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PA TAX LAW NEWS

COMPROMISES TO BE PERMITTED AT BOARD OF APPEALS: MAJOR ANNOUNCEMENT ALTERS DECADES-LONG PRACTICE

The Pennsylvania Department of Revenue has announced a change in tax appeals procedure potentially offering taxpayers much quicker resolution of tax disputes, but requiring thorough preparations by taxpayers and their representatives at the first administrative appeal level.

In a bulletin issued November 16, 2011, the Department announced that, effective immediately, the Board of Appeals will have the power to implement compromises of most types of tax appeals filed with the Board (including Corporate Net Income Tax, Capital Stock/Franchise Tax, Personal Income Tax, Sales and Use Tax and Gross Receipts Tax appeals). *Miscellaneous Tax Bulletin 2011-02*. The stated goal for the Department's implementation of compromise procedures at the Board of Appeals is to provide an "impartial, timely and inexpensive resolution of tax disputes." There will be two bases for compromise: (1) doubt as to liability; and/or (2) the promotion of effective tax administration.

Under the previous system, taxpayers were not able to negotiate settlements of state tax liabilities until after the filing of an appeal with the Commonwealth Court, which meant that taxpayers had to pursue appeals before two administrative boards (the Department of Revenue's Board of Appeals and the Board of Finance and Revenue) before they had any chance to resolve an appeal by negotiated settlement. However, one of the advantages of the prior system was the involvement of the Attorney General's Office in negotiations at the court level. While the AG's Office represented the Commonwealth's interest, they brought a fresh viewpoint to the table, not colored by being involved in making the Department's initial determination on an issue. The AG's Office will not be involved in negotiations at the Board of Appeals level but, presumably, if an agreement is not reached at the Board level and further appeals are taken, negotiations with the AG's Office may ensue after appeal to court.

While the Board of Appeals' hearing officers will be authorized to conduct informal settlement conferences to facilitate settlement discussions, the Department may be represented in those conferences. And, any compromise involving less than $50,000 of relief will require approval by a Deputy Chief Counsel of the Department while any settlement providing more than $50,000 of relief will require the approval of the Department's Chief Counsel and a designee for the Secretary of Revenue.

If negotiations under the prior system are any indication, one may expect the Revenue Department's participant in negotiations at the Board of Appeals level often to take aggressive positions on legal

(continued on back page)

IN THIS ISSUE

"CHEP" PALLETS EXEMPT AS WRAPPING SUPPLIES

by James L. Fritz and Sharon R. Paxton

Companies which have paid Pennsylvania Sales and Use Tax on CHEP pallets should file refund claims immediately! A three-judge panel of the Commonwealth Court has ruled that "CHEP" pallets qualify as exempt "wrapping supplies." *Procter & Gamble Paper Products Co. v. Commonwealth*, 786 F.R. 2009, October 13, 2011.

P&G Paper rents pallets from CHEP USA. Following use, the pallets are returned to CHEP, which reconditions and then reissues the pallets.

At audit, the Pennsylvania Department of Revenue assessed Use Tax on P&G Paper's payments for use of the pallets. On appeal, the Department's Board of Appeals and the Board of Finance and Revenue rejected the company's claim that the pallets are exempt "wrapping supplies" on the basis that the pallets are taxable as "returnable containers."

The Tax Reform Code of 1971 provides an exemption for:

> the sale at retail, or use of wrapping paper, wrapping twine, bags, cartons, tape, rope, labels, **non-returnable containers** and all other wrapping supplies, when such use is incidental to the delivery of any personal property, except that any charge for wrapping or packaging shall be subject to tax at the rate imposed by Section 202.

72 P.S. § 7204(13)

The regulations are to similar effect, providing the following definitions:

> Returnable containers – Containers which are designed to deliver property more than one time, including containers which require cleaning, repair or refurbishing prior to their subsequent use.
>
> Wrapping supplies – The term includes property, **except for returnable containers** as defined in this section, which is used as an outside covering or internal packing in order to deliver personal property to a purchaser. The term also includes items such as nonreturnable containers, mailing labels, envelopes and packing slips attached to the covering transferred with the personal property, instruction sheets, warranty cards, material for preservation of the property, paper and plastic plates, cups and similar items. The term does not include napkins, wooden or plastic spoons, forks, straws and similar items and these items are therefore subject to tax when sold to restaurants or other eating places.

61 Pa. Code § 32.1.

The Commonwealth Court panel endorsed P&G Paper's argument that the pallets, themselves, are not "containers" and constitute exempt "wrapping supplies." As the term "container" is not defined

in the statute, the court looked to the common meaning, citing a dictionary definition defining a "container" as:

> a receptacle (as a box or jar) or a formed or flexible covering for the packing or shipment of articles, goods or commodities.

The term "contain" was defined as "to have within: hold." The court then stated:

> A wooden pallet is merely a frame with boards placed upon it and attached to it. It is neither a receptacle nor a covering for the products placed upon the pallet. Indeed, P&G Paper must use card board slip sheets, corner posts, and stretch wrap to cover and hold products placed on a pallet.

The court seemed to employ somewhat questionable logic in distinguishing the Pennsylvania Supreme Court's decision in *Commonwealth v. Yorktowne Paper Mills*, Inc., 426 Pa. 18, 231 A.2d 287 (1967). In that case, in which non-returnable pallets were treated as exempt wrapping supplies, the court referred to pallets as "containers." The Commonwealth Court stated:

> The Board argues that, in *Yorktowne*, our Supreme Court determined that pallets are "containers." We disagree. In *Yorktowne*, the question was whether the company's purchase of lumber, nails and metal bands was subject to the tax. The company placed its products on pallets, i.e., the lumber and nails, and secured the products by placing metal bands around the entire unit. *Id. at* 20-21, 231 A.2d at 288. In referring to the pallets as "containers," the Court was referring to the entire unit, i.e., the pallet with the metal bands securing the product. Here, there is no question that the unit load, i.e., the slip sheet, corner posts, stretch wrap and wooden pallet, "contains" products. However, that is not the issue. Rather, the issue is whether the wooden pallets by themselves, apart from the slip sheet, corner posts and stretch wrap, are "containers." Alone, the wooden pallets are only part of the "containers," i.e., the flooring.

The Commonwealth filed Exceptions on November 10, requesting further review by the Commonwealth Court. Most likely this case ultimately will be appealed to the Pennsylvania Supreme Court. If your company has paid tax on CHEP pallets, we can assist you in filing refund claims which may then be held pending the ultimate final decision. As a three-year statute of limitations generally applies to refund claims, any delay could deprive you of the ultimate opportunity for refund of amounts you have paid. ■

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PA TAX COLLECTIONS CONTINUE TO LAG

by James L. Fritz

Pennsylvania's General Fund collections through October continued to lag significantly. Although year-to-date collections for many taxes appear to be higher than for the same period last year, they are significantly behind projections. If collections do not soon improve, the Commonwealth likely will have to slow spending, freeze hiring, etc. to bring the budget back to balance for the remainder of the fiscal year ending June 30, 2012. As legislators and others begin to contemplate the 2012-13 budget, weak collections will make a difficult job even tougher. Results for July-October, versus projections:

Total General Fund:	$ -282.1 million	(-3.6%)
Sales Tax:	$ -8.6 million	(-0.3%)
Personal Income Tax:	$ -134.6 million	(-4.2%)
Corporate Taxes:	$ -142.9 million	(-16.7%)
Inheritance Tax:	$ -2.1 million	(-0.8%)
Realty Transfer Tax:	$ -8.9 million	(-7.8%)
Other Taxes:	$ +8.1 million	(+1.6%)
Non-tax Revenue	$ +6.9 million	(+8.2%)
Motor License Fund: (gas & diesel taxes)	$ -5.8 million	(-0.7%)

DEEPER DOWN THE RABBIT HOLE:

PENNSYLVANIA SALES AND USE TAX IMPLICATIONS OF ONLINE DIGITAL MARKETPLACES

by Timothy J. Horstmann

In the July 2011 edition of *PA Tax Law News*, we introduced our readers to the basics on sales and use taxation of digital goods and services in Pennsylvania. In this edition, we delve deeper into this relatively uncharted territory, and consider Pennsylvania Sales and Use Tax implications with respect to the evolving world of online digital marketplaces.

The concept of an "online digital marketplace" is not new. For years consumers have purchased software from Amazon, Apple's iTunes, Google's Android Market and other similar services whereby consumers receive their purchases by direct download. In Pennsylvania, virtually all purchases of software from these marketplaces are subject to the sales and use tax, regardless of the method of delivery.

Recently, however, consumers have been given the option of making purchases at new digital marketplaces that exist within the user experience provided by a software application used by the consumer. Most commonly seen in video gaming applications, consumers typically make "in-game" purchases of items used in the game to provide a temporary or continuing change in the play experience. For example, the popular "Angry Birds" series of games, in which players use a sling shot to launch bird-like projectiles at fixed targets, offers players the option of purchasing, in-game, an additional projectile, the "Mighty Eagle," to help the player clear particularly difficult levels in the game.

Other gaming applications take the concept of the digital marketplace further, and feature persistent online worlds complete with in-game markets where players may barter *with each other* for in-game items. For example, in the upcoming video game "Diablo III," players will have the option of buying and selling items acquired within the game at the "Auction House," a digital marketplace established by the game developer but made up solely of transactions among the game's players. To pay for their purchases, players will have the option of using in-game currency, their own in-game items as barter, or actual real-world currency.

Are such in-game purchases subject to tax in Pennsylvania? While the Department of Revenue has yet to issue formal guidance on the issue, it is possible that, based on existing regulations, the Department may consider such purchases to be subject to tax.

As discussed in our earlier newsletter, purchase of a "digital good" in Pennsylvania is subject to tax if the purchase involves the transfer of canned computer software. The Department distinguishes between "executable" canned computer software and "readable" canned computer software, with only the former being subject to sales and use tax in Pennsylvania. "Executable" canned computer software programs are programs with which the user can manipulate and interact, such as video games and productivity programs. "Readable" canned computer software programs are programs which the user may only experience, but not manipulate, such as music, movies and books.

Therefore, under the Department's interpretation, an in-game purchase will be subject to tax, if a "transfer" occurs. It is arguable whether a meaningful transfer of software occurs in these transactions, as the purchaser does not receive a new executable piece of software, but merely pays for a change in the playing experience for which he has already purchased and paid tax. However, the Department's regulations define "canned computer software" to include "updates, enhancements and upgrades" to that software. The Department has signaled that it considers in-game purchases as purchases of "upgrades or enhancements" to the taxable software application already purchased, and therefore considers these purchases to be subject to tax. ■

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COMMONWEALTH COURT TO CONSIDER FAILURE TO COMPLY WITH IFTA DOCUMENTATION REQUIREMENTS *by Sharon R. Paxton*

The Commonwealth Court heard oral argument on November 14 (Pittsburgh), in *R & R Express v. Commonwealth*, No. 533 F.R. 2007. The case deals with the tax impact of a motor carrier's failure to comply with IFTA mileage and fuel documentation requirements.

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 a liability of over $300,000 in tax, 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 auditor increased the company's reported mileage, imposed the statutory 4.0 m.p.g. factor for at least some vehicles and disallowed credit claimed for reported tax-paid fuel purchases.

PENNSYLVANIA IS NOT AT LIBERTY TO COMPROMISE THE RECORDKEEPING REQUIREMENTS THAT THE IFTA AGREEMENT IMPOSES ON MEMBER STATES AND LICENSEES

R & R Express contends that (1) the audit deficiency should be stricken because the methodology used by the Department of Revenue improperly allows the state to collect tax twice on the same gallons of fuel, first at the time of purchase and again at audit, and (2) in the alternative, the company should be permitted to have its tax for the audit period recomputed based on data from reporting periods subsequent to the audit period. In its brief, the company argues that, since its recordkeeping procedures improved after the audit, the data from later reporting periods represents the "best information available" to compute its additional tax due for the audit period.

The Commonwealth, on the other hand, asserts that Pennsylvania is not at liberty to compromise the recordkeeping requirements that the IFTA Agreement imposes on member states and licensees, and that granting the requested relief would place Pennsylvania out of compliance with the Agreement. The Commonwealth argues that double taxation does not exist because the two taxes imposed on the company apply to different objects – the tax paid at the retail fueling station is imposed on the sale of the fuel and the second tax is imposed on the consumption of the fuel on public highways. Furthermore, the two taxes imposed on a motor carrier might not be imposed by the same taxing jurisdiction since the fuel could be purchased in one jurisdiction and "consumed" in another jurisdiction. With respect to the taxpayer's second argument, the Commonwealth argues that the IFTA Audit Manual requires the base jurisdiction to use a 4.0 m.p.g. factor in the absence of the required documentation.

The decision issued by the court in this case could have far-reaching effects on the resolution of IFTA audit appeals for Pennsylvania-based motor carriers. ■

GROSS RECEIPTS TAX REMINDER

In our September newsletter, we indicated that a number of Gross Receipts Tax issues are being prepared for litigation by telecommunications companies. If your company pays the GRT, we can assist you in identifying possible refund opportunities and in filing protective refund claims, to preserve your rights as to tax paid within the three-year statute of limitations.

CONSOLIDATION OF LOCAL EARNED INCOME TAX COLLECTION

by Sharon R. Paxton

Major changes relating to the collection of local Earned Income Tax ("EIT") will take effect on January 1, 2012. Act 32 of 2008 mandates the consolidation of EIT collection and reporting (one tax collection district per county) for taxes levied and collected after December 31, 2011, and applies to all municipalities and school districts in all counties except Philadelphia. Under the new tax collection system, all employers doing business in the state, even those located in jurisdictions that do not impose an EIT, will be required to withhold applicable EIT from compensation paid to their employees. Employers with business locations in multiple counties will be permitted to file one return with the county tax collection district where their payroll operations are located, or with another tax collection district approved by the Department of Community and Economic Development. However, employers who exercise that option will be required to remit withholdings and employee tax detail electronically on a monthly basis, whereas Act 32 otherwise requires quarterly tax returns and payment.

Act 32 substantially expands the scope of an employer's obligation to withhold EIT from compensation paid to employees. Under the current regime, an employer is only legally required to withhold an EIT imposed by a jurisdiction in which the employer has a place of business. Under Act 32, an employer will be required to withhold EIT from employees at a rate equal to the greater of the tax rate imposed by the employee's place of residence or the nonresident tax rate imposed by the locality where the employee works. The tax collection district will then be responsible for distributing the taxes to the correct jurisdictions. Act 32 requires employers to obtain a Residency Certification Form from all new employees and from current employees who provide notification of a name and/or address change. While it is recommended that employers require all current employees to verify their residency information for EIT withholding purposes, it is not required by Act 32. ■

PA NOTES *by Timothy J. Horstmann*

PURTA Surcharge Rate
The Pennsylvania Department of Revenue recently announced that the surcharge rate applicable to the Public Utility Realty Tax in 2012 will be zero mills.

Local Amusement Tax
The Commonwealth Court has upheld a decision of the Berks County Court of Common Pleas denying a taxpayer's requests for relief from the Ruscombmanor Township's local amusement tax. Use of the tax solely to support the local fire company did not violate the statute because the amounts collected from the tax were general revenue funds, and had been properly devoted to the fire company at the discretion of the Township. The Court explained that the fact that a class of taxpayers is made up of only one business does not violate the Pennsylvania Constitution. *Oak Leaf Investors, Ltd. v. Ruscombmanor Twp.*, No. 191 C.D. 2011 (Oct. 12, 2011) (unreported)

Wind Generation Equipment
The Commonwealth Court has held that an internet

SALT SEMINAR CIRCUIT

- Jim Fritz and Sharon Paxton will be presenting a full-day Sales and Use Tax seminar through Lorman Education Services in Lancaster on January 11, 2012. Registration information (including a special discount code) accompanies this newsletter.
- Randy Varner will be co-presenting "Tax Advice for Companies Doing Business in Pennsylvania, Indiana and Kentucky" during the Ohio Tax Conference on January 25th. Randy recently co-presented a Mid-Atlantic State Tax Update at the 2011 Advanced Tax Institute co-sponsored by the Maryland State Bar Association, Inc. and the Maryland Association of CPA's.
- Bert Goodman and Randy Varner will be presenting at the Pennsylvania Bar Institute's 15th Annual Real Estate Institute in Philadelphia on December 7 and 8.
- Jim Fritz presented a Pennsylvania tax update during the recent state and local tax conference sponsored by the Philadelphia Chapter of the Tax Executives Institute.
- The members of the McNees SALT group thank all who attended their recent full-day Pennsylvania Taxes seminars at Lancaster and Altoona! ■

communications tower equipped with a wind generation device for the purpose of generating electricity to power the tower's communications equipment is not exempt from real property taxation as property "used for the purpose of wind energy generation." The purpose of the tower was to provide internet communications services, not to generate wind energy. *Robert C. Cryan (EA Media) v. Snyder County Bd. of Assessment Appeals*, No. 73 C.D. 2011) (Oct. 13, 2011).

Gaming Taxes

The Commonwealth Court, in a 2-1 decision, has held that certain promotional items awarded to slots machine players are not deductible from gross terminal revenue used in calculating various taxes and assessments due the Commonwealth that are based upon slot machine play. The taxpayer relied on a deduction in the statute for "any personal property distributed to a player as a result of playing a slot machine." The Court viewed the taxpayer's awards as promotional items given to attract and keep customers, and not prizes awarded for playing, and consequently denied the deductions. *Greenwood Gaming & Entertainment, Inc. v. Commonwealth*, No. 617 F.R. 2009 (Oct. 13, 2011). ■

MCNEES PUBLISHES SALT WHITE PAPERS

The following "White Papers" may be downloaded at www.mwn.com, by accessing the "Publications" menu at the "Newsroom" tab and searching by keyword or searching for all "state and local tax" publications.

- Navigating Pennsylvania's Tax Appeals Process, by Jim Fritz
- An Overview of Pennsylvania's Production-Based Tax Exemptions, by Jim Fritz
- Pennsylvania Sales & Use Tax Exclusions for Manufacturing, Fabricating, Compounding, Processing and "Other Operations," by Jim Fritz
- Pennsylvania's Local Tax Exemptions for Manufacturing, By-Products of Manufacturing and Industrial Establishments, by Jim Fritz
- International Fuel Tax Agreement Compliance Tips, by Sharon Paxton
- Unclaimed Property Reporting – Are You In Compliance, by Sharon Paxton ■

FIRST DIRECTOR OF INDEPENDENT FISCAL OFFICE NAMED

On August 30th, legislative leaders announced that Matthew J. Knittel, a senior financial economist with the U.S. Department of Treasury, was selected to serve as the first director of Pennsylvania's new Independent Fiscal Office.

Knittel, 43, holds a Ph.D. in Economics from Michigan State University, where he also earned an M.A. in Economics. He earned two bachelor's degrees, in economics and business administration, from Hope College in Holland, Michigan.

The Independent Fiscal Office (IFO), created by Act 120 of 2010, has several specific responsibilities, including:

- Preparing annual revenue estimates;
- Providing an annual assessment, by November 15 of each year, of the state's fiscal condition;
- Developing performance measures for executive-level programs and departments;
- Providing an analysis of all tax and revenue proposals made by the Governor or the Office of the Budget; and
- Studying and analyzing the existing sales and use tax law and making recommendations for change (including possible base expansion). ■

JIM FRITZ NAMED TO *BEST LAWYERS IN AMERICA®* LIST

Jim Fritz again has been named to the *Best Lawyers in America®* list. For 2012, Jim has been listed in the category "Litigation & Controversy – Tax." *Best Lawyers* is based on an exhaustive annual peer-review survey. 36 other McNees lawyers have also been named to Best Lawyers – including 33 in the Harrisburg office, one in Lancaster and two in Columbus. ■

THE BEST LAWYERS IN AMERICA

COMPROMISES TO BE PERMITTED AT BOARD OF APPEALS *continued from page 1*

issues. Obtaining a reasonable settlement will require taxpayers and their representatives to have a complete understanding of the legal arguments applicable to the facts of their cases and to have a full sense of the strengths and weaknesses of their position. Negotiations may require extensive back and forth about the merits of the arguments advanced by both sides.

We regard the Department's initiative as a major improvement in the Commonwealth's appeals process because it will provide taxpayers with the possibility of negotiating early in the appeals process. However, taxpayers and their representatives will have to be prepared to evaluate whether an early settlement makes sense in a particular case based on the terms on which the Department is willing to settle the appeal at the Board level.

The members of McNees Wallace & Nurick's State and Local Tax Group have extensive experience both in handling matters before the Department's Board of Appeals and in negotiating settlements of tax appeals. If your company is considering an appeal of a Pennsylvania tax matter and wishes to discuss the new appeal procedure, please contact one of the following members of the McNees SALT group:

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