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Via Electronic & US Mail
Silvan B. Lutkewitte, III, Chairman
Independent Regulatory Review Commission
333 Market St., 14th Floor
Harrisburg, PA 17101

Re: Regulation #15-449 (IRRC #2852)
Department of Revenue
Return and Payment of Tax

Dear Chairman Lutkewitte:

On behalf of the nearly 21,000 members of the Pennsylvania Institute of Certified Public Accountants (PICPA), I am writing in response to the Department of Revenue final-form regulation Return and Payment of Tax, #15-449 (IRRC #2852).

We submit the attached comments for your consideration and ask that the regulation not be approved in its present form until the concerns of PICPA are adequately addressed, and the interests of the Commonwealth and those of the taxpayer and practitioner are more fairly balanced.

Thank you and please do not hesitate to contact me with questions.

Sincerely,

Peter N. Calcara, CAE
Vice President—Government Relations

Enclosure

CC: Honorable Michael Brubaker, Majority Chair, Senate Finance Committee
Honorable John Wozniak, Democratic Chair, Senate Finance Committee
Honorable Kerry Benninghoff, Majority Chair, House Finance Committee
Honorable Phyllis Mundy, Democratic Chair, House Finance Committee

Pennsylvania Institute of Certified Public Accountants (PICPA)
Comments on 61 Pa. Code Ch. 117 – Return and Payment of Tax

§ 117.9. Form of return.

§ 117.9(a)(5) – The phrases "plausibly purport to be in compliance" and "honest and genuine attempt" need to be defined. The Department of Revenue should consider changing "honest and genuine" to "good faith."

Department of Revenue Response: Federal and state case law clarify what may be plausibly considered to be intended to have the appearance of conforming to return filing requirements.

PICPA Rebuttal: One of the major purposes of a regulation is to interpret or explain a statute. If the Department uses terms in a regulation that establishes the standards to which a return must conform, it is only fair and reasonable that those terms are also defined in the regulation. The definitions of those terms provide a taxpayer with more concrete guidance as to what is expected of him/her in the preparation of a processible return.

§ 117.9(a)(6)(i) – The phrase "substantially incorrect" is vague and should be clarified.

Department of Revenue Response: The terminology "substantially incorrect" is statutory. *See* 72 P.S. § 7352(i).

PICPA Rebuttal: Although the terminology is statutory, the statute does not define the term. One of the major purposes of a regulation is to interpret or explain a statute. As the term is not defined in the statute but the Department uses the term in the regulation, it follows that the term should be defined in the regulation in order to provide a taxpayer with meaningful guidance.

§§ 117.9(a)(6)(ii) and (iii) – These provisions are too broad; inconsistent with federal income tax procedures; fundamentally unfair; and impose undue hardship on a taxpayer. For example, if a taxpayer fails to place his/her telephone number or school code on his/her tax return, it would not constitute a processible return under the criteria set forth in the proposed regulation. Consequently, a minor omission on a tax return that has no impact on the Department's ability to determine a taxpayer's liability would prevent the starting of the applicable statute of limitations for assessing additional tax.

In its Amendment to Chapter 117 – General (pages 3 -4), the Department cites a four-prong test that the Tax Court of the United States has adopted for treating a document as a processible return:

(1) There must be sufficient data to calculate the tax liability;

(2) The document must purport to be a return;

(3) There must be an honest and reasonable attempt to satisfy the law; and

(4) The taxpayer must sign the return under penalty of perjury.

WG&L Tax Dictionary 691 (2004 -2005). In order for a tax return to be processible and commence the running of the applicable statute of limitations, the first prong of the federal income tax test only requires that there must be sufficient data to calculate a taxpayer's tax liability. The fact that an omission of certain information on a tax return, *e.g.*, school district code, may make the Department's ability to comply with certain statutory reporting requirements more difficult has no relevance in the Department's ability to ascertain a taxpayer's correct tax liability. Thus, Subsection (a) should only include those items that are necessary for the Department to determine a taxpayer's tax liability.

The failure to file a processible return is equivalent to not filing a return at all. Thus, even if a tax return is filed timely, it will not be treated as being filed until all deficiencies are corrected. As a result, the filing of a processible return has significant procedural ramifications to a taxpayer, including the commencing of the running of the statute of limitations for assessing additional tax. In their current form, the proposed regulation strengthens the Department's compliance/audit/enforcement powers, at the expense of weakening the procedural safeguards afforded to taxpayers.

The objectives of the Commonwealth must be weighed against the corresponding consequences to the taxpayer. Due to the procedural ramifications stemming from what constitutes a processible return, it is imperative that the criteria listed in Section 117.9(a) only include those items that fall within categories (1) through (4) listed above. For example, if a taxpayer files a complete return on its face, but fails to submit a required form or document, the taxpayer's mere failure to submit that form or document, should not constitute a *per se* incomplete return if the Department can otherwise ascertain the taxpayer's tax liability. Rather, the taxpayer should be provided time, *e.g.*, 30 days, to submit the missing form(s). Only if the taxpayer fails to respond to the information request within that period, would the

return constitute an unprocessible return. This type of approach balances the interests of both the Commonwealth and taxpayer.

§ 117.9(b)(2) – The proposed regulation does not accurately reflect 72 Pa.C.S § 806.1(a)(5). In general, there would be no interest on an overpayment if a refund is paid within 75 days after a final return or report is filed. However, if the Department does not pay the refund within 75 days, it would appear that interest would begin running from the original due date of the return, as per similar language in IRC § 6011(e) has been interpreted. The proposed regulation should be amended to read "[c]ommence the running of interest...on the return, *pursuant to 72 Pa.C.S. § 806.1(a)(5)."*

Department of Revenue Response: The Department's response explains the application of Section 806.1(a)(5) in various instances where an overpayment is claimed on a complete and incomplete return.

PICPA Rebuttal: In the proposed regulation, the Department states that the filing of a processible return starts the running of interest on overpayments. Section 806.1(a)(5) provides the rules regarding the running of interest on overpayments, e.g., the 75-day rule. The regulation would be more informative and complete if the Department would incorporate its response to the comments to Section 117.9(b)(2) into its proposed regulation.

§ 117.9(d) – For consistency purposes, "return," should be added before "form or transmittal" and "completed" should be changed to "processible."

§ 117.9(f) – See "Partners and Partnerships" comments below.

§ 117.9(h) – See "Partners and Partnerships" comments below.

§ 117.9b. Consistent positions.

§ 117.9b(a) – A taxpayer should not be required to take consistent positions with respect to the facts asserted in a prior taxable year in instances where he/she discovers that the prior tax treatment of a transaction was erroneous. This rule should apply whether the statute of limitations for the prior year is still open. Under AICPA Statement on Standards for Tax Services No. 1, Tax Return Positions, a practitioner would not be permitted to prepare/sign a return knowing that the return was prepared incorrectly. In addition, the knowing of a preparation/filing of a false return presents other serious issues.

In order to address the underlying issue raised in the regulation, the Department should seek legislation to amend the PIT statute to include provisions similar to IRC §§ 1311 – 1314

(statutory mitigation provisions), and/or incorporate the judicial doctrines of estoppel, recoupment and set off into the PIT through statute or regulation.

Department of Revenue Response: In its response, the Department states that "Section 117.9b...addresses instead the situation where a taxpayer would deny the truth of facts that the taxpayer certified to be true in his tax returns for prior taxable years after the Commonwealth has justifiably acted in reliance of such certification to its detriment. In this situation, a taxpayer has the duty of consistency and should not be permitted to deny the misrepresented facts...".

PICPA Rebuttal: In order to comply with the proposed regulation a taxpayer would be required to take consistent positions in subsequent tax years, even if a practitioner learns that those positions turn out to be erroneous. In attempting to protect the interests of the Commonwealth, the Department fails to take into account the ethical and legal implications imposed upon practitioners and taxpayers. Under AICPA Statement on Standards for Tax Services No. 1, Tax Return Positions, a practitioner would not be permitted to prepare/sign a return knowing that the return was prepared incorrectly. In addition, the knowing of the preparation/filing of a false return presents other serious issues. The regulation needs to balance the interests of both the Commonwealth and practitioners. If necessary, the Department should seek legislation to incorporate certain safeguards provided under the federal income tax laws to prevent the abuses that the regulation attempts to address.

§ 117.9b(b) – The proposed regulation needs to explain what constitutes notice to the Department and the partnership of a correction. The Department may want to consider adopting a form similar to federal Form 8082 for reporting the inconsistent treatment of an item from a pass-through entity. The use of a form similar to federal Form 8082 would provide the Department with sufficient information to review a return.

Department of Revenue Response: The Department will address notice requirements in instructional materials.

PICPA Rebuttal: The proposed regulation imposes a new duty upon a partner or S corporation shareholder to report an item of income, etc. in a manner consistent with how the entity reported that item of income, etc. on its information return unless the change in treatment results from an error and the partner or S corporation shareholder notifies the Department and pass-through entity of the error. However, the proposed regulation does not provide guidance on what constitutes adequate notice. If the proposed regulation imposes a new disclosure requirement, completeness dictates that the proposed regulation also provides a taxpayer with

guidance up front as to what constitutes adequate disclosure. A taxpayer should not have to search other Department publications that do not have the authority of a regulation for this information.

§ 117.9c. Execution of return by Secretary of Revenue.

§ 117.9c(a) – The PIT statute needs to be amended to give the Secretary of Revenue the authority to make and subscribe a return. It is questionable whether the general authority granted to the Department in 72 Pa.C.S. § 7354 to adopt rules and regulations to administer the PIT would broaden the specific powers given to the Department to adopt rules and regulations regarding returns contained in 72 Pa.C.S. §§ 7332 – 7335. Those sections do not grant the Secretary the authority to make and subscribe a return.

Assuming that there is statutory support for the proposed regulation, due process requires that the Department provide a taxpayer notice prior to making and subscribing a return on behalf of a taxpayer. It is unclear whether proposed § 117.9(g) would also cover this situation. In addition, the Department should be required to provide a taxpayer with a copy of that return in a timely manner.

Recommended Change:

(a)(1) If a taxpayer fails to make a processible return at the time prescribed thereof, the Secretary or Deputy Secretary may make the return from his/her own knowledge and from information obtained through testimony or otherwise. Prior to making the return, the Secretary shall provide the person with notice of his/her intention and reasonable time to file a processible return. The Secretary shall provide the person with a copy of the return by certified mail to his/her last known address within 30 days after making that return.

(a)(2) If a person makes, willfully or otherwise, a false or fraudulent return the Secretary shall provide the person with a copy of the return by certified mail to his/her last known address within 30 days after making that return.

§ 117.9c(b) – Assuming that the Secretary has the legal authority to make and subscribe a return, the proposed regulation needs to explain what is meant by "all legal purposes."

Department of Revenue Response: The Department asserts its authority to make a return is derived from statutory provision that allows the Department to make an estimated assessment. The Department states that providing a copy of a prepared return to the taxpayer is not

necessary, as the assessment notice will contain all the relevant information. In addition, the Department refers to federal law to define "all legal purposes."

PICPA Rebuttal: The Department's reliance on the estimated assessment provision as the basis for granting the Department the authority to prepare returns is clearly erroneous. In administering the corporate taxes, the Department's Bureau of Corporation Taxes also issues estimated assessments; however, without the need to prepare reports. In the corporate tax area, the purpose of issuing an estimated assessment is to get a corporation to file a complete report. Upon the taxpayer's filing of a complete report, the Department will remove the estimated assessment. PICPA reincorporates the remainder of its original concerns with the proposed regulation into this section.

The Department should incorporate into the proposed regulation the actual federal definition, or cite the provisions that define the term "all legal purposes." In general, the PIT statute does not incorporate provisions of the Internal Revenue Code. However, the Department selectively incorporates certain provisions through policy or regulation. In the instant case, if the Department chooses not to define "all legal purposes" in the proposed regulation, the Department should include the federal definition.

Partners and Partnerships

The proposed regulations unfairly prejudice a partner in instances where the partnership fails to provide the partner with a PA Schedule RK-1 or NRK-1. In many instances partners only own *de minimis* interests in partnerships and are unable to obtain the requisite information from them in order to prepare at least a PA Schedule RK-1 or NRK-1. In addition, partnerships themselves that own interests in lower-tier partnerships are not able to obtain information from those entities for the same reason.

Rather than address this issue, the proposed regulation merely codifies the Department's policies regarding the treatment of partners in partnerships in instances where the partnership fails to provide the partner with a PA Schedule RK-1 or NRK-1 or a properly completed return. This situation most frequently arises in instances where a resident partner invests in a partnership that does not have nexus with PA, or in tiered partnership situations. In many instances, the lower tier entities have no knowledge that residents own interests in the upper-tier partnerships. As a result, the upper-tier partnerships are unable to provide adequate information to resident partners. Under current policy, the Department does not treat the partner's return as complete, and ultimately will deny deductions or losses if adequate documentation is not provided within a specified period of time.

The Department should incorporate into the proposed regulation guidance on how a resident and nonresident partner that owns a *de minimis* interest in a partnership may file a processible return through the use of information on his/her federal Schedule K-1 or other information in instances where the partnership refuses to provide him with a PA Schedule RK-1 or NRK-1. The adoption of these procedures would save both taxpayers and the Commonwealth scarce resources.

Department of Revenue Response: The Department's response is based upon the premise that an owner, no matter how large an interest in a pass-through entity he/she owns, is entitled to complete access to, and to inspect and copy, all of the entity's books and records and all of the books and records of any lower tier pass-through entities in which the upper–tier pass-through entity is an owner and is able to retain a competent tax advisor at reasonable cost to prepare a PA-20S/PA-65 information return.

PICPA Response: The Department's proposed regulation imposes undue hardship especially upon residents of Pennsylvania who own *de minimis* interests in pass-through entities. Assuming *arguendo* that a taxpayer has access to a pass-through entity's books and records, which in reality he/she does not, the information necessary to prepare a PA-65/PA-20S information return in many instances does not exist, especially in tiered pass-through entity structures. In tiered entity structures, a lower-tier entity that does not do business in PA and/or is not aware of indirect owners who are residents of PA is not required to, and does not file a PA-20S/PA-65. As a consequence, the only information that the upper-tier pass-through entity receives is a federal Schedule K-1. Due to the difference in the federal and PA tax laws, the items of income, loss and gain are not classified and adjusted to reflect the PA tax laws. Consequently, the income is passed-through unadjusted. As a resident of PA is taxed on all of his/her income, he/she must report the unadjusted income as reported from the upper-tier entity. In this instance, a pass-through entity's books and records would not contain the information necessary for a resident owner of an interest in a pass-through entity to prepare an entity level return. In fact, the Department may deny losses or other deductions to resident pass-through entity owners where documentation is not available.

The Department's comparison of a resident who is sole proprietor with a resident who is an owner of an interest in a pass-through entity is misguided. A sole proprietor has access to his/her business books and records. A passive investor in a private equity fund does not have access to all the information necessary to prepare a PA-20S/PA-65. In many instances that information does not exist. Therefore, it is unreasonable to treat a resident owner of an interest in a pass-through entity in the same manner as a sole proprietor.

As there are instances where it is impossible for a resident owner of a pass-through entity to comply with the Department's proposed regulation, the proposed regulation should be amended to provide practical guidance to deal with those situations without exposing the resident owner to harsh consequences.