LEHIGH VALLEY ASSOCIATION OF INDEPENDENT COLLEGES

Sales and Use Tax As Applied to Charitable Organizations in Pennsylvania

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Agenda

- Sales & Use Tax General Overview
- Nonprofit Exemption in PA
- Exemption Limitations
- Collection Requirements
- Audits
- Update - Tax Issues for Nonprofits

SALES & USE TAXES

Sales & Use Tax General Overview

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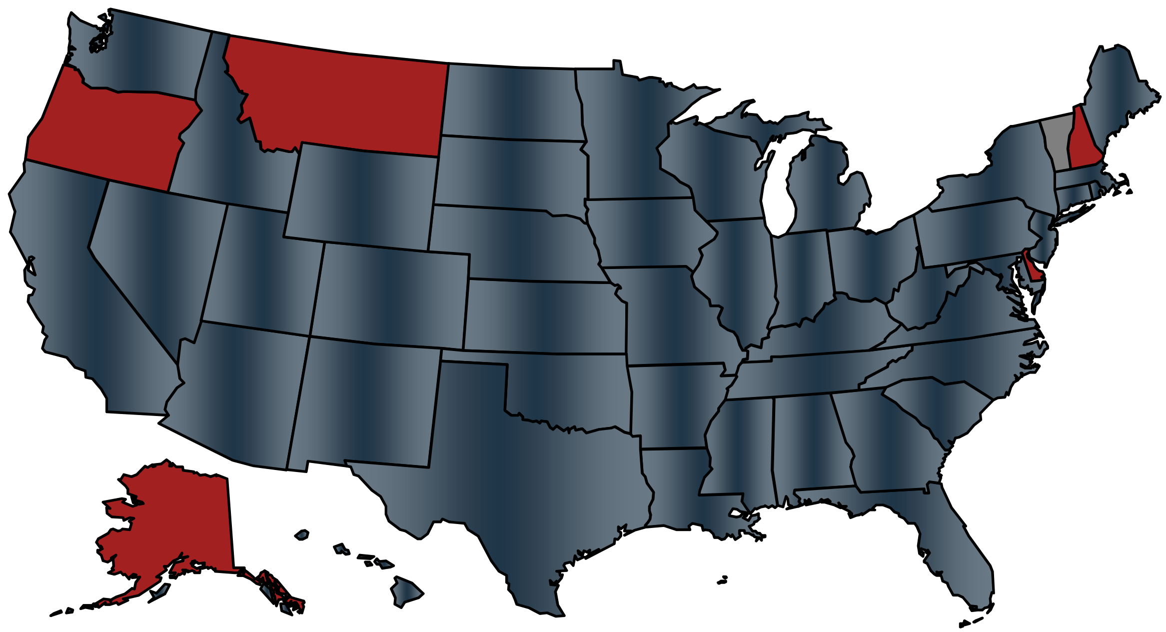
General Information

- There are 45 states and the District of Columbia which impose a sales and use tax.

- No sales tax in Alaska*, Delaware*, Montana, New Hampshire and Oregon.



General Information

- Pennsylvania imposes a statewide sales and use tax on the purchase or use of tangible personal property and certain enumerated services at the rate of 6%.

- A local tax is imposed in the City of Philadelphia (2%) and Allegheny County (1%) on the retail sale or use of tangible personal property and services.

- Sales of property or services made by retailers within Philadelphia or Allegheny County that are delivered to locations outside of Philadelphia or Allegheny County, yet inside Pennsylvania, are subject to the local tax.

General Information

- Most states exempt from sales tax goods purchased for use as ingredients or parts in further **manufacturing**.

- The **place and manner of sale** may affect whether a sale of particular goods is taxable. Many states tax food for consumption on premises but not food sold for off premises consumption

- Many states exempt **charitable, religious, and certain other organizations** from sales or use taxes on goods purchased for the organization's use. Generally such exemption does not apply to a trade or business conducted by the organization.

General Information

- The amount subject to sales tax is generally the **net sales price**. Such price is generally after any applicable discounts.
    - Cash discounts
    - Early payment discounts
- Some states exempt a portion of sales or purchase price from tax for some classes of goods.
- **Use Tax** : The states imposing sales taxes also impose a similar tax on buyers of taxable property or services in those cases where sales tax is not paid. Use taxes are functionally equivalent to sales taxes. The sales and use taxes, taken together, "provide a uniform tax upon either the sale or the use of all tangible personal property irrespective of where it may be purchased.“
- Some states permit offset of sales taxes paid in other states on the purchased goods against use tax in the taxpayer's state.

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Nonprofit Exemption in Pennsylvania

Purchases by Charitable Organizations (061 Pa. Code § 32.21)

- The sales and use tax exemption to which a charitable organization is entitled is limited to:
  - the purchase of tangible personal property or services that are either used in an activity which bears a reasonable relationship to the purpose for which the organization exists; or
  - which is a material or supply used in the routine maintenance or repair of real estate used in an activity which bears a reasonable relationship to the purpose for which the organization exists.

Status of Nonprofit Exemption in PA

As of today, a nonprofit must prove that it meets the Pennsylvania Constitution's definition of "**purely public charity**"

The General Assembly may by law exempt from taxation:

.....

> (v) Institutions of purely public charity, but in the case of any real property tax exemptions only that portion of real property of such institution which is actually and regularly used for the purposes of the institution.

Pennsylvania Constitution, Article VIII, Section 2(a)(v)

Status of Nonprofit Exemption in PA

A Pennsylvania Supreme Court decision outlined the factors necessary to prove "purely public charity status". These are known as the "**HUP" Factors**:

The HUP factors are fairly strict, requiring that the organization:

1. Advance a charitable purpose
2. Donate or render gratuitously a substantial portion of its services
3. Benefits a substantial and indefinite class of persons who are legitimate subjects of charity
4. Relives the government of some of its burden; and
5. Operates entirely free from private profit motive

<u>Hospital Utilization Project v. Commonwealth</u>, 487 A2d 1306 (Pa.1985)

Status of Nonprofit Exemption in PA

In 1997 the General Assembly passed **Act 55**, which was expected to alleviate the inconsistent manner in which the HUP Factors were being applied.

The **Act 55** standards are similar to the HUP Factors:

1. The institution must advance a Charitable Purpose by meeting 1 of 6 possible criteria.

2. The institution must operate entirely free from private profit motive by meeting all of 4 requirements

3. The institution must donate or render gratuitously a substantial portion of its services by meeting 1 of 7 possible criteria

4. The institution must benefit a substantial and indefinite class of persons ho are legitimate subjects of charity (“those who are unable to provide themselves with what the institution provides for them”)

5. The institution must relieve the government of some of its burden by meeting 1 of 6 possible criteria.

Status of Nonprofit Exemption in PA

In 2011, the Pennsylvania Supreme Court determined that the relevant portion of the Constitution did not grant, but rather, limits legislative authority to create exemptions and that the General Assembly exceeded its Constitutional authority in establishing Act 55.

The court re-instituted the HUP Factors as the threshold test, but also established the necessity to meet the Act 55 standards as well.

Mesivtah Eitz Chaim of Bobov, Inc. v. Pike County Board of Assessment Appeals, 13 A.3d 463 (2011)

Status of Nonprofit Exemption in PA

Foundation for Eldercare v. Dauphin County Board of Tax Assessment Appeals, 2018 WL 2107230 (Pa. Commw. Ct. May 8, 2018)

- In *Foundation for Eldercare v. Dauphin County Board of Tax Assessment Appeals, 2018 WL 2107230 (Pa. Commw. Ct. May 8, 2018)* the Pennsylvania Commonwealth Court held that Foundation for Eldercare (Eldercare), a 501(c)(3), was not a purely public charity under Pennsylvania law where its low-income housing services did not benefit an indefinite class of senior citizens and its work did not relieve the government of a burden.

- Eldercare operated senior housing in Dauphin County. It rented its units to disabled and senior citizens age 65 and over who were lower income under IRS guidance, meaning their income was less than 80 percent of the median household income in Dauphin County. Eldercare charged rent that represented 70 percent of its costs, which was significantly less than fair market rent, and provided subsidies to 60 percent of its tenants in Dauphin County. Eldercare applied for an exemption from real estate tax on the grounds that it was a purely public charity.

- Court ruled that Eldercare failed to satisfy the third prong the HUP because its housing services were not available to low income seniors generally, but only those tenants who could afford to pay the rent.

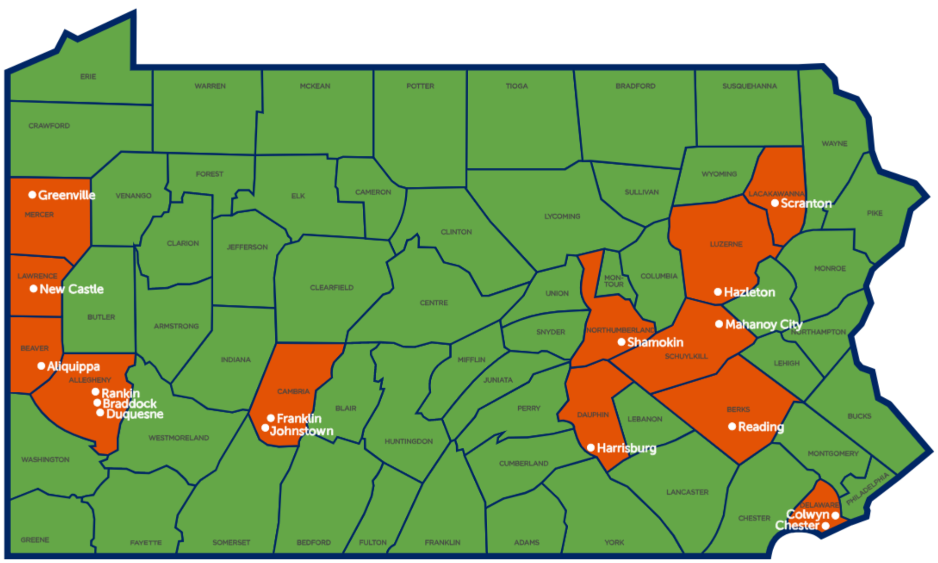
- Further, the Court ruled Eldercare failed to satisfy the fourth prong, as its operations did not prevent its tenants from being placed in assisted nursing care or from requiring government housing assistance. Further, it did not accept Medicaid, subsidies, or grants, and did not provide medical services, health screenings, meals, or transportation services to its tenants.

Status of Nonprofit Exemption in PA

Recent Developments, Act 47

Local governments and school districts are in dire financial straits. Sixteen municipalities are in Act 47 – the program to help insolvent local governments.

Local governments are seeking to improve their financial circumstances by attempting to (a) revoke exemptions and (b) establishing Payment in Lieu of Tax programs



Municipalities Currently in Act 47

Status of Nonprofit Exemption in PA

Recent Developments by Locality

1. **Pittsburgh** - In 2018, UPMC threatened to close Mercy Hospital, which coincided with the Pittsburgh City Council's initial decision to decline UPMC's planned $2 billion expansion in the Uptown part of Pittsburgh. The City Council subsequently reversed its decision and approved the expansion, which includes property tax exemption for the buildings.

2. **Philadelphia** - *The Philadelphia Inquirer* reports that the Philadelphia Office of Property Assessment has begun auditing real-estate tax exemptions for a number of nonprofits and religious groups.
   - A strict application of the five-prong test established by a 1985 Pennsylvania Supreme Court decision is being applied.
   - The audits have often resulted in agreements between the OPA and the organizations requiring them to register for city business tax and/or to pay property taxes based on a percentage of the property value.
   - At least a dozen appeals are pending in Common Pleas Court.

Status of Nonprofit Exemption in PA

Recent Developments by Locality

1. **Allentown** - The Parkette National Gymnastic Team is in a tax dispute with the City of Allentown related to a $62,333 assessment for business privilege taxes from 2007 through 2016.
   - In civil court paperwork filed Feb. 26, 2019, the organization says the Parkettes shouldn't be considered a business because it operates "exclusively for educational purposes" and is recognized as a nonprofit by the IRS.
   - The gymnastics group first filed an appeal with the Allentown Tax Appeal Board in October.
   - In January, the board issued its decision, reducing the bill to $60,163.29, but saying the Parkettes does engage in business as defined in the business privilege tax ordinance. The board found the group is not a "purely public charity" because it primarily serves people who can afford to pay for its services. The board also found the organization does not keep records of services it donates or gives at a reduced cost.
   - Parkettes is appealing the board's decision.

Status of Nonprofit Exemption in PA

Payment in Lieu of Taxes Agreements ("PILOT")

- In recent years, many nonprofit entities are entering into payment in lieu of taxes agreements ("PILOT") with the taxing jurisdictions in order to forego the costs and risks of litigation as to whether or not it is a "purely public charity."

- Taxing jurisdictions in Pennsylvania are various means of to pressure nonprofit entities into entering PILOTs in order to forego costs of litigation. Specifically, taxing jurisdictions have been known to use the media (i.e. television, social media or newspaper) to identify a nonprofit entity for seeking exempt status on a property and thus removing much needed tax revenues from a struggling school district or municipality.

- There have also been instances where taxing jurisdictions have publicly announced what one nonprofit entity was paying in a PILOT with the expectation that another nonprofit entity seeking a PILOT would agree to pay the same amount.

- Few precedents exist regarding PILOTs, requiring nonprofits to be vigilant and to scrutinize any agreements proposed by local taxing jurisdictions.

SALES & USE TAXES

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Limitations - Construction

- The purchase of equipment (e.g. lawn mowers, hammers, floor polishers and snow blowers) for use, but not installation, in the construction, reconstruction, remodeling, repair and maintenance of real estate are subject to tax when purchased by a charitable organization.

- Materials, supplies and equipment which are purchased by a charitable organization for use and installation in the construction, reconstruction, remodeling, repair or maintenance of any real estate structure which become a permanent part thereof are subject to tax, *other than building machinery and equipment.*

- *Building machinery and equipment* is defined to include generation equipment, storage equipment, conditioning equipment, distribution equipment, and termination equipment.

Limitations – Construction (cont'd)

- Specific examples of *building machinery and equipment* include the following:
  - air conditioning;
  - electrical;
  - plumbing;
  - communications (voice, video, data, sound, master clock and noise abatement);
  - fire, security and detection alarms; control systems (energy management, traffic, parking lot and building access);
  - medical systems (diagnosis, treatment equipment, medical gas, nurse call and doctor paging);
  - laboratory systems;
  - cathodic protection systems; and
  - furniture, cabinetry and kitchen equipment.

Limitations – Construction (cont'd)

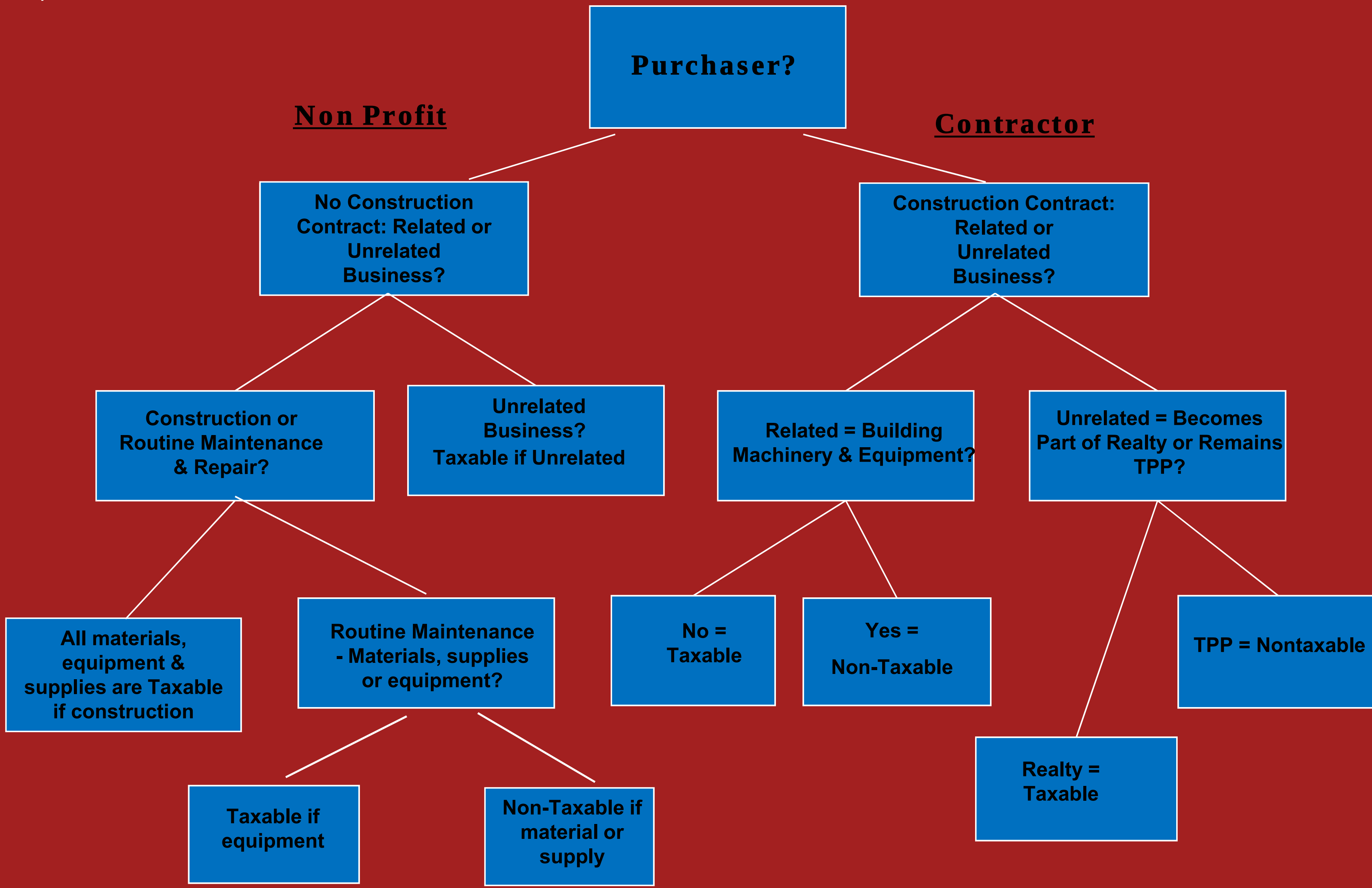
- The term *building machinery and equipment* also includes the following, whether or not they are considered to be a fixture or otherwise affixed to the real estate:

  boilers, chillers, air cleaners, humidifiers, fans, switchgear, pumps, telephones, speakers, horns, motion detectors, dampers, actuators, grills, registers, traffic signals, sensors, card access devices, guard-rails, medial devices, floor troughs and grates, and laundry equipment

- The following items are specifically excluded from the definition of *building machinery and equipment:*

  guard-rail posts, pipes, fittings, pipe supports and hangers, valves, underground tanks, wire, conduit, receptacle and junction boxes, insulation, ductwork and coverings

Sales & Use Tax – Construction - Decision Flowchart



Limitations – Unrelated Trade or Business

- An otherwise exempt organization must pay tax on its purchase of tangible personal property or services used in an "unrelated trade or business" carried on by the organization in the performance of an activity that bears **no reasonable relationship** to the purpose for which the organization exists.

- It is important to note that the definition of an "unrelated trade or business" for Pennsylvania sales tax purposes differs from the definition of an "unrelated trade or business" for federal income tax purposes.

- For federal purposes, an unrelated trade or business is defined as any activity which is **not substantially related** to the performance of its charitable, educational, or other purpose, which constitutes the basis for its exemption under Internal Revenue Code Section 501(c).

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Collection & Remittance Responsibilities

- A charitable organization making sales of tangible personal property or services has the same collection and remittance responsibilities as any other vendor under the sales tax law.
- If taxable property is sold, the fact that the organization makes no profit from its sale will not excuse it from collecting and remitting the tax or from registering with the Department.
- However, if the sale is an isolated sale, tax need not be collected.
  - Note special rules regarding nonprofit educational institutions and fund raising activity.

Non-collection of Tax

- All persons who are required to collect sales tax but do not collect it must have available for the Department of Revenue one of the following:
  - evidence that the sale did not involve tangible personal property of taxable services;
  - documentary evidence that the sale was to the federal or state government;
  - documentary evidence that it was required to and did deliver the property to an out-of-state destination; or
  - a properly executed exemption certificate.

Exemption Certificates

- Exemption certificates are certificates that must be furnished by a purchaser to a vendor in order to claim exemptions from transactions not subject to tax, except for those transactions that were never subject to tax or transactions in interstate commerce.

- Exemption certificates must be in the hands of the vendor on or before the 60th day following the sale or lease.

- Generally, the Pennsylvania Department of Revenue requires purchasers to use the exemption certificate Form REV-1220AS when claiming an exemption, including resale.

- Any form other than REV-1220AS must contain each item of information currently provided on the form and must be approved by the Bureau of Audits to be valid.

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Audit Procedures & Record Retention

- The Department of Revenue has the authority to audit the books, papers, and records of any taxpayer.

- For purposes of conducting such an audit, each taxpayer must retain its records for a period of at least three years from the end of the calendar year to which the records relate.

- All University entities should, prior to the destruction of any documents or records, notify the Corporate Tax Office of their intentions.

- All records must be dated, legible, written in English and maintained and preserved in such a manner as to disclose in readily available and verifiable detail the basis for an accuracy of the taxpayer’s sales and use tax return.

Prepare for the Audit

- Receive notice from the state
- Contact the auditor and finalize administrative details
- Prepare for the auditor's visit

Prepare for the Audit

Effective management is the key to a successful audit. It is important to prepare for an audit before the notification from the state --- be in a state of continual preparation for the audit.

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Pennsylvania Act 43 of 2017

- Act 43 of 2017 provided several amendments, additions, and modifications to existing Pennsylvania tax statute and regulations, including:
  - **Sales/Use Tax**
    - Help desk or call center support for software exempted.
    - Marketplace sales collection and reporting requirements.
  - **Personal Income Tax (PIT)**
    - Additional non-resident withholding requirements.
  - **Corporation Tax**
    - NOL $5 million cap removed and increased as a percentage of taxable income.
  - **Petition for Reassessment Procedures**
    - Period of time to submit a petition for reassessment to the Board of Appeals (BOA) and to appeal a BOA decision concerning a petition for reassessment at the BF&R was reduced from 90 to 60 days.

Update - Tax Issues for Nonprofits

Pennsylvania Act 43 of 2017 – Withholding

- Of note for charitable organizations, Act 43 implemented additional non-resident withholding and reporting requirements:
  - Requires payors of nonemployee compensation and business income to non-resident individuals (or disregarded entities with a non-resident owner) to withhold income tax from such payments.
  - Only federal and PA state entities are excluded from this withholding requirement.
  - Lessees of Pennsylvania real estate making “lease payments” to non-resident lessors are also required to withhold personal income tax on such payments. Residential rental payments are exempt from the withholding requirement. Withholding of tax is required for payments of $5,000 or more annually. Withholding is optional on payments less than $5,000.
  - Act 43 also expanded the requirements with respect to when a copy of Federal Form 1099-MISC is required to be filed with the Pennsylvania Department of Revenue. Payees and lessors having tax withheld who receive a copy of the Federal Form 1099-MISC from the lessees are required to file a copy thereof with their Pennsylvania tax return.
  - Businesses that currently withhold Pennsylvania personal income tax from employee compensation can use the same account to report, withhold and remit 1099-MISC withholdings.
  - If the payor or lessee does not currently have an employer withholding account, entities required to withhold and remit Pennsylvania personal income tax are required to apply for a 1099-MISC withholding account by completing a PA-100 Pennsylvania Enterprise Registration Form.

Update - Tax Issues for Nonprofits
South Dakota v. Wayfair

- Nexus - the amount and degree of business activity that must be present before a state can tax an entity's income or for taxes on sales within the state.
- On June 21, 2018, the U.S. Supreme Court ruled in favor of South Dakota, overturning the 26-year-old Quill physical presence standard in determining nexus.
- South Dakota Senate Bill 106 instituted an economic presence standard that requires sales tax collection and remittance for any entity exceeding an annual sales threshold of $100,000 or engaging in 200 or more separate transactions in South Dakota.
- Many states, including Pennsylvania, have subsequently adopted similar economic presence standards.
- See PwC's current **Wayfair State Guidance** matrix for more detail.
- Registration and filing implications for nonprofits, especially in regards to Unrelated Business Income ("UBI").

Update - Tax Issues for Nonprofits

Tax Reform

- The Tax Cuts and Jobs Act (“TCJA” or “Tax Reform”) of 2017 made significant changes to the Internal Revenue Code for business and individual income tax purposes.
- One of the most notable impacts of Tax Reform on organizations exempt from federal income tax under IRC Section 501(a) include the IRC section 512(a)(7) add-back provision for Qualified Transportation Fringe (“QTF”):

  Unrelated business taxable income of an organization shall be increased by any amount for which a deduction is not allowable under this chapter by reason of section 274 and which is paid or incurred by such organization for any qualified transportation fringe (as defined in section 132(f)), any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or any on-premises athletic facility (as defined in section 132(j)(4)(B))

- Exempt organizations should ask themselves - do the states to where unrelated business income is sourced conform to section 512(a)(7)?

Questions?

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