



**INDEPENDENT REGULATORY REVIEW COMMISSION
COMMONWEALTH OF PENNSYLVANIA
333 MARKET STREET
14TH FLOOR
HARRISBURG, PA 17101**

**(717) 783-5417
Fax (717) 783-2664**

October 30, 1997

Honorable Robert A. Judge, Sr., Secretary
Department of Revenue
11th Floor, Strawberry Square
Harrisburg, PA 17128

Re: IRRC Regulation #15-381 (#1882)
Department of Revenue
Personal Income and Corporate Taxes

Dear Secretary Judge:

The Independent Regulatory Review Commission (Commission) has enclosed comments on your proposed regulation #15-381. These comments outline areas of concern raised by the Commission. The comments also offer suggestions for your consideration when you prepare the final version of this regulation. These comments should not, however, be viewed as a formal approval or disapproval of the proposed version of this regulation.

If you or your staff have any questions on these comments or desire to meet to discuss them in greater detail, please contact Chuck Tyrrell at 772-3455. He has been assigned to review this regulation.

Sincerely,


Robert E. Nyce
Executive Director

REN:wbg

cc: Anita Doucette
Douglas A. Berguson
Office of General Counsel
Office of Attorney General
Pete Tartline

COMMENTS OF THE INDEPENDENT REGULATORY REVIEW COMMISSION

ON

DEPARTMENT OF REVENUE REGULATION NO. 15-381

PERSONAL INCOME AND CORPORATE TAXES

OCTOBER 30, 1997

We have reviewed this proposed regulation from the Department of Revenue (Department) and submit for your consideration the following objections and recommendations. Subsections 5.1(h) and 5.1(i) of the Regulatory Review Act specify the criteria the Commission must employ to determine whether a regulation is in the public interest. In applying these criteria, our Comments address issues that relate to legislative intent and clarity of the regulation. We recommend that these Comments be carefully considered as you prepare the final-form regulation.

1. Section 101.1 - Definition of Employee and Employer - Legislative Intent

The Department is proposing to amend the definitions of "employee" and "employer" as a result of a 1989 amendment to the Tax Reform Code. However, the proposed definitions are not consistent with the statute. The statutory definitions of "employee" and "employer" are as follows:

"Employee" - means any individual from whose wages an employer is required under the Internal Revenue Code to withhold Federal income tax.

"Employer" - means an individual, partnership, association, corporation, governmental body or unit or agency, or any other entity who or that is required under the Internal Revenue Code to withhold Federal income tax from wages paid to an employee.

The proposed regulatory definitions for these terms are more expansive than the statutory definitions because the regulation will include instances when an employer is not required to withhold federal income tax. We believe the statute is clear that the standard for defining "employee" and "employer" is the requirement of withholding Federal income taxes pursuant to the Internal Revenue Code. We do not believe it is consistent with the legislative intent for the Department to create other standards or criteria to determine who will be considered an "employee" or "employer."

Therefore, the Department should delete the proposed definitions of both terms and adopt the statutory definitions.

The Department is not amending Section 113.1 of its regulations, relating to withholding taxes. However, this section contains a definition of "employer" which is not the same as the proposed regulatory definition or the statutory definition. We recommend the Department also amend this definition to be consistent with the statutory definition.

2. Section 103.12 - Taxation of Regulated Investment Companies - Legislative Intent

The Department is amending the definition of personal income tax income, as it relates to regulated investment companies. Under the Tax Reform Code, regulated investment companies are required to pay the capital stock or franchise tax. The statute provides that part of the tax will be based on the apportioned undistributed personal income tax income of the company, with the personal income tax income to be calculated pursuant to the personal income tax.

Stradley, Ronon, Stevens & Young (Stradley) commented that the Department's change in definition in personal income tax income will treat regulated investment companies as individuals, not as businesses. The result will be that these companies will not be able to deduct management fees in calculating their tax base. Stradley believes that regulated investment companies should be able to choose the "net profits" category in the personal income tax income classification for determining its tax base.

The Department believes that regulated investment companies should be treated the same as individuals with respect to the determination of personal income tax income. Because caselaw does not allow individuals to deduct expenses involved with personal investments, a regulated investment company should also not be allowed to deduct such expenses. Therefore, the purpose of the amendment is to clarify the Department's position on this issue.

The Department cited *Morgan v. Commonwealth (Morgan)*, 400 A.2d 1384 (1979) in support of its position that regulated investment companies should be treated the same as individuals and therefore should not be allowed to deduct expenses.

However, in *Morgan*, the taxpayer was buying and selling stocks and bonds for his personal pecuniary benefit. The taxpayer did not hold a license to engage in the purchase or sale of securities for the accounts of others, nor did he act as an investment advisor. The Commonwealth Court categorized the taxpayer's activity as "personal money management for profit," not as "a business, profession, or other activity" under Section 303(a)(2) of the Tax Reform Code.

The court stated that to fall under the class of net profits of Section 303(a)(2), the business, profession, or other activity must be "engaged in as commercial enterprise." The court defined "commercial enterprise" as the rendering of goods or services to others in a marketplace. The court held that since the taxpayer's "activity of personal money management cannot be viewed as a rendering of services to anyone but himself, his activity is clearly not a commercial enterprise."

Regulated investment companies, unlike the taxpayer in the *Morgan* case, are businesses as defined under Section 301 and interpreted by the court. The nature of a regulated investment company is clearly an undertaking engaged in as a commercial enterprise conducted for profit. A regulated investment company renders mutual fund services to individual investors in the financial market. Therefore, regulated investment companies should be treated as businesses under the regulation and allowed to categorize their undistributed personal income tax income as net profits.

3. Section 101.1 - What will be considered “allowable” - Clarity

In the proposed definition of income, the Department uses the phrases “Allowable unreimbursed business expense,” “allowable costs of goods sold,” and “allowable costs of acquisition, expenses of sale and collection expenses.” There is no indication in the regulation as to what will be considered “allowable.” The Department explains that there will be future rulemakings that will provide this clarification. We encourage the Department to proceed with the other rulemaking expeditiously so that it can be finalized at the same time as this rulemaking. If the regulation will not be proposed in the near future, the Department should consider dropping these phrases to avoid confusion or inconsistent application.

INDEPENDENT REGULATORY REVIEW COMMISSION

To: Anita Doucette
Agency: Department of Revenue
Phone: 7-1382
Fax: 2-1459

From: Kristine M. Shomper, Executive Assistant
Company: Independent Regulatory Review
Commission
Phone: (717) 783-5419 or (717) 783-5417
Fax: (717) 783-2664

Date: October 30, 1997
of Pages: 5

Comments: We are submitting the Independent Regulatory Review Commission's comments on the Revenue Department's regulation #15-381 (#1882). Upon receipt, please sign below and return to me immediately at our fax number 783-2664. We have sent the original through interdepartmental mail. You should expect delivery in a few days. Thank you.

Accepted by: Anita M. Doucette Date: 10/30/97