



This Week in State Tax (TWIST)

March 3, 2025



Pennsylvania: BFR Says Deemed Royalty and Related Party Intangible Expenses Included in Corporate Net Income

The Pennsylvania Board of Finance and Revenue (BFR) ruled that a taxpayer was required to both include a deemed royalty payment in its Pennsylvania net income and recharacterize a portion of its cost of goods sold as disallowed related party intangible expenses. The taxpayer (Parent) engaged in a restructuring termed an F reorganization under the Internal Revenue Code by transferring stock in a domestic subsidiary to a wholly owned foreign subsidiary (IP Holder) then converting the domestic subsidiary into an LLC. Although I.R.C. § 367(d) required Parent to include a deemed royalty payment from IP Holder on its federal return, it excluded this amount from its Pennsylvania return. In a related (but separate) transaction, Parent began purchasing finished goods for from a second foreign subsidiary (Manufacturer) for U.S. distribution. Manufacturer paid royalties to IP Holder for use of intellectual property in the manufacturing process. Parent deducted its payments to Manufacturer as cost of goods sold from both its federal and state returns. On audit, the Pennsylvania Department of Revenue (Department) determined both that Parent was required to include the 367(d) deemed royalty in its Pennsylvania net income, and that a portion of the deduction for payments to Manufacturer should be disallowed as (in effect) an intercompany intangible expense.

On appeal, Parent argued that inclusion of the deemed royalty on a state tax return would violate the foreign commerce clause under the U.S. Supreme Court's holding in *Kraft General Foods v. Iowa Department of Revenue* because the lack of a combined reporting regime or a foreign tax credit mechanism in Pennsylvania meant that more state tax was imposed on a transfer to a foreign subsidiary than would be imposed on an equivalent transfer to a domestic subsidiary. The taxpayer also argued that inclusion of the deemed royalties in Pennsylvania net income was distortive because the transfer to a foreign entity of a California-based corporation lacked a connection to business done in Pennsylvania.

On the cost-of-goods-sold adjustment, Parent argued that all relevant transactions (Parent/Manufacturer and Manufacturer/IP Holder) were conducted at arm's length pursuant to transfer pricing studies. Further, it alleged that its principal purpose for engaging in the relevant transactions was not to avoid tax because the F reorganization was conducted to centralize ownership of intellectual property and reduce the number of legal entities in its corporate structure, and the purchase of finished goods from Manufacturer was intended to take advantage of both Manufacturer's production expertise and Parent's sales expertise.

The BFR rejected Parent's arguments. For the deemed royalty, the BFR simply stated that "Petitioner has not

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proven it was entitled to this deduction or that the royalties lacked any connection to Pennsylvania.” It also noted that it lacked authority to consider Parent’s constitutional argument. For the cost of goods sold deduction, the BFR ruled that Parent “has not sufficiently proven the types of transactions [it] engaged in served an economic purpose” or that “tax avoidance was not the principal purpose of its arrangements.” It is unknown whether Parent will attempt to appeal further. For questions about [Decision No. 2403677](#), contact [Mark Achord](#).

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