The Pennsylvania Institute of Certified Public Accountants
Greater Philadelphia Chapter
Committee on Legislation and Local Taxation

2002 Question & Answer Session with the City of Philadelphia
Department of Revenue

1. ADMINISTRATIVE: "No Tax Due" Notices

Q: A taxpayer receives a notice from the City of Philadelphia Department of Revenue ("PHLDOR") regarding past due taxes. Through research and correspondence, the PHLDOR agrees that the taxes on the notice are in fact not due and the account is adjusted to remove the tax balance. There is no mechanism in place for the taxpayer to receive a revised notice confirming that no tax is due. The PHLDOR may state that since the notices stop going to the taxpayer that is proof that the taxes are not due. It is far more comforting, however, for the taxpayer to receive a separate statement confirming that there are no taxes due. Is there any way that the taxpayer can receive a notice from the PHLDOR stating that there are now no outstanding taxes due?

A: *There are no current plans by the PHLDOR to issue "no tax due" statements. If a taxpayer feels they must have written confirmation that an erroneous tax delinquency has been removed, they can request a "balance bill" from Taxpayer Services at 215-686-6600.*

2. ADMINISTRATIVE: Voluntary Disclosure Programs

Q: Does the City have a formal or informal Voluntary Disclosure Program for those who have never filed returns (e.g. Business Privilege Tax, Net Profits Tax, Wage Tax, School Income Tax, etc.) and who have not been contacted by the City? Are there standard terms (i.e. limited look back period, waiver of interest and/ or penalties)? In initiating the voluntary disclosure, can the taxpayer choose to enter into an agreement with the PHLDOR, the Law Department, or a City tax collection agency such as St. Hill & Associates or Revenue Collection Bureau? If so, can you please provide a list of contact people for each agency?

Philadelphia Code § 19-1705 provides to the Revenue Commissioner the discretion to abate in whole or part, interest and /or penalties in amounts equal to or less than ten thousand dollars ($10,000) accruing upon any unpaid money or claims collectable by the PHLDOR. Would this provision affect a potential voluntary disclosure agreement where interest and /or penalties accrued are in excess of $10,000?

Does the PHLDOR have any plans for a Tax Amnesty Program?

A: *The PHLDOR does have a formal Voluntary Disclosure Program. Only those taxpayers who have never filed with the PHLDOR and have not received a tax discovery notice can avail themselves of the program. The PHLDOR will seek to collect six (6) years of the back taxes along with interest. The penalty will be waived so long as the amount does not exceed the Revenue Commissioner's authority (i.e. equal to or less than $10,000). The program is designed to bring into compliance those individuals and businesses that may have been innocently unaware of their respective tax liabilities. It is not designed to offer protection to those individuals and businesses who may have employed fraudulent or questionable methods to conceal their liabilities or whose level of knowledge or sophistication is such that they should have known there was a legal filing requirement (e.g. attorneys, accountants etc.).*

There is no statute that would prohibit a taxpayer or his/her representative from voluntarily approaching any one of the Law Department's outside tax collection vendors. However, since the terms for voluntary disclosure are uniform, the PHLDOR prefers taxpayers and their representatives to contact the PHLDOR Compliance Unit at 215-686-6614. If interest and penalty due exceeds $10,000, PHLDOR will involve the Law Department in the final settlement of the voluntary disclosure.

There are no current plans by the PHLDOR to offer a tax amnesty program.

3. ADMINISTRATIVE: Statute of Limitations for Audit

Q: It is our understanding that the PHLDOR has a policy of applying a three-year (3) statute of limitations when performing audits on business tax returns (i.e. Business Privilege Tax, Net Profits Tax, Wage Tax, etc.). However, Philadelphia Code § 19-510 provides a six-year (6) statute of limitations. How does the PHLDOR determine whether to apply the three or six year statute of limitations?

A: *Effective for audit examinations that were scheduled on or after April 1, 1993, the PHLDOR decided to administratively restrict the period for audit assessments to the three most recent tax years. This administrative policy was implemented based on the recommendation in City Council's* ***Report of the Select Committee on Business Taxes*** *that was issued in February 1993 and was seen as a way of giving taxpayers "a greater belief in the fairness of the system".*

A decision to depart from the three-year statute of limitations is made on a case-by-case basis. The Revenue Examiner, after conferring with his or her

supervisor and / or the senior management of the Audit Division, may decide to expand the scope of the audit to six years where the underpayment of the tax due appears willful and is material in amount. The scope may also be expanded where a prior audit report documents errors the taxpayer continues to make on tax returns filed subsequent to the report. The scope may also be expanded where the PHLDOR receives third-party information on a particular taxpayer and in due diligence must follow-up on the accuracy and validity of the information. The PHLDOR is in the process of reviewing the conditions that would expand the audit period.

4. BUSINESS PRIVILEGE TAX: Nexus – Financial and Operational Leases

Q: For purposes of liability for the net income base of the Business Privilege Tax ("BPT"), please distinguish between an operational lease and a financial lease (i.e. conditional sale). Assume that the only presence in Philadelphia is that of a salesmen soliciting business, followed by the "leases" of tangible personal property. Also assume that the salesmen's activities are sufficient to be considered "active presence" and subject the taxpayer to nexus for the gross receipts portion of the BPT. Additionally, what are the sourcing rules for sales in connection with a financial lease? In other words, will such transactions be treated as the sale of tangible personal property or as a service?

A: *The third paragraph of subsection A of Business Privilege Tax Regulation 103 [What Constitutes Doing Business (Having Nexus) in Philadelphia] states:*

> *"**Only the sale of tangible personal property is afforded immunity under Public Law 86-272. The provision of services for a fee, the sale of other than tangible personal property, the leasing, renting, licensing or other disposition of tangible, intangible or any other type of property is not immune from taxation by reason of Public Law 86-272**."*

*Additionally, BPT Regulation 101CC defines the term "**Sale**" as the**"(t) ransfer of title to goods, wares, commodities or merchandise…**" Therefore, any lease of tangible personal property within the City of Philadelphia that does <u>not</u> provide for (or reasonably anticipates) the transfer of title /ownership to the lessee by the end of the lease term (i.e. operating leases) will subject the taxpayer (i.e. lessor) to <u>both</u> the gross receipts and net income bases of the BPT. If the lease terms provide for the lessor-taxpayer's transfer of title to the tangible personal property (i.e. Sales-type leases) to the lessee, then the lessor-taxpayer is protected from the net income portion of the tax so long as there is no physical presence within Philadelphia and the activity is limited exclusively to solicitation for the sale. If the lessor-taxpayer is merely providing third party financing (and never had title*

or ownership to the tangible personal property), the taxpayer is not making sales and therefore not protected from the net income base of the BPT.

The receipts sourcing rules for leases that do not involve the transfer of title or ownership to the tangible personal property are found in BPT Regulation 303. The section can be accessed at www.phila.gov./Revenue under "Technical Rulings".

5. BUSINESS PRIVILEGE TAX: *QED* Decision and Act 511 Townships

Q: In light of the decision in ***Township of Lower Merion vs. QED Inc.*,** 738 A.2d 1066, (Pa. Commw. October 22, 1999), what is the PHLDOR's position on "active presence" if *QED* asserts that it is a privilege tax and is attributable back to its home office? Can the City of Philadelphia impose a tax, in addition to the Act 511 townships on the same receipts? Would this be considered "double taxation"? Are there any crediting provisions between the City of Philadelphia and the Act 511 townships?

A: *In **Township of Lower Merion vs. QED Inc.**, the Commonwealth Court of Pennsylvania held that receipts from a general contractor's work performed within Lower Merion Township was not subject to the Lower Merion Business Privilege Tax since the contractor's sole office was located in another township. (i.e. Radnor). The tax in QED was a privilege tax imposed on all of the gross receipts from all business activities anywhere, so long as the base of operations is within the political subdivision. The Court stated that under the Local Tax Enabling Act ("LTEA"), QED was only responsible for the payment of a business privilege tax on gross receipts to one municipality for the privilege of having a base of operations. Since QED had its sole office in Radnor Township, Lower Merion Township could not impose its business privilege tax on the service receipts earned within its jurisdiction.*

*The **QED** decision does not negatively impact on the City's ability to impose the BPT on non-Philadelphia businesses since the authority for the tax does not come from the LTEA. Philadelphia's BPT, as opposed to the tax in QED, is a transaction tax imposed on the receipts from transactions that are actually performed within Philadelphia. The City of Philadelphia's BPT is authorized by the Commonwealth of Pennsylvania's **First Class City Business Tax Reform Act** (53 P.S. § 16181 et seq.). This enabling legislation allows a city of the first class (i.e. Philadelphia), in spite of any other Commonwealth provision to the contrary, to tax every "person" engaging in any "business" within the City of Philadelphia. The Commonwealth statute does **not** specify that a person must have a physical location within the City of Philadelphia in order to be subject to the BPT. This point is emphasized in the BPT ordinance at Philadelphia Code § 19-2603(3) which states," **(p) hysical presence (the maintenance of an office***

or property) in the City is not required to establish active presence in the City*".*

If QED (or any other similarly-situated taxpayer) were to engage in the performance of building construction services (or any other service) within the City of Philadelphia, the PHLDOR would assert nexus for the BPT in spite of that taxpayer's payment of a privilege or transaction tax on all of their receipts (i.e.100%) to their home township (e.g. Radnor). The City would ***not*** *have to provide any credit on the BPT for taxes paid on the same receipts to the home township.*

6. BUSINESS PRIVILEGE TAX: Net Operating Loss Carry Forward Provisions

Q: The City of Philadelphia Business Privilege Tax allows for a three year carry forward of net operating losses. Can the survivor of the merger carry forward net operating losses generated by a taxpayer prior to a merger? If so, are there any limitations on the net operating losses? Please distinguish between Method I and Method II taxpayers, if applicable.

A. *For Federal tax- planning purposes, corporations with accumulated net operating losses have long been in demand for tax saving purposes. A corporation that acquires another by purchase or reorganization also gets the acquired corporation's tax position for many items, one of which is net operating loss carryovers. A profitable corporation will acquire and merge with a loss corporation or vice versa, with the idea of offsetting the income of the profitable corporation with the losses of the loss corporation. If a corporation that has sustained a loss is acquired by purchase or reorganization, there is a question of how the loss carryover is affected. The deductibility of the net operating loss is governed by a specific provision of the Federal tax code (i.e. IRC § 382 limitations).*

The Philadelphia Code prohibits the filing of a consolidated or combined tax return. The Code provides no authority for the use by one taxpayer of an operating loss generated by another taxpayer under any circumstances. Moreover, the rules for net operating losses under the Code expressly do not incorporate the provisions of the Federal Internal Revenue Code for either Method I or Method II taxpayers. Accordingly, it has been the Department's consistent position since the inception of the BPT that the survivor of a merger cannot report the net operating loss of the non-survivor.

7. BUSINESS PRIVILEGE TAX: Change from a Disregarded Entity or Partnership to a Corporation

Q: Please advise on the Business Privilege Tax filing requirements for an entity that was treated as a disregarded entity pursuant to federal "check the box" rules, but years later converted to a C Corporation. Please advise on the filing requirements for both the owner of the disregarded entity (i.e., Final BPT returns?) and new C Corporation (i.e., New Start BPT returns?). Also, please advise on the filing requirements for an entity that was taxed federally as a Partnership, but years later elected to be treated as a C Corporation.

A: *Under the Federal "check the box" system of classifying entities for tax purposes, "eligible entities" --unincorporated business entities that aren't trusts and that aren't required under the IRC to be classified as corporations-- may choose their federal tax classification. An "eligible entity" may achieve a "hybrid" status in that it may be treated as one type of entity for purposes of state and local laws governing its formation and operation, but be another type of entity for Federal tax purposes.*

The Philadelphia Code does not have a comparable version of the Federal "check-the-box" regulations. The PHLDOR will generally, however, recognize the Federal "check the box" entity classification the taxpayer chooses. If, in the example provided, a single member limited liability company ("SMLLC")(that was treated as a "disregarded entity") and owned by an individual later sought classification as a C corporation, the SMLLC would file a final BPT and Net Profits Tax return ("NPT") and the new corporation would file a New Start BPT return under a new account number (and obtains a new BPT license). A partnership seeking to be treated as a corporation would follow suit.

8. BUSINESS PRIVILEGE TAX: Taxation of Check-the-box entities

Q: A corporation is the sole member of an LLC that is a disregarded entity for federal income tax purposes under the check-the-box rules. Collectively, the corporation and its single-member LLC own 100% of a partnership that conducts business in Philadelphia. Therefore, the partnership is also disregarded and an entity for federal income tax purposes. Is the partnership subject to business privilege tax as a separate entity or is it treated as a division of the corporation?

A: *For Federal purposes, the classification of the single member limited liability company ("SMLLC") as a "disregarded entity" will cause it to be seen as an entity that is **not** separate from its owner. That is, for Federal tax purposes the disregarded entity SMLLC (which may be separately recognized under a given state's tax law) in effect does **not** exist. That being the case, the partnership cannot exist under Federal tax law since a partnership must have at least two*

partners. The corporation therefore (as was noted in the question) will be the only reporting Federal taxpayer.

As was mentioned in a previous question, the PHLDOR will generally honor a taxpayer's Federal "check-the-box" classification for the entity. Under that classification system, when all is said and done, there is only one taxpayer, the corporation. Therefore, for the scenario presented, the corporation will be the reporting entity for Philadelphia BPT purposes.

9. BUSINESS PRIVILEGE TAX / NET PROFITS TAX: Owner Occupied Rental Property

Q: A taxpayer owns a boarding home. The taxpayer lives upstairs and the boarding home occupies the downstairs of the home. The boarding home is incorporated and the taxpayer is the only shareholder. The boarding home is paying rent to the taxpayer. Based on the aforementioned facts, what is the Department of Revenue's position regarding the taxability of owner occupied rental property?

A: *Excluded from the definition of "Business" under Business Privilege Tax Regulation 101(D.)(8.) is "… rental income generated from real property which is the principal residence of the owner and consists of three or less residential units." Additionally, Income Tax Regulation 220(b)(1)(a) excludes from the NPT rental activity which meets* ***each*** *of the following criteria: 1) it is the principal residence of the owner; 2) is totally residential; and consists of three (3) rental units or less.*

BPT Regulation 103(D.)(4.) lists as an example the "(h)olding, acquiring, leasing, or disposing of any property located in Philadelphia" as an activity which constitutes doing business in Philadelphia and subjecting a taxpayer to the full measure of the tax (i.e. gross receipts and net income bases). In the scenario presented, the individual sole shareholder receives rental income from a business lessee (in this particular case, a corporation) that in effect changes the character of the rental income to the individual as "commercial" rent. The "residential rental" protection from BPT/NPT taxation of the regulations noted above would ***not*** *apply. This rental activity is fully taxable for BPT/NPT purposes.*

10. BUSINESS PRIVILEGE TAX / NET PROFITS TAX: Changing From a Sole Proprietorship to a Corporation

Q: A taxpayer, a sole proprietor, started a medical practice in the City of Philadelphia in January 2000. In January 2001, the practice incorporated. In May 2001, the taxpayer purchased the building that the practice operated in and the corporation started to pay rent to the doctor.

Based on the facts above, is the rental activity considered to be a continuation of the sole proprietorship if the Business Privilege Tax and Net Profits Tax returns were filed using the same social security number? Or, should the taxpayer start filing "new" Business Privilege Tax Returns in 2001 since it is a new business? Please explain the compliance requirements for the sole proprietorship and the corporation. Would the answer change if these separate, unrelated business activities took place in the same year?

A: *The BPT regulations do not specify how much time must elapse between the termination of one business activity and the commencement of another in order for the **same** entity to be required to file the New Start (BPTNS) returns again. The rule historically employed by the PHLDOR has been that if the new activity is within a few months of the old, the business activity will be seen as continuous. If the new activity would commence a year or so after the prior business activity, it would be seen as a new business. In the scenario presented, the sole proprietor's rental activity would be seen by the PHLDOR as a continuation of business activity since both the medical practice and rental activity occurred within a few months (i.e. 5 months) of each other. If the sole proprietor's medical practice ceased in January 2001 and the rental activity began in May 2002 (a year later than the scenario), the PHLDOR would say that a 2002 BPT NS (first year new start return) would be due for the rental activity. (**Note:** The PHLDOR may consider a taxpayer's specific facts and circumstances in order to determine intent as to the termination of an existing business activity or the commencement of a new business activity.)*

The sole proprietor (in this scenario) would be responsible for the filing of BPT and NPT returns for 2000 and forward. The corporation would be subject to the filing of the 2001BPTNS return (first year New Start return) and for each privilege year return thereafter. Both taxpayers would need to have their respective BPT license.

11. NET PROFITS TAX: Taxation of Check-the-box entities

Q: Are Partnerships and LLCs that elect to be treated as Corporations under the federal check-the-box rules (*see* Treas. Reg. § 301.7701-3) subject to the Philadelphia Net Profits Tax? Are LLCs that are treated as partnerships subject to the NPT?

A: *The issue of whether or not an LLC is subject to the Net Profits Tax (NPT) is more a function of the Commonwealth of Pennsylvania's tax structure. Prior to Pennsylvania's Act 7 of 1997, all LLCs were treated as "corporations" by the Pennsylvania Department of Revenue and were, therefore, subject to the Corporate Net Income Tax (CNI). This was true even for LLCs that under the Federal check-the-box regulations were classified as "partnerships". The CNI levy by the Commonwealth effectively preempted the City of Philadelphia from imposing the NPT since the Sterling Act (see 53 P.S. § 15971) prohibits a city of the first class (i.e. Philadelphia) from imposing a tax on a privilege or transaction that is subject to a state tax or license fee.*

*Pennsylvania's Act 7 (effective for tax years beginning on or after January 1, 1998) brought the Commonwealth into conformity with the Federal check-the-box regulations. That is, the LLC (being treated as a partnership for Federal purposes) would no longer be subject to the CNI tax. (**Note**: This change had no impact upon the LLC's liability for Capital Stock/Franchise Tax and such a taxpayer must still file). With the effective date of this amendment to the Commonwealth's statutes, the Commonwealth's preemption is no longer at issue and the City is now free to impose its NPT upon those LLCs that would not be subject to the CNI. Therefore, for tax years beginning on or after January 1, 1998, LLCs classified as "partnerships" under the Federal check-the-box-regulations will be subject to the NPT. In line with this, LLCs classified as corporations under Federal check-the-box regulations (and for Pennsylvania CNI purposes) will be exempt from the NPT. (**Warning:** Prior to Pennsylvania's Act 7 of 1997, the Restricted Professional Company (RPC) class of LLC was treated for Pennsylvania purposes as a limited partnership. As such, they were not subjected to the CNI and, therefore, were subject to the NPT for tax years beginning on or before January 1, 1998.)*

12. NET PROFITS TAX: Fiscal Year Taxpayers' Net Profits Tax Rates

Q: The City of Philadelphia Wage Tax rates have historically decreased and generally take effect on July 1 of each year. The Net Profits Tax rate decreases have been retroactive and apply January 1 of each year. Pursuant to Philadelphia Ordinance Section 19-1502, calendar year taxpayer may use post July 1 tax rates for the entire year (consistent with the treatment for the past several years). For a taxpayer with a fiscal year end (e.g. September 30, 2001), what Net Profits Tax rate(s) should be used?

A: *Historically, the Net Profits Tax (NPT) rates have been set effective for net profits earned on or after January 1 of a given year. For net profits earned on or after January 1, 1996 and for every January 1 thereafter, the rates have been reduced on an annual basis. However, it can never be assumed that future rates*

will continue to be reduced since tax rates are a function of the City's budgetary forecasts and revenue needs for a given fiscal year.

Calendar year NPT filers will use the rate in effect for the calendar year. A fiscal year NPT filer will have to prorate the reported net profits between two (2) calendar periods. Worksheets A and B of the Fiscal Year Net Profits Tax return (Form FYNPT) are used to make this pro-ration of the net profits tax for residents and nonresidents respectively, between the two calendar year rates on a monthly basis. For a taxpayer whose fiscal year ended September 30, 2001, the net profits tax will be three (3) months at the 2000 calendar rate and nine (9) months at the 2001 rate.

13. NET PROFITS TAX: Deductibility of 401K and Pension Contributions

Q: For a partnership, are employers' contributions to 401K plans and pension plans on behalf of both partners and employees deductible for purposes of the Net Profits Tax?

A: *The partnership's contributions to a pension / profit sharing / retirement plan on behalf of its employees are deductible for Net Profits Tax purposes. Contributions to a partner's retirement plan, however, are <u>not</u> deductible for NPT purposes. The expense is not seen by the PHLDOR as ordinary, necessary and reasonable as is required under the definition of "Net Gain" at Income Regulation 101(h.). A contribution to the retirement plan of a partner is not an expense; it is a distribution and use of the partnership's profits.*

14. REALTY TRANSFER TAX: Conversion of Corporation into a Limited Partnership.

Q: In the June 2001 Q&A session, the Pennsylvania Department of Revenue responded that the conversion of a Delaware corporation into a limited partnership under Delaware Code Title 8, Chapter 1, Subchapter IX, §266 will have no realty transfer tax consequences. The Department reasoned that there is no break in the continuity of the entity's existence but merely a change in form. Will the City of Philadelphia conform to the exempt treatment of such conversions? (Note that the Department's analysis did not involve a corporate merger exemption or other provision wherein the City of Philadelphia ordinance departs from state rules).

A: *No. To the extent that a Delaware corporation has ownership / title to real estate within Philadelphia when it is converted (pursuant to 8 Del. C. § 266) to a Delaware limited partnership, the transaction will give rise to Philadelphia Realty Transfer Tax.*

The Realty Transfer Tax ordinance at Philadelphia Code § 19-1406 states:

> *Except as otherwise provided in section 19-1405 documents which make, confirm or evidence any transfer or demise of title to real estate between associations or corporations and the members, partners, shareholders or stockholders thereof are fully taxable. For the purposes of this article, corporations and associations are entities separate from their members, partners, stockholders or shareholders.*

Realty Transfer Tax Regulation 404 also states that transfers in consideration of the issuance or cancellation of stock are fully taxable.

.