

Revenue Commissioner's Report On Philadelphia Income Tax Regulations

On December 19, 2008, pursuant to Section 8-407(a) of the Philadelphia Home Rule Charter, the Department of Revenue filed amendments to Section 224 of the City of Philadelphia Income Tax Regulations with the Department of Records.

Public notice of the filing of the proposed amendment was published and a request for a public hearing was made by Stephen D. D. Hamilton of DrinkerBiddle & Reath LLP. A public hearing was scheduled and held on Friday, February 13, 2009 at 9:00 am at the Municipal Services Building, Philadelphia, Pennsylvania. Mr. Hamilton testified and noted that his client, the Pennsylvania Real Estate Investment Trust (PREIT), has an interest in the amendment. Stephen Ryan of Grant Thornton, LLP also spoke.

The proposed regulation amendment removes a change made by a previous amendment to Sections 224 of the Philadelphia Income Tax Regulation that allows certain adjustment to the Federal taxable income reported by deemed Real Estate Investment Trusts (UPREIT) for the purpose of filing the Business Privilege Tax return under Method II. The amendment previously made was found invalid and in violation of the Business Privilege Tax enabling legislation by the Philadelphia Law Department.

Mr. Hamilton stated that “from a tax policy perspective and from tax fairness perspective the net income of REITs and UPREITs should be determined consistently.” Power is not vested in the Department of Revenue to disregard an explicitly stated provision of the law just because the provision appears to be unfair and inequitable. Doing so, to use Judge Avellino’s remark in *New Plan Realty*, results in “substituting what amounted to a policy argument for the plain language [of the law].” We believe Mr. Hamilton’s argument falls in this category and lacks foundation when it is examined from the perspective of the law.

Mr. Hamilton further stated that “as a matter of statutory interpretation, the position taken in the regulation was a reasonable one.” The Department of Revenue respectfully disagrees. In reviewing the decision of the Tax Review Board in *New Plan Realty*, the Common Pleas Court saw the unfairness of the law that “allows” REITs and their shareholders to escape taxation, but ended up reversing the decision of the Board anyway. As Judge Avellino aptly puts it:

When all is said and done, I can see the loophole. There is a loophole and I can see the mischief. I agree with the comments of the Tax Review Board. ... I

think [the loophole] is terrible. It strikes me as outrageous. But the answer lies, I believe, in changing the code, not in putting strained constructions upon the plain language of the ordinance. The ordinance needs to be amended, I think, to close this loophole. (Emphasis added)

The BPT enabling act defines Method II Net Income as “the taxable income from any business activity as returned to and ascertained by the Federal Government prior to giving effect to the exclusion for dividends received and net operating loss, subject to the following adjustments: ...” (Emphasis added). Other than the adjustments explicitly provided by the Act itself, for the determination of taxable income of taxpayers who elect to use the federal method, the Act authorizes neither the City Council nor the Revenue Commissioner to make additional adjustments. The Pennsylvania law of statutory construction provides that “[w]hen the words of a law are clear and free from all ambiguity, the letter of it is not to be disregarded under the pretext of pursuing its spirit.” The law further requires that “[p]rovisos shall be construed to limit rather than to extend the operation of the clauses to which they refer.” On the issue at hand, the statute is too explicit to be considered doubtful or ambiguous. Simply put, such adjustments could only be made by an act of the legislators in Harrisburg.

Mr. Hamilton suggested that “the partnership distributions are, in fact, ‘returned to and ascertained by the Federal government’ – just as the partnership’s other items of income and deductions are.” It is therefore “a reasonable approach”, so he says, to “take into account the partnership’s distributions” of “a partnership that operates like a REIT” in computing the federal taxable income for BPT purposes. In this scenario, “an UPREIT partnership and a REIT conducting the same business activities in the City will pay the same level of business privilege tax.” Here again, we kindly disagree with Mr. Hamilton’s opinion.

“Partnership distribution” of an UPREIT is not an item of deduction that is reflected on the federal partnership income tax return whereas “dividends paid deduction” is an allowable deduction for the determination of the REIT’s taxable income as defined under Section 852(b)(2) of the IRC. Whether or not the legislature intended such result, it’s a consequence of using the federal taxable income as a tax base that results in the REIT having an unfair advantage over its competitors. “Within the limits of the constitution, selection of subjects for taxation and their classification and exemption from taxation are legislative matters.” (*Sharpless v. Mayor of Philadelphia*, 21 Pa. 147). The City cannot undo or adjust by ordinance or by departmental regulation what the legislators did by their legislative act, unless there is a specific provision in the act that authorizes the City to do so. On the issue at hand, there is no such provision in the Act. It is with this understanding of the law that the Department of Revenue respectfully disagrees with Mr. Hamilton’s urge to disregard the proposed amendment to Section 224 of the Income Tax Regulations.

Stephen Ryan of Grant Thornton, LLP and Mr. Hamilton testified that, if we disagree with their proposal to disregard the amendment, given the reliance that people have put on Section 224 for the last ten years, the amendment should be prospective only. The Department of Revenue is mindful of this fact and, in spite of the fact that Section 224 is found to be ultra-vires by the City's Law Department, does not intend to apply this amendment retroactively on taxpayers who relied on Section 224 to file their original BPT returns for years prior to privilege year 2009.

The amendment to Section 224 of the City of Philadelphia Income Tax Regulations is hereby filed as originally proposed.