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PA TAX LAW NEWS

LONG AWAITED TECH ONE ASSOCIATES DECISION CLARIFIES TAXATION OF LEASEHOLD INTERESTS *by Bert M. Goodman*

In a much anticipated decision, the Pennsylvania Supreme Court in *Tech One Associates v. Board of Property Assessment, Appeals and Review of Allegheny County,* 32 WAP 2010 (April 25, 2012), held there is statutory authority to tax leasehold interests as part of the totality of the assessment. Thus an assessment can properly include the value of land, buildings, and other improvements, regardless of whether the buildings and land were put there by the landlord or the tenant. This will alter what had been confusing present practice, and will require parties to leases to carefully consider tax responsibility.

The issue before the court was the validity of a single unified assessment of both a tract of land and the buildings of a shopping center, movie theater and restaurant located on land owned by Tech One Associates. The buildings and improvements were constructed by a second entity and owned by that entity under a long term lease. The Board of Property Assessment of Allegheny County treated the land, buildings and the improvements all as real estate subject to taxation.

Tech One argued that it should be taxed on the rent paid for the ground by the lessee and the present worth of the reversionary interest in the property at the conclusion of the long term lease, reasoning that the current value of the improvements should not be included in its assessment.

After analyzing the contentions of the parties, the Court ultimately determined that leasehold interests are taxable under the phrase "All Real Estate" in 72 P.S. § 5020-201. Therefore, the Pennsylvania Supreme Court has now held that there is statutory authority to tax leasehold interests as part of the totality of the assessment.

After determining that buildings and improvements of the shopping center were real estate, the Court then determined the proper methodology for valuing the real estate. In doing so, the Court stated the following:

> "The term 'actual value' as used in Section 402 means 'market value.' *In re Brooks Bldg.,* 391 Pa. 94, 97, 137 A.2d 273, 274 (1958). Market value is 'a price which a purchaser, willing but not obliged to buy, would pay an owner willing, but not obliged to sell, taking into consideration all uses[s] to which the property is adapted and might in reason be applied.' *Deitch Co. v. Bd. of Prop. Assessment, Appeals and Review*, 417 Pa. 213, 217-218, 209 A.2d 397, 400 (1965) (quoting *Buhl Found. v. Bd. Of Prop. Assessment, Appeals and Review*, 407 Pa. 567, 570, 180 A.2d 900, 902 (1962)). Thus, in an assessment appeal, '[e]vidence presented by appraisers must be directed to the market value of the property as a whole.' *Rieck Ice Cream Co. v. Bd. Of Prop. Assessment, Appeals and Review*, 417 Pa. 249, 256, 209 A.2d 383, 387 (1965); see also *Miracle Mile Shopping Center v. Bd. Of Prop. Assessments*, Appeals and Review, 417 Pa. 243, 245, 209 A.2d 394, 395 (1965) ('The basic and controlling substantive issue in a real estate assessment appeal is the correctness of the total assessment of the property as a unit.'). The 'property as a whole' in this case, i.e., the real estate comprising the tax parcel at issue, consists of the land upon which the shopping center buildings and improvements sit, as well as the buildings and the improvements themselves; hence it is the market value of this entire parcel – land, buildings, and improvements – which Allegheny County was required

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PHILADELPHIA COMMON LEVEL RATIO DRAMA CONTINUES

by Randy L. Varner

In April, the State Tax Equalization Board ("STEB") revised the 2011 Philadelphia common level ratio ("CLR") upward from 18.1% to 25.2%. This increase came after the City of Philadelphia and the School District of Philadelphia (collectively "Philadelphia") objected to STEB's prior lowering of the CLR from 32.0% to 18.1%. This change by STEB should have only a modest impact on most appeals originally filed due to the CLR rate drop.

In previous editions of this newsletter, we alerted you to the dramatic drop in Philadelphia's 2011 common level ratio ("CLR") from 32.0% to 18.1%. This drop in CLR resulted in the implied fair market values of properties in Philadelphia exploding, thus resulting in appeal opportunities. For instance, a property with a current assessment of $100,000, under the "old" 32% CLR, had an implied fair market value of $312,500. When the CLR dropped to 18.1%, that same property suddenly had an implied fair market value of $552,486. Therefore, the reduction in CLR from 32% to 18.1% meant that this property's value in the eyes of Philadelphia increased 57% overnight. Not surprisingly, Philadelphia received over 2000 appeals due to the CLR rate drop.

By letter dated September 30, 2011, Philadelphia filed an appeal with STEB, arguing that it should be given the opportunity to revise its CLR based on the ongoing efforts of Philadelphia's newly formed Office of Property Assessment (OPA) to refine its data gathering, coding and analysis. OPA might then be able to submit to STEB revised 2010 information that would "present a more complete and accurate picture of real property values" in Philadelphia. After working with STEB staff, the OPA on December 28, 2011, submitted to STEB a second data set file containing 9,492 sales that OPA determined to be valid sales for the purpose of calculating CLR.

COURT UPHOLDS IFTA LIABILITY AGAINST MOTOR CARRIER WITH INADEQUATE RECORDS

by Sharon R. Paxton

A three-judge panel of the Commonwealth Court has upheld the results of an audit conducted by the Pennsylvania Department of Revenue under the International Fuel Tax Agreement, which imposed a substantial tax liability against a brokerage company that failed to comply with IFTA mileage and fuel documentation requirements. *R & R Express v. Commonwealth*, No. 533 F.R. 2007 (February 8, 2012). The taxpayer, R & R Express, has appealed the panel's decision, and argument before the full Court has tentatively been scheduled for June 2012.

R & R Express is a brokerage company that uses owner operators to haul steel and other commodities throughout the United States. All fuel used in the company's motor carrier operations is purchased at retail locations. An IFTA audit conducted by the PA Department of Revenue resulted in an additional tax liability of over $300,000, plus interest. The company's owner/operators did not consistently turn in trip reports and fuel receipts for their activity. Since the company did not maintain adequate mileage and fuel records, the determination of additional tax liability was based, in part, on estimates of unreported miles and fuel consumption. In addition to disallowing credit for tax paid on all fuel purchases that were not properly documented, the auditor imposed the statutory 4.0 m.p.g. factor in cases where the calculated m.p.g. factor was determined to be too high or where mileage had been traveled but no fuel had been reported.

R & R Express essentially contended that the audit deficiency should be stricken because it had already paid tax on all fuel used in its motor carrier operations (at the time of purchase), and the Department's audit methodology therefore resulted in double taxation. In the alternative, the company asserted that it should be permitted to have its tax for the audit period recomputed based on data from reporting periods subsequent to the audit period. The company argued that, since its record-keeping procedures had improved after the audit, the data from later reporting periods represented the "best information available" to compute its additional tax due for the audit period.

Although the Court seemed sympathetic to the taxpayer's situation, it agreed with the Commonwealth that strict compliance with the reporting framework set forth in the tax statute, the IFTA Agreement, and accompanying regulations and guidelines, is required. The Court stated: "The relevant and controlling law explicitly requires documentation, not estimates of the sort proposed by Taxpayer, no matter how accurate we may believe such estimates to be, nor how sympathetic we may be to Taxpayer's plight."

Philadelphia also tried to submit additional sets of sales information. STEB conducted a hearing on March 23, 2012, at which Philadelphia made a presentation in support of its third data set submission and asked STEB to revise its CLR based on this submission. In the alternative, Philadelphia asked STEB to accept its second data set and to revise the CLR based on this second data set.

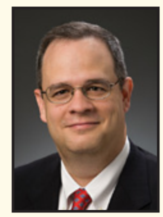
In its Memorandum and Order, published in the April 14, 2012 *Pennsylvania Bulletin* (42 Pa.B. 2152), STEB rejected Philadelphia's request to use the third set of values, and instead accepted the second set of values and recalculated Philadelphia's CLR at 25.2%. It is possible that Philadelphia will appeal this decision to the Commonwealth Court.

While the CLR has risen, it still has dropped from a previous value of 32.0% to the current 25.2%, which means that the implied fair market values of properties in Philadelphia have still gone up due to the rate drop. So it is likely that most property owners who filed appeals will still be able to justify relief.

Philadelphia also is planning a reassessment of all properties next year, and has already begun work to that end. After the reassessments are issued, property owners should once again analyze the assessment to make sure that it comports with the actual fair market value of the property.

We will continue to monitor this situation and will keep you updated in future editions of this newsletter.

Please address questions concerning real estate tax valuation matters to Randy Varner (rvarner@mwn.com, 717-237-5464) or Bert Goodman (bgoodman@mwn.com, 610-240-0345). ■



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The Court's decision in *R & R Express* demonstrates that a motor carrier's failure to properly maintain mileage and fuel records for IFTA reporting purposes could have a devastating impact in the event of an audit. The taxpayer's appeal in this case may not be finally resolved until sometime next year. In the meantime, it remains to be seen how this decision will impact settlement negotiations for IFTA audit appeals filed by other taxpayers.

If your company requires assistance with IFTA reporting and compliance matters, or appeals, please contact Sharon Paxton (spaxton@mwn.com, 717-237-5393) or another member of the McNees State and Local Tax group. ■

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PA BUDGET WATCH: REVENUES IMPROVE; ADDBACK LEGISLATION ADVANCES

by James L. Fritz

The budget picture in Pennsylvania has improved markedly, with FY 2011-12 revenue shortfall estimates being cut back from over $700 million to $300 million or less. The Senate has passed a preliminary budget restoring some cuts previously targeted by Governor Corbett. There now is talk about a final budget being adopted two weeks or more in advance of the June 30 constitutional deadline.

We now expect to see a Tax Reform Code Bill in conjunction with the FY 2012-13 budget. The bill almost certainly will not include any general tax increases but will include a number of "tweaks" to the tax code. The House recently passed Corporate Net Income Tax legislation (H.B. 2150) providing for addback of royalties and related interest paid to certain affiliates, tied to rate reduction, single sales factor, and gradual lifting of the net loss cap. A number of other tax bills are moving in the House and Senate. Only time will tell which of the proposals will make the final budget package.

Questions concerning Pennsylvania tax legislation may be addressed to Jim Fritz (jfritz@mwn.com, 717-237-5365) or another member of the McNees Wallace & Nurick SALT Group. ■

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GOODWILL INCLUDED IN SUBSIDIARY VALUATION FOR HOLDING COMPANY APPORTIONMENT TEST *by James L. Fritz*

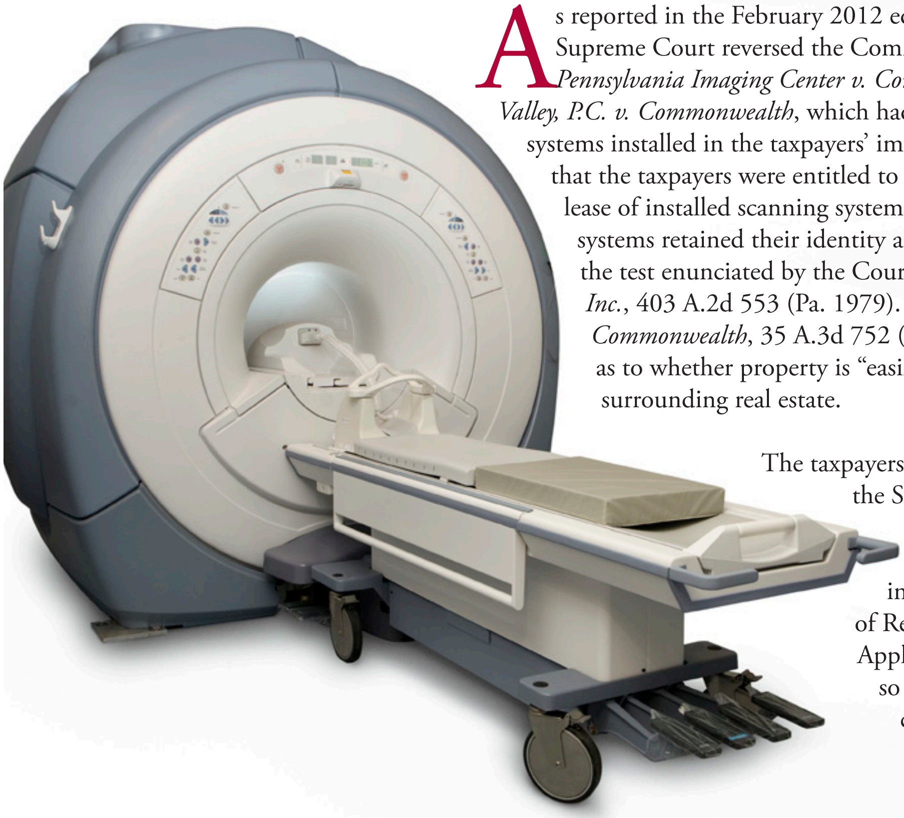
Although Pennsylvania Capital Stock and Franchise Taxes are being phased out, a recent case demonstrates that the taxes still generate significant issues. In *Systems & Computer Technology Corp. v. Cmwlth.*, 77 F.R. 2009 (April 18, 2012), the taxpayer had reported Franchise Tax utilizing statutory 10% "holding company apportionment." The Department of Revenue increased the tax by several hundred thousand dollars, on the basis that the value of the company's subsidiaries, as reflected by the "investment in subsidiary" on its balance sheet was less than 60% of the value of its total assets - violating the "asset test" in the statute.

On appeal the taxpayer pointed out that the company and its subsidiaries had been acquired for a price well in excess of the value of recognizable assets. The difference was reflected as "goodwill" on the company's balance sheet, but really reflected value attributable to its operating subsidiaries. The company, itself, merely acted as a holding company.

Noting that the statute's "asset test" refers to "actual value," the Commonwealth Court cited several precedents from varying areas of taxation to support its conclusion that the goodwill must be attributed to the operating subsidiaries in order to determine their "actual value." The taxpayer and its subsidiaries had been purchased in an arms-length transaction and looking only to the book investment in subsidiary would have ignored the portion of the real value which had been recorded as goodwill. The court reversed the Department's balance sheet-based determination.

Questions concerning Pennsylvania corporate taxes may be directed to Jim Fritz (jfritz@mwn.com, 717-237-5365) or another member of the McNees Wallace & Nurick SALT Group. ■

PA SUPREME COURT DENIES RECONSIDERATION OF DECISION ADDRESSING CONSTRUCTION CONTRACTS WITH NON-EXEMPT ENTITIES *by Sharon R. Paxton*



As reported in the February 2012 edition of *PA Tax Law News*, the Pennsylvania Supreme Court reversed the Commonwealth Court's 2009 decisions in *Northeastern Pennsylvania Imaging Center v. Commonwealth* and *Medical Associates of the Lehigh Valley, P.C. v. Commonwealth*, which had held that MRIs and other medical scanning systems installed in the taxpayers' imaging centers became part of the "real estate," so that the taxpayers were entitled to a refund of sales tax paid on their purchase and lease of installed scanning systems. The Supreme Court held that the scanning systems retained their identity as tangible personal property after installation under the test enunciated by the Court in *Commonwealth v. Beck Electric Construction, Inc.*, 403 A.2d 553 (Pa. 1979). *See Northeastern Pennsylvania Imaging Center v. Commonwealth*, 35 A.3d 752 (Pa. 2011). The *Beck* test involves a determination as to whether property is "easily" removable without damage to itself or to the surrounding real estate.

The taxpayers had filed Applications for Reconsideration with the Supreme Court in early January, requesting, among other things, that the Court reconsider and clarify the parameters of the *Beck* test and the interrelationship of that test with the Department of Revenue's regulations. The Court denied the Applications for Reconsideration on March 5, 2012, so no further guidance will be issued by the Court concerning the taxation of construction contracts with non-exempt entities in connection with these appeals. ■

SUPREME COURT AFFIRMS CONSTITUTIONAL TEST MUST BE MET BY THOSE SEEKING CHARITABLE EXEMPTIONS *by Randy L. Varner*

In a 4-3 decision, the Pennsylvania Supreme Court, in *Mesivtah Eitz Chaim of Bobov, Inc. v. Pike County Board of Assessment Appeals,* No. 16 MAP 2011 (April 25, 2012) ("*Mesivtah")*, held that a property owner seeking an exemption from real property taxation as a "purely public charity," must first meet the five-prong test set forth in *Hospital Utilization Project v. Commonwealth,* 487 A.2d 1306 (Pa. 1985) (the "*HUP* Test"). As explained below, this decision does not alter substantive exemption law, although it may encourage some taxing jurisdictions to take harder looks at exemptions. Those entities with exemptions should be aware of the *Mesivtah* decision and its limited holding.

In *Mesivtah*, the Commonwealth Court had held that the Appellant (a not-for-profit religious summer camp), did not relieve the government of some of its burden and, therefore, failed one of the prongs of the *HUP* Test, the test used to determine whether an institution qualifies as a purely public charity under the Pennsylvania Constitution.

...if an appellant can pass the HUP Test, then it should also be able to pass the Act 55 test...

Appellant appealed to the Supreme Court and argued that courts should defer to the five-prong test in the Institutions of Purely Public Charity Act, 10 P.S. §§ 371-385 ("Act 55"), when analyzing whether an institution is a purely public charity. Act 55 was passed by the General Assembly after the *HUP* Test was announced by the Supreme Court, and sought to provide some objective criteria for the five prongs of the *HUP* Test based upon case law that the *HUP* court had relied on. In *Mesivtah,* the Supreme Court only looked at whether it must defer to Act 55 when analyzing whether an institution is one of purely public charity, not to facts of the case or how those facts fit into the five-prong tests.

The Court held that before even getting to Act 55's test, an institution must pass constitutional muster by clearing the five-prong *HUP* Test. While the General Assembly is free to place more restrictive requirements on an institution seeking an exemption, it may not legislate away constitutional minimums, as established by the *HUP* Test. Therefore, the Court affirmed the Commonwealth Court's denial of the exemption.

Importantly, the Supreme Court did not review the Commonwealth Court's application of the *Mesivtah* facts to the law. Nothing in the Supreme Court's decision in *Mesivtah* changes prior case law interpretation or application of the prongs of either test. The Commonwealth Court's decision in *Mesivtah*, like all exemption cases, turned on the facts of that case. The Supreme Court, by making clear that the *HUP* Test must be met before undertaking analysis under Act 55, did not alter what "relieving the government of some of its burden" has meant under case law.

As a practical matter, if an appellant can pass the *HUP* Test, then it should also be able to pass the Act 55 test, and *vice versa*. The Appellant in *Mesivtah* argued that it met the Act 55 "governmental burden" prong, as part of its overarching argument that Act 55 should guide the Court's analysis of the *HUP* Test. However, it does not appear as if the trial court or the Commonwealth Court ever conducted an Act 55 analysis. In reality, if the courts did not believe that the Appellant met the "governmental burden" prong of the *HUP* Test, it is doubtful they would have found that it met the Act 55 prong.

Some commentators have argued that *Mesivtah* will make it harder for an institution to prove that it is a purely public charity. That is not a fair reading of the *Mesivtah's* holding.

We have always advised clients that the *HUP* Test must be met first, followed by the Act 55 test and have presented appeals based upon that premise. Again, nothing in *Mesivtah* alters what is meant by "relieving the government of some of its burden" under the *HUP* Test. We have found through representing clients in exemption appeals that it is usually far more difficult dealing with Act 55's objective standards in an appeal than those developed in the *HUP* Test.

Still, the holding in *Mesivtah* may invite taxing jurisdictions or boards of assessment appeals to be more aggressive with institutions who are seeking or have exemptions. The most important thing institutions should remember—and this was not altered by *Mesivtah*—is to fully set forth how each prong of each of the tests is met when seeking an exemption or defending one.

If you have any questions related to the real estate tax exemption for purely public charities, please contact Randy Varner (717-237-5464, rvarner@mwn.com), or another member of the McNees Wallace & Nurick SALT Group. ■

LONG AWAITED TECH ONE ASSOCIATES DECISION *continued from page 1*

to ascertain for assessment purposes."

Tech One Associates, 32 WAP 2010.

Therefore, in valuing the land owned by Tech One as the leased fee, the Court held that it was necessary to consider the impact of the ownership division and rent restrictions created by the lease on Appellant's ability to sell the land, and, in capitalizing the value of the income stream that an owner of the land could expect to receive. Likewise, in valuing the shopping center buildings and other improvements owned by Lessee as leasehold interests, it is necessary to consider the impact of the lease on the value the Lessee could expect to receive if it attempted to assign the leasehold interests to others, and, in capitalizing the value of the income stream generated by Lessee's leasehold interests, it is necessary to use the contract rent which Lessee received under the subleases which it had entered into with tenants.

This case is significant because it clarifies the taxable status of leased fee interests and leasehold interests. In short, the Court held that both the leasehold interest and the leased fee interest are taxable real estate and that their combined value must be calculated and their assessment based on the total combined value. While the Court held that both leasehold and leased fee interests are taxable, it did not make any ruling that separate tax parcels can be created but rather confined the holding to how to assess a unified tax parcel.

It is critical that drafters of leases in these types of situation be cognizant of the holding in this case, because there is nothing in this case which allows a County to create separate tax parcels for the leasehold and lease fee. Leases will have to be drafted carefully to allocate tax responsibility.

Please address real estate tax valuation questions to Bert Goodman (bgoodman@mwn.com, 610-240-0345) or Randy Varner (rvarner@mwn.com, 717-237-5464). ■

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