b)(4) (relating to regulated investment companies) is being amended to provide that the term means income computed in the same manner and on the same basis as the income of an individual under Article V. Personal Income Tax.

Affected Parties

Regulated investment companies that are subject to the capital stock/foreign franchise tax and business owners, investors and tax practitioners may be affected by the proposed amendments.

Fiscal Impact

The Department of Revenue has determined that the proposed amendments will have no fiscal impact on the Commonwealth.

Paperwork

The proposed amendments will not generate additional paperwork for the public or the Commonwealth.

Effectiveness/Sunset Date

The regulations will become effective upon final publication in the Pennsylvania Bulletin. This regulation is scheduled for review within five years of final publication. No sunset date has been assigned.

Contact Person

Interested persons are invited to submit in writing any comments, suggestions, or objections regarding the proposed amendments to Anita M. Doucette, Office of Chief Counsel, PA Department of Revenue, Dept. 281061, Harrisburg, Pennsylvania 17128-1061, within thirty (30) days after the date of the publication of this notice in the Pennsylvania Bulletin.

Regulatory Review

Under Section 5(a) of the Regulatory Review Act, the Act of June 30, 1989 (P.L. 73, No. 19) (71 P.S. § 745.1-745.15), the agency submitted a copy of this proposed regulation on *August 20, 1997* to the Independent Regulatory Review Commission and to the Chairpersons of the House Committee on Finance and the Senate Committee on Finance. In addition to submitting the regulation, the agency has provided the Commission and the House and Senate Finance Committees with a copy of a detailed Regulatory Analysis Form prepared by the agency in compliance with Executive Order 1996-1, "Regulatory Review and Promulgation." A copy of this material is available to the public upon request.

If the Commission has any objections to any portion of the proposed regulation, it will notify the agency by 30 days after the close of the public comment period. Such notification shall

specify the regulatory review criteria that have not been met by the portion. The act specifies detailed procedures for review of objections raised, prior to final publication of the regulation, by the agency, the General Assembly and the Governor.

06/06/97

CONTINUATION SHEET
FOR FILING DOCUMENTS
WITH THE LEGISLATIVE REFERENCE BUREAU
(Pursuant to Commonwealth Documents Law)

ANNEX A

Title 61. Revenue, Part I. Department of Revenue, Subpart B.
General Fund Revenues, Article V. Personal Income Tax, Chapter
101. General Provisions.

§ 101.1. Definitions.

The following words and terms, when used in this article,
have the following meanings, unless the context clearly indicates
otherwise:

* * *

Employe - [Every individual performing services if the
relationship between him and the person for whom he performs the
services is the legal relationship of employer and employe as
determined by the usual common law rules. Generally, the
relationship of employer and employe exists when the person for
whom services are performed has the right to control and direct
the individual who performs the services, not only as to the
result to be accomplished by the work but also as to the details
and means by which the result is accomplished. That is, an
employe is subject to the will and control of the employer not
only as to what shall be done but how it shall be done. In this
connection, it is not necessary that the employer actually direct
or control the manner in which the services are performed; it is

sufficient if he has the right to do so. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employe.

(i) The definition of "employe" for Pennsylvania Personal Income Tax purposes is the same as that for Federal income tax withholding purposes. Consequently, an individual who is issued a Form W-2 indicating Federal income tax withheld, is an employe unless he can affirmatively prove that the Federal withholding was not required, that is, that an employer-employe relationship does not exist and the withholding was done merely as a convenience. In addition, the remuneration paid for certain types of services is not subject to Federal income tax withholding regardless of whether an employer-employe relationship exists. In these cases, the failure to withhold does not indicate nonemploye status and a determination must be made based on the particular facts of the relationship. The remuneration referred to is cited at section 3401-(a) of the IRC and includes, inter alia, that paid:

- (A) For agricultural labor.
- (B) For domestic service in certain circumstances.
- (C) For services performed by an ordained, commissioned or licensed minister of a church in the exercise of his ministry.

(D) For services performed by an individual under the age of 18 in the delivery or distribution of newspapers.

(ii) Generally, F.I.C.A. employe tax is only withheld on individuals who are "employes" within the common law meaning. Consequently, an individual who is issued a Form W-2 indicating F.I.C.A. employe tax withheld, will be considered an employe unless he can affirmatively prove:

(A) That he is among the classes of individuals cited at section 3121(d) of the IRC who are employes for F.I.C.A. purposes only.

(B) That no employer-employe relationship otherwise exists. The classes of individuals referred to are:

- (I) Certain agent-drivers or commission drivers.
- (II) Full-time life insurance salesmen.
- (III) Certain home workers.
- (IV) Certain traveling or city salesmen.

(ii) Generally, evidence of payment of Federal Self-Employment Tax is conclusive proof that an individual is not an employe. However, this does not apply to certain classes who are subject to Self-Employment Tax regardless of whether an employer-employe relationship exists. In these cases, the payment of Self-Employment Tax does not indicate nonemploye status and a determination must be made based on the particular facts of the relationship. The classes referred to are cited at section 1.1402(c)-3 of the IRC and include, inter alia:

(A) Certain newspaper vendors.
(B) Certain sharecroppers.
(C) Employes of foreign governments.
(D) Ministers and members of religious orders unless exempt.

(E) State and local government employes compensated on fee basis.

(iv) Where the presence or absence of an employer-employee relationship cannot be determined on the basis of Federal income tax withholding, F.I.C.A. employe tax withholding or payment of Self-Employment Tax, the following factors are considered, in addition to the elements enumerated in subparagraph (i) in making the determination. No one factor is conclusive; rather, the test is one of the totality of the following circumstances:

(A) Whether the individual is required by his principal, or by the person from whom remuneration is received, to work fixed hours, follow a prescribed routine or perform prescribed duties.

(B) Whether the individual participates in pension, unemployment, disability or hospitalization plans offered by the principal.

(C) Whether the individual is guaranteed an amount of remuneration by the principal.

(D) Whether the individual is either reimbursed for expenses or receives an expense allowance.

(E) Whether the individual represents only one principal.] The term shall include any individual who performs any service, of whatever nature, for any other individual or any entity and earns or receives remuneration therefor; provided, however, that for the purpose of Chapter 113 (relating to Withholding of Tax), the term shall have the same meaning as when used in Chapter 24 of the Internal Revenue Code of 1986, as amended (relating to collection of income tax at source on wages).

Employer - [An individual, partnership, association, corporation, governmental body or unit or agency, or another entity employing one or more persons for compensation. A person required under the Internal Revenue Code, as amended, to withhold Federal income tax from compensation of an employe is prima facie deemed to be an employer.] The term shall mean any person for whom an individual performs any service, of whatever nature, provided, however, that:

(1) If the person for whom the individual performs the service does not have the payment of the remuneration for such service, the term means the person having the payment of such remuneration.

(2) For the purpose of Chapter 113 (relating to withholding of tax), the term shall have the same meaning as when used in Chapter 24 of the Internal Revenue Code of 1986, as

amended (relating to collection of income tax at source on wages).

* * *

Income - The total of the classes enumerated under Chapter 103 Subchapter B (relating to the determination of tax) received by a taxpayer directly, or through partnerships, associations or Pennsylvania S corporations and the amount of each class derived by the taxpayer through estates or trusts[. There may be no setoff between or among the classes.] determined and computed in accordance with the requirements of this article relating to the taxation of a natural individual's personal income, including the requirements that:

(i) There be no setoff between, or among, any different classes of personal income tax income.

(ii) No deduction be allowed for expenses, whether paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property, except:

(A) Allowable unreimbursed employee business expense.

(B) Allowable costs of goods sold and expense incurred in the operation of a business.

(C) Allowable costs of acquisition, expenses of sale, and collection expenses.

(D) Expenses necessary to the production or collection of rents and royalties or for the management, conservation, or maintenance of rents, royalties, patents, or copyrights.

(iii) In the case of a PA S corporation, partnership or other association, trust or estate, the distributive income of the same be classed, determined, and computed in the same way and on the same basis as the taxable income of a natural individual; and, in the case of a PA S corporation, partnership or other association, each shareholder, partner or member take into income such shareholder's, partner's or member's pro rata share of the income or loss in each applicable class of income received by the PA S corporation, partnership or other association.

(iv) Married persons may not compute their tax as if they were one person; and no setoff between married persons is permitted. For example, an individual's net profit from manufacturing toys is \$100, his net loss from the business of selling garden supplies is \$20, his wife's loss from a business she operates is \$20, and his net loss from passive ownership of investment rental properties is \$10. His total net business profits are \$80 which is his [total] income, against which he may not set off his losses on rentals or his wife's business losses.

* * *

Chapter 103. Imposition and Determination of Tax.

§ 103.12. Net Profits.

(a) Net profits shall be the net income from the operation of a business, profession or other activity after provision for all costs and expenses incurred in the conduct thereof [are]. They shall be determined either on a cash or accrual basis in

accordance with accepted accounting principles and practices [but without deduction of taxes based on income].

(b) Net profits are different from other classes of personal income in that:

(1) Such profits are derived from the marketing of a product or service to customers on a commercial basis; from securities employed as working capital in such business operations; from accounts and notes receivable from sales of products or services sold in the ordinary course of such business operations; or from assets which serve an operational function in the ordinary course of business operations.

(2) Such marketing activity is conducted with the manifest objective of achieving profitable operations.

(3) Such marketing activity is conducted with regularity and continuity and is not limited or exclusive.

(c) Net profits shall be computed wholly without reference to any item of revenue, cost, expense or liability derived or incurred in connection with, or attributable to:

(1) The ownership or disposition of assets that are held for investment purposes or otherwise serve an investment function.

(2) The trading in securities for personal purposes and not for the accounts of customers.

(3) The sale, discontinuation or abandonment of a business or segment thereof.

(4) Any tax imposed on, or measured by, gross or net earned or unearned income.

(5) An isolated or nonrecurring transaction which is not a normal or routine business activity.

(d) Choosing to form a partnership or other entity or to associate with others, receiving and reporting income or gain as the income of the partnership, entity or associates or dividing the same among its partners, beneficial owners or associates or the trading in securities for the benefit of shareholders, partners, members or associates does not of itself make the income of the partnership, entity or associates net profits.

Chapter 155. Capital Stock Tax and Foreign Franchise Tax.

§ 155.30. Regulated investment companies.

* * *

(b) Definitions. The following words and terms, when used in this section, have the following meanings, unless the context clearly indicates otherwise:

* * *

(4) Personal Income Tax Income - [The term includes compensation, net profits from the operation of a business, profession or farm, interest income, dividends received, net gains or income from the sale, exchange or disposition of

property, rents, royalties, patents and copyrights income from estates and trusts and gambling winnings.] The term means income computed in the same manner and on the same basis as the income of an individual under Article V. Personal Income Tax.

06/06/97

**TRANSMITTAL SHEET FOR REGULATIONS SUBJECT TO THE
REGULATORY REVIEW ACT**

I.D. NUMBER: 15-381

SUBJECT: Personal Income & Corporate Taxes: Definitions; Net Profits &
Regulated Investment Companies

AGENCY: Department of Revenue

TYPE OF REGULATION

X Proposed Regulation

Final Regulation

Final Regulation with Notice of Proposed Rulemaking Omitted

120-day Emergency Certification of the Attorney General

120-day Emergency Certification of the Governor

FILING OF REGULATION

DATE	SIGNATURE	DESIGNATION
<u>7-20-97</u>	<u>Bonnie J. Brackbill</u>	HOUSE COMMITTEE ON FINANCE
<u>8-20-97</u>	<u>Regene A. Baker</u>	SENATE COMMITTEE ON FINANCE
<u>8/20/97</u>	<u>J. Gilbert</u>	INDEPENDENT REGULATORY REVIEW COMMISSION
		ATTORNEY GENERAL
<u>8/20/97</u>	<u>Wynne Dodge</u>	LEGISLATIVE REFERENCE BUREAU

July 31, 1997