We provide here a written summary of answers provided by the Department Revenue to the committee at periodic question and answer sessions. These documents are classified as revenue information issued for informational purposes only for the convenience of PICPA’s members. Pursuant to 61 Pa. Code Section 3.4, these documents should not be relied upon for any purpose or used in tax appeals. Taxpayers requiring a binding opinion on a specific fact situation may request a written letter ruling under 61 Pa. Code Section 3.3.

PICPA State Taxation Committee Annual Meeting with the PA Department of Revenue PA Manufacturers’ Association Building Thursday, October 26, 2017 1:00 p.m.

ADMINISTRATIVE

1. Please explain for CNIT and PIT purposes whether P.L. 86-272 applies to sales in international commerce. For example, a non-U.S. corporation makes sales into Pennsylvania. The activities of the non-U.S. corporation do not exceed “solicitation.” Would the activities of the non-U.S. company be protected under P.L. 86-272?

PIT - While P.L. 86-282 is a Federal, not state, law (it is codified at 15 U.S.C. § 381, et seq.), the Department believes that, for PIT purposes, P.L. 86-272 would apply to a company making sales of tangible personal property into Pennsylvania if its only activity in Pennsylvania is solicitation. Protection would apply to a nonresident partner/shareholder. A resident partner/shareholder is taxed on income everywhere and is not protected under P.L. 86-272. However, CNIT - P.L. 86-272 by its terms only applies to interstate commerce and does not apply to foreign commerce. If this question concerns a specific taxpayer, consideration should be given to disclosing the identity of the taxpayer and all relevant facts to the Department and requesting a ruling.

2. Please explain the criteria the Board of Appeals looks at in determining whether to abate a penalty under 72 Pa.C.S. § 9706

This section provides that penalty may be waived if the petitioner acts in good faith, without the intent to defraud the Commonwealth and without negligence. The Board will generally review the petitioner's filing history for a certain period of time (dependent on the tax) to determine if penalty should be abated. If the petitioner has a good filing history for that time, then penalty will generally be abated. For the trust fund taxes, the look back period is prior 12 months. For Personal Income Tax and Corporate taxes, the look back period is three years. If it is a sales and use tax audit assessment, the Board will generally abate penalty if this is the first audit and there is no failure to remit collected tax. If it is a subsequent sales and use tax audit, the Board will review whether there has been improvement in the areas of deficiency in the first audit. The Board may also not abate
penalty in an audit assessment if the taxpayer did not provide records or did not cooperate with the auditor. Please be aware that these are merely general guidelines used by the Board when reviewing penalty abatement. There may be some exceptions to these guidelines based upon the facts and circumstances of a particular appeal.
3. Please explain how an LLC or S Corp that was only subject to CS/FFT for tax years beginning prior to 1/1/16 may be removed from the tax rolls in instances where the entity did not complete RCT-101, Section E.

The entity should not file an amended report only to claim the RCT-101 is final. The entity should fax a statement to the Bureau of Compliance 717-783-8265 stating the 2015 Corporate Income Tax Report should have been marked a Final Report due to the corporation not being subject to CNI due to [state reason] and no longer subject to Capital Stock/Franchise Tax as of 2016.

4. Would the DOR consider posting a comprehensive, searchable database of redacted Office of Chief Counsel rulings for tax issues on the Department’s website?

DOR currently publishes redacted OCC letter rulings on the website, grouped by tax type, and with comprehensive titles. DOR will look into the possibility of creating a searchable database.

CORPORATE INCOME TAX

5. For CNIT purposes, a corporate REIT is entitled to a dividends-paid deduction that usually results in federal taxable income of $0. However, the REIT may have PA modifications to federal taxable income. If the net modifications result in PA taxable income, please explain whether the REIT would have a CNIT liability.

In most cases, this will not happen, but if they have PA modifications after taking the dividends then they would be subject to any liabilities, the same as any other corporation.

6. How should a taxpayer handle a notice of assessment for a year in which the appeal deadline has passed regarding the former Capital Stock/Foreign Franchise Tax (CSFT), but the increase in tax is due to a change in prior year book income that is under appeal? The additional tax should not be due unless the taxpayer is unsuccessful in its appeal for the prior year. Would a lien be filed for the current year?

If the appeal deadline has passed for the current year and the prior appeal has not been resolved, their recourse would be to pay the increase in tax and petition for refund. There would be no additional lien imposed except for the increase in tax, unless the prior appeal is not determined before the current year goes through all the collection steps. If the appeal is decided in the taxpayers favor and the statute of limitations has not expired on the current year, a redetermination could be done.
7. For PA CNIT purposes, please explain how (1) receipts for laboratory R&D services and (2) receipts for contracting with third parties to conduct clinical trials on behalf of related parties should be sourced under market-based sourcing.

Taxpayer is domiciled in PA and provides research and development services ("R&D services") to related parties at an arm’s-length rate. Related parties are domiciled in PA, other states, and outside the US. The R&D services are managed and directed on a global basis from outside the US, while some local oversight occurs within PA.

R&D services are comprised of (1) research and development of products in a laboratory environment occurring within PA and (2) contracting with unrelated clinical research organizations ("CROs") to conduct Phase I through IV clinical trials in PA and in other states. Taxpayer employees oversee the activities of CROs across the US from the Taxpayer’s office in PA. The purpose of clinical trial activity is to result in new products or efficacies of existing products for sale across the world.

The issues raised in this question are not general in nature. The person asking this question should consider making full disclosure of the facts, including the taxpayer’s identity, and submitting these issues as letter ruling request to the Department.

8. Please explain how a CRO should source receipts for conducting and/or managing drug trials for third-parties. Assume that the CRO will perform services in multiple states in connection with a particular contract.

The issues raised in this question are not general in nature. The person asking this question should consider making full disclosure of the facts, including the taxpayer’s identity, and submitting these issues as letter ruling request to the Department.

9. To the extent non-inconsistent with the statute, please explain whether a corporate taxpayer may rely upon the MTC’s Section 17 regulation for purposes of sourcing receipts from services until the PA Department of Revenue (DOR) issues market-based sourcing regulations for CNIT purposes.

From a legal perspective, the MTC regulation cannot be relied upon as having the effect of legal authority. However, since Pennsylvania’s statutory language is very similar to that adopted by the MTC, the Department believes the MTC’s regulations for sourcing receipts from services represent a valuable guideline for Pennsylvania taxpayers seeking additional guidance on how to interpret the statutes.

DISCLAIMER: The Department of Revenue has prepared draft regulations for sourcing receipts of services and intangibles. The initial drafts are currently under internal review and will be made available for public inspection/review/comment as soon as practical. Accordingly, any responses contained herein are based on previously-provided guidance from the Department.
10. Please explain how a corporate taxpayer should apply the income producing activity/cost of performance (IPA/COP) method to source royalties or other receipts from the licensing of marketing and non-marketing intangibles for CNIT purposes.

The income producing activity occurs where the benefit is received from the marketing or non-marketing intangibles. Generally, this means the income producing activity occurs where the licensed intangibles are used.

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11. Please explain how a corporate taxpayer should apply the IPA/COP method to source receipts/gain from the sale of a patent, trademark or similar intangible for CNIT purposes.

Unlike transactions involving receipts from the licensing of intangible property, where the income producing activity occurs where the license is used, the income producing activity for receipts from the sale of intangible property may not necessarily be sourced to the location where the intangible property is used. Further, while the licensing of intangible property generally occurs over a continuous period of time, the sale and legal transfer of property from one party to another generally occurs just once, at a particular instant in time. Therefore, determination of where the income producing activity occurs may depend on unique facts and circumstances, including considerations such as state or federal laws governing sales of certain property, the commercial domiciles of the parties involved, and the history of licensing and/or usage of the property.

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12. Please explain how a corporate taxpayer should apply the IPA/COP method to source goodwill from the sale of a business.

Generally, the income-producing activity occurs where the benefit is received by the customer. However, the Department believes the sale of goodwill is unique and must be evaluated on a case-by-case basis. It is anticipated the Department’s draft regulation addressing receipts from intangibles will specifically address this subject.

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13. The DOR has sent out many notices requesting additional information for Cost of Goods sold and other line items on the schedule C. In many cases, responses can be voluminous. Every notice that our clients have provided us with received a timely response via mail as the fax number was busy or the amount of data was too large to fax. Recently, several of our clients have received follow-up notices stating that DOR has not received the mailed response. It appears that DOR is unable to process responses in a timely manner or route responses to the proper location in the system. What lessons are being learned through this process? How will procedures change in future to ensure that taxpayer responses are processed in a timely manner?

*The department has developed “TIPS for Successfully Filing PA Schedule C” and “TIPS for Successfully Filing PA Schedule UE”*

*We have agreed to extend the deadline for providing additional information from 15 days to 30 days.*

*We have extended the time between a first and second notice an additional 30 days.*

*If the return has been processed as originally filed, the department will advise the taxpayer that no adjustments were made.*

*The department has been reevaluating current year suspensions and has started making adjustments.*

14. If a Schedule C review is conducted and accepted for the 2016 year, can we expect that subsequent years will not be subject to review? Why would the DOR continually ask for data that has already been substantiated?

*If we suspended a return for review this year, and we were able to get comfortable with the support provided by the taxpayer, we will not suspend the same taxpayer for the same reason again next year.*

15. Is there a threshold for the amount of Schedule C expenses to be reviewed? If we have a client that has a $20,000 expense that is questioned, the possible state tax impact is $614. By the time copies of the supporting documents are made, the data reviewed (and billed for), it may be more affordable for the client to just pay the additional state tax.

*The department uses data analytics to identify average expenses, line items on the Schedule C, which are claimed by a particular industry. Returns are examined when outliers are identified. We are not limiting our review to either a particular industry or particular level of income. The department has been reevaluating current year suspensions and has started making adjustments.*
16. What procedure is next after the second Schedule C Review notice? Will it be another request for information, a billing notice, or something else?
   *If a taxpayer cannot support the amount of the expense included on Schedule C, the department will generate a denial notice for the refund or an assessment for additional tax due. Both notices can be appealed.*

17. In the event the DOR does not accept the Schedule C as filed, and denies some expenses resulting in a change in taxable income, will that information be shared with the IRS and local taxing authorities?
   *If adjustments fall within an IRS request or affect the federal income tax, it may be shared with the IRS. Local taxing authorities will get income adjustments.*

18. Are the Schedule C reviews being handled by RSI (Revenue Solutions Inc.) and if they are, couldn’t improved analytics be utilized to more accurately reflect Schedule C’s that may actually need to be reviewed?
   *The department uses data analytics to identify average expenses, line items on the Schedule C, which are claimed by a particular industry. Returns are examined when outliers are identified. We are not limiting our review to either a particular industry or particular level of income. The department has been reevaluating current year suspensions and has started making adjustments.*

19. PA-40 Schedule OC credits seem to be a continual issue that causes refunds to be delayed and/or billings to be issued. Is there not a better way than to send credit award letters and allocation schedules to the Bureau of Corporation Accounting Division?
   *Prior to the phase out of CS/FF, the Bureau of Corporation Taxes had to wait for the filing of the RCT-101 in order to apply the credit to corporate tax in accordance with statute. Only then was any remaining credit available for sale or pass through. Unfortunately with the award notification coming way ahead of the corporate annual filing due date (even longer if under extension) this put a pass through request in a holding pattern. If the return suspended, the timeframe is even longer.*

20. Please explain how PA applies the income producing activity/cost of performance method for PIT purposes. For example, please explain whether DOR’s application of the IPA/COP method in Information Notice Corporation Taxes 2014-01 also applies for PIT purposes.
   *Information Notice Corporation Taxes 2014-01 applies to corporate taxes. The notice does not apply to PA PIT.*
21. Please explain the PA PIT tax consequences of a conversion of a PA S Corporation to a limited partnership, i.e., whether the transaction would not be subject to tax.

*Historically the department treated this transaction as the termination of one entity and the creation of a new entity. This was the general rule prior to 2015 since the Commonwealth did not have a conversion statute.*

*There is no definitive policy at this time and the department is considering the effect of the 2015 statute.*

22. For PIT purposes, please explain whether federal income tax principles are “acceptable by standards of the accounting profession.” If the answer to that question is affirmative, please explain why a taxpayer that follows federal income tax principles for accounting purposes is not permitted to make elections like IRC secs. 734, 743, 745, 754 and 1031 for PIT purposes. The DOR has not adopted regulations prohibiting the application of these sections.

*The federal income tax method of accounting is not an accepted accounting principle and practice under PA law and regulations. It allows taxpayers to invoke various non-recognition and deferral principles that do not clearly reflect income.*

*It is not an accepted accounting method that clearly reflects income, as required by PA law and regulations.*

*As noted in a recent BF&R opinion (Docket 1624564), even if the federal income tax method of accounting was an accepted accounting principle and practice under PA law and regulations, various Pennsylvania case law acts to prohibit its use for PIT purposes.*

23. In 2016, a question was posed asking DOR’s position regarding the PIT treatment of an IRC sec. 351 transaction with boot. The Department never provided an answer. Please explain the DOR’s position on this issue.

*For PIT purposes, all the gain would be recognized as taxable if boot received pursuant to 72 P.S. §7303(a)(3)(iv).*
24. In a 2015 PICPA Q&A, the DOR indicated that services provided by services like CCH, RIA, LEXIS and Bloomberg constituted nontaxable information retrieval services. Recently, the DOR has indicated that these services constituted taxable sales of software and/or taxable sales of digital products. Please explain the basis for the DOR’s change of position. In addition, please explain how an information retrieval service can also be a digital product.

The Graham Packaging and Dechert decisions provided the legal authority for the Department to consider all digitally/electronically delivered software products, including those sold by CCH, RIA, LEXIS, and Bloomberg as taxable. See Graham Packaging Company L.P. vs. Commonwealth, 882 A.2d 1076 (Pa.Cmwlth. 2005); Dechert, LLP v. Commonwealth, 998 A.2d 575 (Pa. 2010). However the taxation of digitally/electronically delivered software products not specifically addressed by the court, was held in abeyance pending legislative direction. The Department’s response to PICPA’s inquiry in 2015 reflects this position by characterizing sales made by CCH, RIA, LEXIS, and Bloomberg as “information retrieval services.”

In 2016 through Act 84 the legislature amended and clarified the term “tangible personal property” to include “any other otherwise taxable printed matter” and “any other otherwise taxable tangible personal property electronically or digitally delivered, streamed or accessed.” Act 84 of 2016. With the passage of Act 84 there is no distinction between a service providing “electronic” tangible personal property and a service providing “hard copy” tangible personal property. Given this legislative directive, the Department could no longer maintain the position reflected in its answer to PICPA’s question in 2015, and not apply the holdings in the Graham Packaging and Dechert decisions.