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PA TAX LAW NEWS

HOME STRETCH TO A PA BUDGET *by James L. Fritz*

As the Pennsylvania General Assembly heads down the home stretch to the June 30th deadline for passage of a budget for 2013-14, all indications suggest that the budget package will include significant substantive and administrative tax changes. The real question is whether the changes will include any surprises.

On May 6th, the Pennsylvania House of Representatives passed H.B. 440, as amended, and sent it to the PA Senate where it likely will undergo further revisions before possible passage as part of the 2013-14 budget package. As we reported in our February newsletter, this bill was introduced by Representative Dave Reed and a host of co-sponsors to reprise tax legislation which also passed the House but did not make it through the Senate last year. This time, the bill was amended in committee before reaching the floor, to retain Reed's royalty add-back provisions and incorporate many of the tax provisions from Governor Corbett's budget proposal.

The question now is whether the provisions now in H.B. 440 will survive in the final 2013-14 budget package and whether there will be any significant changes or additions. Following are short summaries of the current H.B. 440 provisions.

- **Corporate Net Income (CNI) Tax Rate** would be phased down from the current 9.99% to 9.89% for taxable years beginning on or after January 1, 2015, and then in annual increments until being reduced to 6.99% for tax years beginning on or after January 1, 2025.

- **CNI Sales Factor Sourcing Rules** would be amended for tax years beginning after December 31, 2013. Receipts from sale, lease, rental or otherwise of real property would be sourced to the property location. Receipts from rental, lease or licensing of tangible personal property would be sourced initially to Pennsylvania if the customer first obtained possession in PA and, if subsequently taken out of state, a reasonable estimate of PA usage could be applied. Instead of applying the current "costs of performance" rules, receipts from sales of services would be sourced to PA if "delivered to a location in" PA and, if delivered to locations in multiple states, part of the receipts would be attributed to PA, based on the percentage of the value of the service delivered to PA. If a taxpayer could not determine the delivery point, sales to an individual (not a sole proprietor) would be sourced to the person's billing address and sales to other customers would be sourced to the point from which the customer placed its order in the regular course of operations (or to the customer's billing address if the taxpayer could not determine where the order was issued). The standard "destination" rule would continue to apply to sales of tangible personal property and the "costs of performance" rules would continue to apply to sales of intangibles.

- **CNI Net Loss Deduction Cap** would be increased from the greater of 20% or $3 million to the greater of 25% or $4 million for tax years beginning in 2014 and to the greater of 30% or $5 million thereafter.

- **Add-back of Royalties and Interest** - Deductions would be disallowed for "intangible expenses or costs" (i.e., royalties, license fees, etc,) and "interest expenses or costs" to the extent "directly related to an intangible expense or cost," when paid to an "affiliated entity" (50% ownership test). A credit would be provided where the affiliate pays tax to PA or another state on the income. Deductions would not be required where (a) the affiliate passes payment through to an entity which is not an affiliate; (b) the affiliate to which payment is made is located in a foreign nation with a comprehensive U.S. income tax treaty; or (c) the transaction with the affiliate is directly related to a "valid business purpose" (which is presumed if done at arm's length terms).

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- **CNI Penalties** for failure to file a timely report would be increased to $500 plus one percent "for every dollar of tax determined to be due in excess of … $25,000."
- **Capital Stock/Franchise Tax Phase-out** would not be changed - the tax rate is 0.89 mills for 2013 and 0 mills thereafter.
- **Sales & Use Tax** provisions would remain essentially unchanged. As passed by the House, there would be no change in the 1% vendor's collection allowance. The "call center" credit provisions would be repealed. County treasurers would no longer be designated as local receivers of use tax.
- **PIT** - "Net Profits" would be reduced to the extent a deduction is taken for federal tax purposes under IRC § 195(6)(1)(A) (start up business deduction).
- **PIT** - "Net Gains or Net Income, less net losses" would no longer include gain or loss from exchange of property qualifying under IRC § 1031 and related regs.
- **PIT** - Partnership - The classification or character of income would be determined at the partnership level.
- **PIT** - Partnership and S Corporation Tax - Certain partnerships underreporting reportable income by more than $1 million would be jointly liable with each partner. Publicly traded partnerships would not be covered. The provisions would apply to partnerships with 11 or more individual partners and those with at least one partner that is a corporation, limited liability company, partnership or trust. Other partnerships with only individual partners could elect to be subject. Similar provisions would apply to Pennsylvania S Corporations with 11 or more shareholders or which elect to be covered.
- **PIT** - Credit would not be allowed for taxes paid to a foreign country.
- **PIT** - Estates and trusts receiving PA-source income would be required to pay withholding tax for nonresident beneficiaries.
- **PIT** - The Revenue Department could establish requirements for information to be provided by Pennsylvania S Corporations to their shareholders, by partnerships to their partners and by estates and trusts to their beneficiaries.
- **PIT** - Estates, trusts, Pennsylvania S Corporations and partnerships (except publicly traded partnerships) which fail to maintain appropriate lists of beneficiaries, shareholders and partners would become responsible for tax, penalties and interest otherwise due from the beneficiaries, shareholders and partners, as would the respective trustees, corporate officers, general partners and tax matters partners.
- **Realty Transfer Tax** - Would eliminate the provision allowing tax avoidance by transferring 89% of interests in a "real estate company" with an option to purchase the remaining 11% after three years.
- **Credits** - The Coal Waste Removal and Ultraclean Fuels Tax Credit would be repealed. ■

Please contact Jim Fritz at 717-237-5365 or jfritz@mwn.com, or any other member of the McNees SALT group if you have any questions concerning possible tax changes.

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PA TO PROJECT VENDOR OVERPAYMENTS IN SOME AUDITS *by James L. Fritz*

The Pennsylvania Department of Revenue has performed a partial "about face" on the audit treatment of sales tax overpayments to vendors. Previously, taxpayers under audit could request credit in the audit for overpayments made to vendors, but Pennsylvania's auditors were not permitted to take such credits into account in projecting deficiencies. With the issuance of Sales and Use Tax Bulletin 2013-01 on May 28, 2013, the Department has indicated that it will allow such overpayments to be included in projections developed through stratified random sampling. Inexplicably, however, the Department will continue to refuse projection when audit deficiencies are developed by block sample methodology.

General Background

The Department of Revenue is authorized to examine a taxpayer's books and records to verify the accuracy and completeness of any return filed with the Department.[1] The Department may utilize a "reasonable statistical sample or test audit performed in accordance with the regulations of the Department if the individual being audited does not have complete records of transactions or if the review of each transaction or invoice would place an undue burden on the Department to conduct an audit in a timely and efficient manner."[2] The Department's regulations have long provided for the development of underpayment deficiencies by use of different sorts of sampling. However, the regulations made no provision for projection of overpayments to vendors or, for many years, even for offset of individual vendor overpayment amounts against the final deficiency within the audit process.[3] Taxpayers, of course, were always free to seek refunds of overpayments by filing a refund petition under the standard three-year statute of limitations, but since audit periods often extend back more than three years, taxpayers sometimes lost the ability to seek a refund by the time they found the overpayment.

The McNeil Case

The Department was forced to make a change in its practices by the Pennsylvania Supreme Court's 2003 decision in *McNeil-PPC v. Commonwealth*,[4] in which the court allowed a taxpayer to offset overpayments within the audit period, even though credit or refund was requested beyond the regular three-year refund statute of limitations. The court recognized that "it is the duty of the auditor to ensure that the proper amount of tax was collected, which necessarily requires that the audit take into account situations where the taxpayer overpaid tax or paid tax where it did not have to during the audit period."[5]

2004 Bulletin

The Department reacted to McNeil by issuing Sales Tax Bulletin 2004-02, which indicated that auditors would grant credits for overpayments discovered in the course of an audit examination, or pointed out by the taxpayer during that examination. However, the bulletin expressly provided that vendor overpayments would only be credited against the final deficiency; no projection was allowed even where the auditor used a sampling method to produce the audit deficiency. This rule applied whether the sampling was conducted by block sample or statistical sampling.

Bulletin 2013-01[6]

After issuance of the 2004 bulletin, taxpayers and their representatives, from time to time, requested projection of overpayments made to vendors. These requests were sometimes granted in administrative appeals and in negotiated settlements of court cases, but there was no official recognition by the Department and auditors continued to deny such requests at the audit level. Bulletin 2013-01 finally, at least partially, has recognized the inequity in allowing the Department to use a sampling methodology to project underpayments of tax to vendors and use tax to the Department but not allowing the taxpayer a similar right to project overpayments made to vendors.

The Bulletin provides that projection of vendor overpayments will be allowed if:

1. The taxpayer is currently under audit by the Department or has entered into an agreement with the Department to conduct a managed audit;

2. Verifiable electronic purchase records are made available to the Department;

3. The volume of records supports the need for use of sampling procedures;

4. An agreement is reached … on the use of the sampling method;

5. Sufficient evidence is provided to allow the Department to determine whether … tax is overpaid for each transaction in the sample.

If the auditor does not grant credits sought by the taxpayer, a petition for refund may be filed with the Department's Board of Appeals within the later of six months from the date of the

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TOWNSHIP BUSINESS PRIVILEGE TAX REJECTED *by Randy L. Varner*

The Commonwealth Court has ruled that Whitehall Township in Lehigh County could not tax sales occurring outside the territorial limits of the township.

In a February 11, 2013 decision, the Commonwealth Court of Pennsylvania struck down the township's business privilege tax assessment primarily based upon the plain language of the imposition ordinance. In *Giles & Ransome, Inc. v. Whitehall Township*, 645 C.D. 2012 (Pa. Cmwlth., February 11, 2013), the Commonwealth Court closely examined Whitehall Township's Business Privilege Tax ordinance and concluded that the ordinance permitted the imposition of tax only on transactions within the territorial limits of the township.

Whitehall Township had issued a Business Privilege Tax (BPT) assessment on Giles & Ransome, Inc. which taxed the gross sales of three salespeople who occasionally used an office in the township, but were not assigned to any particular office and were not managed by anyone in the township. Giles & Ransome sells heavy equipment in the eastern part of Pennsylvania and parts of New Jersey and Delaware. The record showed that the salespeople spent nearly all of their time in the field visiting customers over a multi-county area and that all sales orders were approved or rejected outside the township.

The township argued that these sales should be included in the BPT base, even though the township ordinance only imposes tax on "the actual or whole gross volume of business transacted by such taxpayer within the territorial limits of the Township." Whole or Gross Volume of Business is further defined by the ordinance as "the gross consideration credited or received for or on account of sales made, services performed, rentals of property, and/or other business transactions, within the territorial limits of the Township . . . ."

The township relied on earlier cases allowing municipalities to impose tax on receipts from services rendered outside the township where the service activities were managed, directed and controlled from a headquarters office or "base of operations" within the taxing jurisdiction.

The Commonwealth Court, however, agreed with Giles & Ransome that the township could not tax the extra-territorial sales of the salespeople. Relying on a plain reading of the ordinance, the court noted that this was not a case for a "base of operations" analysis; but rather, the ordinance specifically restricted the imposition of tax to only those transactions within the territorial limits of the township. Since the record contained no evidence of specific sales occurring within the township, the court concluded that the assessment was improper. The township has filed a petition for allowance of appeal to the Supreme Court of Pennsylvania, which has been opposed by Giles & Ransome. We will keep you updated on further developments.

... THE ORDINANCE SPECIFICALLY RESTRICTED THE IMPOSITION OF TAX TO ONLY THOSE TRANSACTIONS WITHIN THE TERRITORIAL LIMITS OF THE TOWNSHIP.

The lesson to be taken away from the court's decision is that it is crucial to analyze the language of the statute to determine what the scope of the tax is. Business privilege and mercantile tax ordinances take different forms, which necessarily require different modes of analysis. For instance, an ordinance can be a broad, privilege-based ordinance, with no territorial restrictions, like the City of Pittsburgh ordinance that was analyzed in the seminal case of *Gilberti v. City of Pittsburgh*, 511 A.2d 1321 (Pa. 1986), the first case to suggest a "base of operations" justification for taxing extraterritorial sales. Alternatively, the ordinance may take the form of a narrow, transaction-based ordinance, with a territorial restriction like the one in Giles & Ransome. In that case, the township may properly tax only those transactions that occur within the territorial limits of the township. ■

[Editor's Note: This case was argued in the Commonwealth Court by Randy Varner.]

If you have questions about business privilege or mercantile taxes, please feel free to contact McNees SALT team member Randy L. Varner at 717-237-5464 or rvarner@mwn.com or another member of the McNees SALT group.

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PENNSYLVANIA SUPREME COURT UPHOLDS IFTA LIABILITY AGAINST BROKERAGE COMPANY WITH INADEQUATE RECORDS *by Sharon R. Paxton*

On April 24, 2013, the Pennsylvania Supreme Court affirmed, without opinion, the Commonwealth Court's decision in *R & R Express v. Commonwealth*, 37 A.3d 46 (Pa. Cmwlth. 2012). In *R & R Express*, a three-judge panel of the Commonwealth Court had upheld the results of an audit conducted by the Pennsylvania Department of Revenue under the International Fuel Tax Agreement (IFTA), which imposed a substantial tax liability against a brokerage company that failed to strictly comply with IFTA mileage and fuel documentation requirements.

R & R Express had 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 recordkeeping 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 Commonwealth Court seemed sympathetic to the taxpayer's situation, it agreed with the Department of Revenue's position that strict compliance with the reporting framework set forth in the tax statute, the IFTA Agreement, and accompanying regulations and guidelines, is required. ■

For questions concerning Pennsylvania fuel taxes, please contact Sharon Paxton at 717-237-5393 or spaxton@mwn.com, or another member of the McNees SALT group.

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PA TO PROJECT VENDOR OVERPAYMENTS IN SOME AUDITS *(continued on from page 3)*

assessment or three years from the date the tax was paid to the vendor. On appeal, the Board of Appeals "will only project an overpayment if it relates to a sample selected by the Department during an audit or during an agreed-upon managed audit process." If tax was overpaid on a transaction not in the selected sample but within the sampled population, "the petitioner may request refund or credit, but has the burden to prove that the credit requested exceeds the amount of credit granted due to the audit projections." As for overpayments on transactions not within the sampled population, the traditional rules continue to apply – requiring proof of payment and adequate support to establish that each transaction was not taxable.

Why Not Project Under Block Sampling?

Bulletin 2013-01 provides no explanation for why the Department will allow projection of overpayments to vendors when the auditor uses a statistical sampling approach, but not when the auditor uses block sampling. If block sampling produces a reliable projection of underpayments, why is the taxpayer not allowed to use the same methodology to obtain credit for vendor overpayments? ■

Questions & Assistance

Please contact a member of the McNees Wallace & Nurick LLC State and Local Tax Group if you have any questions about Pennsylvania sales and use tax audits and appeals. The members of our SALT group have many years of experience dealing with these and other Pennsylvania tax matters

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[1] 72 P.S. §§ 7272, 10003.21(a).
[2] 72 P. S. § 10003.21(b).
[3] See, 61 Pa. Code §§ 8a.1-8a.9.
[4] 575 Pa. 50, 834 A. 2d 515 (2003).
[5] 575 Pa, at 64, 834 A. 2d at 523,
[6] The complete text of Sales and Use Tax Bulletin 2013-01 is available on the website of the Pennsylvania Department of Revenue (www.revenue.state.pa.us).

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