Testimony Presented by
Cheri Freeh, CPA, CGMA
to the
House Finance Committee
PA House of Representatives
Dec. 12, 2017
On behalf of the Pennsylvania Institute of Certified Public Accountants (PICPA), thank you for the opportunity to provide testimony regarding the Pennsylvania Department of Revenue’s examination activities relative to Schedule C and other related compliance activities. My name is Cheri Freeh, and I am a past president of the PICPA and current member of its Committee on State Taxation. I have over 30 years of experience in accounting, auditing, and taxation, with a significant amount of experience with individuals, corporations, partnerships, estates and trusts, nonprofit and government auditing, and a wide array of accounting issues. I am a former member of the Internal Revenue Service (IRS) Advisory Council, where I served among approximately 20 tax professionals from across the country who were appointed to provide input to the IRS. I also serve on the American Institute of CPAs’ IRS Advocacy and Relations Committee.

Founded in 1897, the PICPA is the second-oldest and the fourth-largest CPA organization in the United States. Membership includes nearly 20,000 practitioners in public accounting, industry, government, and education. PICPA members provide auditing and accounting services to individuals, not-for-profit organizations, and employers of all sizes; advise clients on state, federal, and international tax matters; and prepare income and other tax returns for thousands of individuals and businesses throughout Pennsylvania. The PICPA preserves the legacy and propels the integrity of the CPA profession by working with state and federal legislative and regulatory bodies and the public to develop sound public policy in the areas of accounting, auditing, and taxation. Affiliation with the PICPA represents commitment to the CPA profession, including adherence to a code of professional conduct and a stringent set of professional and technical standards.

The focus of today’s hearing is on the Pennsylvania Department of Revenue’s relatively new compliance practice of reviewing Form Schedule C outside of the normal audit process. In late 2015, the Department of Revenue announced that it would begin examining taxpayers’ Schedule Cs. This schedule is typically used by Pennsylvania taxpayers to report income or loss from a business operation or a professional practice as a sole proprietor on their PA-40—the Pennsylvania personal income tax return. These activities qualify as a business if the taxpayers’ primary purpose for engaging in the activity is income or profit, it is conducted with continuity and regularity, and it satisfies the “Commercial Enterprise” test. Certain rental activity may be business income and not rental income. Single-member limited liability companies also complete PA Schedule Cs. The Department of Revenue has issued notices for more than 45,000 personal income tax returns involving Schedule C over the past several months, or roughly 8 percent of such returns filed with the state.
How the Department chose to review Schedule C filings has created a lot of anger, consternation, and resentment in the tax practitioner community. CPAs, tax practitioners, and, most importantly, taxpayers are angry! While the Department did provide notice of its new review process, many tax practitioners—myself included—were caught off guard by the multitude of notices that taxpayers began receiving earlier this year and the sheer volume of information requested. Many of these notices were being received by taxpayers at the same time that the tax amnesty program was operational. This created a lot of confusion for taxpayers.

Let me be clear: The Department of Revenue has the legal standing to review Schedule Cs. While a field or desk audit might be preferable for some taxpayers (and practitioners), the additional step of reviewing the Schedule C is well within the purview of the Department. Our issue is more with the parameters of the program and the resources required to carry out these reviews in an efficient and effective manner. To its credit, the Department has made some changes to the program. For example, the wording on the notices has been improved and the timeframe in between notices has been extended. However, the lack of closure for many outstanding reviews continues to aggravate both taxpayers and tax practitioners, and the Department does not appear to have adequate resources to process these reviews. As a result, taxpayers and their representatives are suffering. We have not been able to get through on phone lines; fax lines have been busy; and when we resort to mailing information the Department ignores the fact that a response was sent and delivers notices claiming that the taxpayer did not respond. This leaves no choice but to send responses via certified mail, which is very inefficient for the Department. We do not question the right of the Department to request information; we simply expect them to be able to efficiently administer their processes.

The PICPA is a long-time proponent for an efficient and effective state and local tax system based on principles of good tax policy. PICPA members championed the passage of legislation that consolidated and reformed the local earned income tax collection process, what is now Act 32 of 2008. We need a tax system that is administrable, stimulates economic growth, has minimal compliance costs, and allows Pennsylvania taxpayers to understand their tax obligations. The PICPA believes the new process of reviewing Schedule C violates several principles of good tax policy, namely certainty, simplicity, and economy of collection. These features of a tax system, along with the other principles, are achievable if principles of good tax policy are considered in the design of the system. Let me highlight the noted principles in more detail.
Certainty

The principle of certainty holds that tax rules should specify when a tax is paid, how it is to be paid, and how the amount to be paid is to be determined. A person’s tax liability should be certain rather than ambiguous. Taxpayers should be able to determine their tax liabilities with reasonable certainty based on the nature of their transactions. If the transactions subject to tax are easy to identify and value, the principle of certainty is more likely to be attained. Certainty is important to the tax system because it helps to improve compliance with the rules and increase respect for the system. Certainty generally comes from clear statutes as well as timely and untestable administrative guidance that is readily available to taxpayers.

Simplicity

Tax laws should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner. Simplicity in the tax system is important both to taxpayers and to those who administer the various taxes. Complex rules lead to errors and disrespect for the system, which can reduce compliance. Simplicity is important both to improve the compliance process and to enable taxpayers to better understand the tax consequences of transactions in which they engage in or plan to engage.

Economy of Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers. These costs include the administrative cost to the government that is influenced by the number of revenue officers necessary to administer the tax. There are also compliance costs incurred by taxpayers to consider. This principle is closely related to the principle of simplicity. The more complex a tax, the greater the costs for the government to administer it and the greater the compliance costs for taxpayers to determine their tax liability and report it.

One last comment. We wish to make you aware that there will be a residual impact on taxpayers at the local level. The Department shares with Pennsylvania’s local tax collectors data from taxpayers’ returns, which is then compared to the returns filed with local governments. When a discrepancy surfaces, taxpayers will receive a notice from the local collector asking for an explanation or simply assessing the taxpayer with additional tax owed. If the Department changes a taxpayer’s Schedule C profit incorrectly and the taxpayer chooses to pay the tax rather than hire a representative and dispute the assessment, then this will flow down to local tax collection.
In closing, I would like to say that failure to allocate sufficient resources to proper and fair collection practices results in a disservice to taxpayers. The act of assessing a tax with the hope that a taxpayer will choose not to argue and will just pay it is an unfair collection practice. This includes burdening taxpayers by requesting large volumes of information and then not allocating proper resources to review that information. Taxpayers who properly comply have not been receiving a timely response and resolution. We do not want to see the Department slip into this practice.

Thank you for allowing me to testify today. I would be happy to answer your questions.