

Background & Return Selection

- 1. Can you provide us some background information about how the Department came to the decision to do reviews of the Schedule C? Was there a compliance study conducted? What is the primary purpose of the reviews?**

A pilot review of Schedule C was done for the 2015 tax year on refund only returns. Information was published in the January 2016 Tax Update regarding the upcoming Schedule C Reviews and they were also a topic at the 2016 Fall Tax Seminars. The reviews are considered a desk review and the primary purpose is to ensure compliance with Pennsylvania reporting requirements. This project is as much about compliance as it is about collection. This Schedule is not something that the Department has traditionally looked at because previously we did not have the necessary analytical tools. We now have them available.

- 2. What are the plans for the future of this project; will letters be sent and subsequent reviews be conducted every year?**

Schedule C reviews will be ongoing, but there have been lessons learned this year and the Department will be tweaking the process based on these experiences during their after action review of the project. Unlike the 2015 pilot, the data analytics that were used resulted in more reviews than anticipated, which means more taxpayers fell above average industry standards for like businesses on various Schedule C line items. Taxpayers who received letters this year where no changes/adjustments were made to the return, will not be flagged again for the same schedule/line item for a minimum 2 year time period.

The Department does encourage practitioners to attach as much information as possible with the initial filing of the tax return. Schedules and summaries can be sent to the Department as PDFs. Providing additional information, though not required, may provide enough explanation to prevent a return from being suspended in the future.

- 3. Is the Department working with a third party vendor in a contingency arrangement as was the case with the UE reviews?**

No, the third party contract has expired. However, the Department has purchased the data analytics software from the company with whom they had the former contract and will continue to use this and other technology to ensure tax compliance.

- 4. What percentage of Schedule C's are being reviewed or how many total returns were selected for review?**

Of the 6,000,000 PIT returns filed with the PA Department of Revenue, 540,000 returns are filed with Schedule C, and of these returns 46,000 returns were suspended for review (or 8% of the total returns with Schedule C). The return breakdown of the 46,000 suspended returns is as follows: 11,000 refunds due, 22,000 equals (no refund/nothing due), and the remaining 13,000 had balances due.

- 5. Can you explain how the returns are/were selected for review and if there are any specific parameters or metrics? Were specific business types targeted in the selection process, for example, internet/retail businesses?**

Specific business types were not targeted for review. The selection process was conducted using data analytics and metrics that were based on average industry standards. The returns that were suspended were outliers or above average for like businesses on particular Schedule C line items.

- 6. Have all of the letters been sent out or are Schedule C's still being selected for review?**

The majority of the letters have been mailed for TY 2016.

The workflow process is as follows:

When returns are flagged for review, examiners will work those requesting refunds first, then equals, and then balance dues. So, if an examiner determines that they need to write out for additional information, they will trigger a letter. When that information then comes in from the taxpayer, responding to our letter, it is worked FIFO.

- 7. Do you have any idea how much additional revenue the Schedule C reviews will generate for the Department?**

No, this was not estimated nor has it been reviewed as it is the initial year. The primary purpose of the review initiative is to promote compliance with Pennsylvania reporting requirements which will eventually result in increased revenue for the Commonwealth.

- 8. Can you share with us what upcoming areas of focus are for the Department?**

The Department will be undergoing a modernization project so practitioners may see a bit of a lull, but there will most definitely be a progression to other schedules in the future.

PA DOR Staffing for Reviews of Schedule C

- 1. Who are the individuals conducting the reviews?**

All tax examiners for the Schedule C Reviews are full time employees of the PA Department of Revenue. The Department does employ temporary examiners as well, but temporary employees are not being used to conduct the Schedule C reviews. The examiners working on the Schedule C reviews are seasoned Department of Revenue employees.

- 2. How many individuals/tax examiners are looking at the responses?**

The Department does not assign examiners exclusively to specific suspended returns. There are approximately 100 tax examiners in PIT, plus some additional temporary examiners. All of the tax examiners reviewing taxpayer responses are seasoned examiners of the PA Department of Revenue.

- 3. How much time is being spent on each Schedule C review?**

The Department of Revenue has prescribed production standards for the reviews; Schedule C Reviews are taking less than one hour on average.

4. **The inability to get through to the Department via telephone is delaying taxpayer/practitioner response time. With such a huge undertaking why is there no dedicated telephone line for the Schedule C reviews? Why weren't satellite offices set up to conduct the reviews? Are there other suggested forms of communication with the Department?**

The Department of Revenue strongly suggests sending responses via FAX (717-772-4193) or sent via email to the resource account: ra-bitpitelfcorfaxes@pa.gov. Faxes and resource account emails are automatically viewable on their system and will speed up the review process.

5. **Will the changes made to Schedule C as a result of these reviews be shared with IRS?**
If requested by the IRS, the department will share this information. Local taxing authorities will get income adjustments.

Timeframe and Communications

The overall perception is that the Department is unable to review the volumes of information that has been requested. Taxpayers are spending a considerable amount of time and money to comply with the requests and in some cases are being asked to resend the same information (even with a certified mail receipt). This is a waste of both time and money for all involved. The Department has a right to review/audit but to put the burden on small business to prepare and send records in mass for a random review is not justifiable. The request for documentation exceeds a correspondence audit.

1. Can you provide us with the facts regarding the backlog situation?
 - Once the information is received by the Department, how much time before the response is logged into the system as received?

The response is typically logged into their system within two weeks from the date it was received. The Department operates on a backlog due to staffing; the Schedule C reviews are in line with the review time for other suspended returns.

- How much time until it is assigned to an examiner/reviewer? - see below
- How much time until the review is actually being conducted? - see below
- How much time before the taxpayer/practitioner receives a response from the Department?

The Department is currently reviewing taxpayer responses that were stamped with a MAY received date by the Department, in other words taxpayers who responded and sent their responses to the Department so that it was received in the month of May. So, the average response time is about 3 months from the time the response is received from the taxpayer.

- Do you recommend sending taxpayer responses via certified mail?

No. It is strongly recommended that practitioners and taxpayers utilize the fax line and the resource account provided on page 2 of the Q&A.

2. Many taxpayers/practitioners have submitted the requested information and sent it certified mail. However, these same taxpayers are receiving second and sometimes even third notices that the information has not been received by the Department. When they contact the

Department, they are told about the backlog. Why are second and third letters being sent inside the timeframe of the backlog? What can be done to eliminate these follow up notices to taxpayers? The follow up notices are creating confusion, are creating needless costs for PA DOR and are generating additional calls to the Department and further clogging up the telephone line.

The 2nd and 3rd notices are an area that the Department will make adjustments to in the future. The Department will review and try to make modifications to lengthen the timeframe for which the notices are sent for the current year.

As far as taxpayers responding to follow up notices and resending information.....the Department advises taxpayers who receive a follow up notice less than a month after they have sent a response not to resend the response. If more than a month has passed since the response was sent and a follow up notice is received, the taxpayer should resend the information to the Department. The Department once again encourages the use of fax or the resource center email address to send the information.

3. Will the Department communicate the status of the review if there is “no change” to the return or that the issue has been resolved? This is the only way that a taxpayer will know that the issue has been resolved and PSTAP urges you to issue these letters. Once again, issuing these letters will also result in fewer follow up calls being made to PA DOR to check on the status. One of the issues that practitioners are facing is that their clients (the taxpayers being reviewed) in some cases are under the impression that they practitioner has done something wrong on their return that has led to the Schedule C review. A resolution letter is the only way that the practitioner has to assure his/her client that the issue is closed.

The Department will send a final letter to the taxpayer in the case that no adjustments were made. Once again, taxpayers should expect to receive the letter approximately three months from the date that their response was received by the Department of Revenue.

4. Is PA Department of revenue under any legal requirement to respond to taxpayers within a certain timeframe?

No, the Department is not.

5. Practitioners are concerned that the backlog will overlap with the preparation of the current year returns. It will be extremely difficult to prepare returns for the current year without knowing the outcome of these reviews. Can you provide any assurance that this will not be the case?

Schedule Cs that exceed industry averages within the context of our analytics will continue to be suspended for review as they are filed through the end of the year. Therefore returns that are filed late into the year do have the potential of overlap. Again, based on our three month timeframe, October responses received by the Department should be reviewed by January etc.

6. Are copies of the REV- 554 being provided to taxpayers who receive the review letters?

No, this is not an audit. This is a desk review.

7. Some of the notices state that they are being issued because revenue is conducting a review of your PA 40 personal income tax return with respect to the expenses being claimed on the PA schedule C. However, in the same letter they are also requesting a copy of the taxpayer's company or union's expense reimbursement policy as a condition of employment or a signed letter from the employer etc. and these items have nothing to do with the Schedule C. Can you please explain this?

This appears to be a correspondence error. Please encourage members to provide copies of this type of letter; we can address it with the examiners.

Acceptable Taxpayer Documentation

1. The various requests for information and documentation are vague and inconsistent and in many cases misleading. The letters indicate that the Department wants receipts but when contacting the Department of Revenue via telephone, many practitioners and taxpayers have been told that a copy of the general ledger or Quickbooks file are sufficient. We seek clarification and guidance on the substantiation requirements for satisfying the Department's requests.

- Copies of the general ledger?
- Account analysis reports?
- Hundreds of photocopied invoices or receipts?
- Federal schedule such as the home office form 8829?
- Canceled checks or credit card statements?

The Department will accept general ledgers, schedules, summaries, canceled checks, bank statements and/or credit card statements etc. that tie back to the line item in question. The Department does not want actual receipts unless that is the only form of substantiation available.

RE: home office deduction and Form 8829. The Department is interested in utility percentage breakdowns.

If an examiner still has questions or wants to see additional information the examiner is supposed to contact the taxpayer via telephone. If a practitioner is listed on the return, the Department should contact the practitioner. This is the process that is supposed to happen.

2. Requiring receipts for every expense seems to exceed what can be reasonably expected for a correspondence audit.

Please see answer above.

- Are the returns considered timely filed?

Yes, the returns are considered timely filed. However, if there is an assessment for underpayment, the payment will be late and the taxpayer will owe interest.

- How does the Department define a review?

The desk review is less in scope than a full blown audit. The desk review is seeking support for a line item or two

- How do these Schedule C “reviews” differ from an audit?

The field audit would require sampling of a lot more transactions, and would likely cover more than just the Schedule C, or even more than one fiscal year.

- While the statute grants inquisitorial powers to the Department of Revenue the audit procedures used by the Department do not seem to allow for a “review” of the taxpayers book and records without rendering some form of written opinion. Can you address this?

This is a desk review, not an audit.

3. Regarding the Schedule C Tips PDF, it indicates that they want all of the receipts scanned into a PDF or mailed to them. In some cases where they are reviewing COGS, clients will have to mail a thousand supply receipts or office receipts and scan it or mail it to PA. Will a general ledger be accepted in this situation?

For COGS the Department is interested in the purchases that took effect that year. As long as the general ledger provides notes/memo about what the purchase was for it would be accepted.

4. Is the Department aware that the return address on top of the letter is not the same as the address on the envelope that is enclosed so if the client does not provide the envelope to their preparer, the responses are going to the wrong PO Box? Does the Department expect that the documentation will fit into the number 10 envelope that was provided in the letter?

The Department is looking into the address difference. Either address will get the information to the right place. The Department may not provide return addresses in the future. Once again, they encourage the use of the fax and the resource center email address for submitting responses.

Required Response Time – 15 Days

1. Is the 15 day response time a hard deadline? While the letters indicate that the taxpayer has 15 days to respond to the request, when contacting PA DOR by telephone, practitioners have been given conflicting information. In one case, a taxpayer was told that the 15 days was just a guide and that he actually has 60 days to respond.
2. Why does the official letter from Department of Revenue indicate a 15 day deadline if it is not a real deadline?
3. Also, if there is such a back log, why only give taxpayers 15 days to respond? 15 days is an extremely tight deadline considering vacations and the fact that by the time the letter is received several days have already passed resulting in less than 15 days of response time. This timeframe seems unreasonable when the Department is taking more than 8 weeks to log in information into their system.

4. In the case of an extenuating circumstance or hardship, is the Department granting any extensions? Some practitioners have written to the Department requesting a time extension but have not received a response one way or the other. What is the proper process for requesting a time extension?

The Bureau will most likely modify the response time of 15 days in the future. A fifteen-day response time is the standard response time for suspended returns throughout the Bureau of Individual Taxes. The Bureau is treating the 15 days as a *guide* and taxpayers will not be penalized for responses that exceed a 15-day turn around. Taxpayers do not have to ask for an extension; the Bureau will not respond to requests for extensions.

Appeals Process

1. Is there an appeals process if substantiation is not accepted by the Department?
Yes, the normal appeals process, to the Board of Appeals will be followed.
2. What is the appeals process if substantiation is not accepted by the Department?
When an assessment is made, the appeals process, to the Board of Appeals is the same, no changes to the process.
3. Can practitioners represent clients/taxpayers in an appeal?
Yes, the appeals process is the same.
4. What documentation is needed to have practitioners represent clients/taxpayers in an appeal?
An appeal must be filed.
5. Will there be a system set up during the appeals process to have a physical meeting with the examiner/auditor?
The normal appeals process, to the Board of Appeals, will be followed.