The Legal Intelligencer

Pennsylvania Tax Assessments: Top 5 Issues to Look Out For

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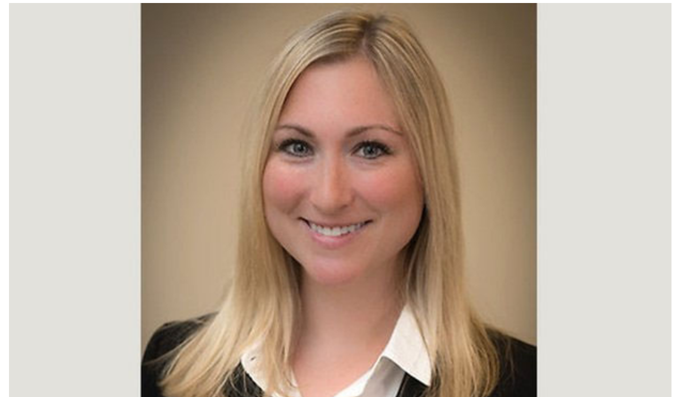
By **Jennifer Weidler Karpchuk** | June 06, 2019



Jennifer Weidler Karpchuk, senior counsel with Chamberlain, Hrdlicka, White, Williams & Aughtry.

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commonwealth. Below are five issues that frequently result in assessments.

Industry Standards

An increasing number of assessments are being made involving so called industry standards. This approach involves the department making an assessment based upon the average sales of other taxpayers in a given industry. For instance, the department may look at pizza shops in a given demographic area and determine the average sales and corresponding sales tax paid among the taxpayers in that industry. The department will then make an assessment where it believes a taxpayer underreported its sales and corresponding sales and use tax (SUT) liability. This most frequently happens when a taxpayer fails to respond to a request for documentation or fails to provide enough documentation to the department.

The inherent problem with using industry standards is that the "standard" represents an average. With an average, some taxpayers will fall above the standard, while some will inevitably fall below the standard. Further, this approach assumes that the taxpayers being used for the sample are representative of the industry as a whole and that the particular taxpayer in question fits within a standard mold. For instance, it would be illogical to equate a large chain grocery store with a small mom-and-pop specialty grocery store. The two will invariably sell different products and have varying amounts of products that are taxable versus nontaxable. It would be expected that a small grocery store specializing in fresh foods and produce would have a very low number of taxable sales compared to a larger more general grocery store that sells various prepared foods and household products. Taxpayers who receive assessments based upon industry standards should request as much detail as possible regarding the basis of the standard used in order to potentially challenge it.

SUT Assessment Leading to PIT Assessment

When a small business is assessed for SUT, many owners initially think that is the worst of their troubles. However, where the department issues an SUT assessment increasing the sales the company allegedly had, in a pass-through entity the department will also assess personal income tax (PIT) against the owner(s) of the company related to the increased income from such sales. It is important to understand that these are two separate assessments and two separate and distinct liabilities, both of which must be separately appealed.

SUT Assessed for Failure to Prove Payment of Tax

In the past, submission of an invoice showing sales tax was charged would have been sufficient to evidence payment of the tax. That historical treatment is consistent with the treatment from other state taxing authorities. However, the Department of Revenue is increasingly issuing assessments for lack of documentation of payment—i.e., without a check or proof of total payment of the invoice, the claim that tax was indeed paid pursuant to the invoice is denied. For large and small companies alike, this is an issue. For smaller businesses, many do not think to maintain this type of proof of payment. For large companies the issue is usually the opposite— too much data. Assuming it is even possible to tie out a specific invoice to an exact payment, to do so can be extremely time consuming and burdensome—particularly for a manufacturer dealing with hundreds of thousands of separate invoices and corresponding payments. This leaves businesses in the untenable position of being assessed sales or use tax on items that, pursuant to an invoice, they very likely already paid.

'Wayfair' and Economic Nexus

In *South Dakota v. Wayfair,* 585 U.S. (2018), the U.S. Supreme Court ruled that out-of-state online retailers can be required to collect sales tax from their customers without the retailers having a physical presence in the state,

overturning over 50 years of jurisprudence. In response, on Jan. 8, the department issued SUT Bulletin 2019-01, in which it announced that, based upon *Wayfair*, substantial economic nexus satisfied Pennsylvania's definition of maintaining a place of business in the commonwealth. The Bulletin further explained that, effective July 1, 2019, persons with $100,000 or more of gross sales in the commonwealth during a previous 12-month period will be considered to have economic nexus with Pennsylvania thereby requiring the collection and remittance of Pennsylvania's sales tax. By looking to gross sales and not taxable sales, the pool of individuals who will fall within the threshold is certainly widened—thereby necessarily increasing the likelihood that a remote seller or marketplace seller or facilitator will be subject to Pennsylvania's collection and remittance requirements.

The Bulletin was intended to complement Pennsylvania Act 43, which was signed into law during October 2017. Enacted prior to the *Wayfair* decision, Act 43 requires remote sellers, marketplace facilitators and referrers with at least $10,000 in taxable Pennsylvania sales during the immediately preceding 12-month period to file an election to either: register for a sales tax license to collect and remit sales tax on Pennsylvania sales; or comply with detailed notice and reporting requirements. Impacted businesses meeting the $10,000 sales threshold were required to file an election by March 1, 2018, (and annually each June 1 thereafter beginning June 1, 2019) to either begin collecting and remitting sales tax by April 1, 2018, or comply with the notice and reporting requirements. Lack of an affirmative election was considered a deemed election to comply with notice and reporting requirements. Act 43 is still valid law and the election to collect or abide by notice and reporting requirements still applies for taxpayers making more than $10,000 in sales, but less than $100,000 in sales.

Act 43's collection or notice and reporting requirements have been in place for over a year, with the first notice and reporting deadline passing during January. Meanwhile, the economic nexus provisions take effect on July 1. Those remote sellers, marketplace facilitators or referrers who fail to comply with either Act 43 or the Department's Bulletin may be subject to various penalties and this will certainly be an audit and assessment issue in the near future.

Withholding

As an employer, failure to withhold the correct amount of tax from your employees can leave you vulnerable to tax, interest or penalties. Further, it is not uncommon that errors are made in payroll that result in too little withholding—whether the fault of the employer or a payroll company. Complicating matters further, Act 43 of 2017 added additional withholding complexities by creating a withholding obligation for certain payors of Pennsylvania-source income and lessees of Pennsylvania real estate to non-residents. Pursuant to Act 43, anyone that leases Pennsylvania real estate to a non-resident or pays Pennsylvania-source non-employee compensation or business income to a nonresident individual or disregarded entity that has a nonresident member is required to file a Federal Form 1099-MISC and to withhold PIT, currently at a rate of 3.07%, from such payments.

However, withholding is optional for payors paying a payee less than $5,000 annually. Therefore, a company is expected to anticipate in advance whether it will need to withhold. For instance, a company pays an independent contractor $3,000 in January and does not intend to use the independent contractor for the remainder of the year. However, during December of that same year, the company again engages the independent contractor and pays the independent contractor an additional $3,000. The company is required to withhold on the entire $6,000 amount even though the first payment did not meet the $5,000 threshold and even though the company had a reasonable expectation that it would not be using the independent contractor again.

Where a payor fails to withhold the required tax, the department can assess and collect the tax from the payor. Further, even where the nonresident payee does in fact remit the tax themselves, the Department can still collect interest and penalties from the payor for failure to withhold the required tax.

Prior to Act 43, proper withholding was already an audit and assessment issue. However, now that companies are having difficulty dealing with the practical implications of implementing the new withholding requirements, that issue may be heightened.

These five issues are just a sample of the various problems that crop up in the course of Pennsylvania audits and assessments. Being aware of potential issues in advance can help to take some of the mystery and shock out of the audit and assessment process and allow taxpayers to better understand and appropriately challenge assessments.

Jennifer Weidler Karpchuk *is senior counsel with Chamberlain, Hrdlicka, White, Williams & Aughtry in Philadelphia. She may be reached at 610-772-2314 or by email at* *jennifer.karpchuk@chamberlainlaw.com (mailto:jennifer.karpchuk@chamberlainlaw.com)*.

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