Business Privilege Tax – Expansion of the Base

Active Presence Nexus Standard

The City of Philadelphia - Department of Revenue was successful in amending Philadelphia Code § 19-2603 to adopt an "active presence" standard for determining when a business entity will be subject to filing a Business Privilege Tax return (i.e. nexus). Effective July 1, 1998, all business entities, regardless of whether they have a physical location within the City of Philadelphia, will be subject to the ***full*** Business Privilege Tax if they have an "active presence" in Philadelphia. The "active presence" standard does **not** require a taxpayer to maintain an actual physical location within the City of Philadelphia but will be met where a business organization pursues profit and gain (within Philadelphia) and conducts those activities in Philadelphia which are essential to that purpose (e.g. missionary salespeople who solicit sales).

The United States Congress, within the power derived from the U.S. Constitution's Commerce Clause, places a limitation on Philadelphia's ability to impose the net income base portion of the Business Privilege Tax on certain taxpayers that are solely, physically located outside the Commonwealth of Pennsylvania. Under United States Public Law 86-272 (15 USC § 381 et. seq.), a state is prohibited from imposing a ***net income tax*** (or a franchise tax that is measured by net income) on an out-of-state business when the business's only activity within the state is for the ***solicitation of orders*** for the sale of ***tangible personal property***. However, the orders must be sent to a place outside the state for acceptance or rejection and, if accepted, must be shipped from a place outside the state. To the extent an out-of-state business's activities in a state stay within those outlined in P.L. 86-272, the business is protected from the state's net income tax (or franchise tax measured by net income). P.L. 86-272 offers this "safe harbor" protection ***only*** to those businesses that are engaged in the sale of tangible personal property and has no applicability or effect on a state's ability to impose a net income tax (or franchise tax as measured by net income) on out-of-state service businesses performing their services within the state.

The Congressional "safe harbor" of P.L. 86-272 has given rise to the "solicitation plus" standard of nexus that the Revenue Department has historically applied to the Business Privilege Tax. If an interstate business (as well as an intrastate business located outside the City of Philadelphia) engaged in the sale/delivery of tangible personal property into Philadelphia and limited its activities to those outlined within P.L. 86-272 (i.e. mere solicitation), they would ***not*** be subject to any portion of the Business Privilege Tax. With the adoption of the new "active presence" nexus standard, this business entity will now be subject to the gross receipt portion of the tax. That is, to the extent that an interstate business maintains an "active presence" within Philadelphia (e.g. sending missionary salespeople to solicit sales), they will now be subject to the gross receipt portion of the tax. This same treatment will also be afforded to those businesses located outside the City of Philadelphia but within the Commonwealth of Pennsylvania. To the

extent that these businesses' activities exceed the protection of P.L. 86-272, they will be subject, as they always were, to the full Business Privilege Tax (i.e. gross receipts and net income bases). The tax treatment of those businesses with a physical location within the City of Philadelphia as well as outside Philadelphia service businesses operating within the city remain as they have always been (i.e. fully taxable).

Analysis of and Justification for the Department of Revenue's Position

First Class City Business Tax Reform Act

The Commonwealth's enabling legislation for the Business Privilege Tax, the **First Class City Business Tax Reform Act** (53 P. S. § 16181 et seq.) does not prohibit the City from making this change. 53 P.S. § 16184 allows a City of the First Class (i.e. Philadelphia) to impose the tax ***"…at rates determined by city council which shall be applicable to taxable receipts, net income or any combination of the two (emphasis added)***…" Therefore, the enabling legislation allows the City of Philadelphia to impose the tax on the gross receipts base only for those businesses that are afforded the protection of P.L. 86-272. It is interesting to note that the enabling legislation is **silent** as to the nexus standards that the City must employ in asserting jurisdiction to tax (i.e. solicitation plus v. active presence). Therefore, the change to the "active presence" nexus standard is allowed and passes the enabling legislation's muster.

United States Constitution

A state (or political subdivision thereof) interpretation of nexus is valid only if it does not violate either the Commerce or Due Process Clauses of the U.S. Constitution.

The Commerce Clause reserves to Congress the power to regulate commerce among the states, with foreign nations, and with the Indian tribes. *(**Note:** The enactment of P.L. 86-272 is an example of Congress asserting its power under the Commerce Clause.)* The primary focus of the Commerce Clause, as it relates to State & Local taxation, is that a state (or a political subdivision thereof) must not impose an undue burden on interstate commerce. That is, a state's taxing scheme must not impose a harsher requirement/burden/standard on the out -of-state business while imposing an easier requirement/burden/standard on a domestic business entity. The active presence nexus standard will not violate the Commerce Clause because a Philadelphia-based business entity would pay the ***full measure*** of the tax whereas the non-Philadelphia businesses (protected by P.L. 86-272) would be subject to the ***gross receipt base only***. The non-Philadelphia business's tax obligation would not be an "undue burden" when taken in relation to the tax obligation of a business located in Philadelphia.

A leading Commerce Clause case, as it relates to a imposition of a franchise or privilege tax in the Commonwealth of Pennsylvania is ***Clairol Inc. v. Commonwealth of Pennsylvania*** 513 Pa. 74 (1986). Clairol was a corporation organized under the laws of Delaware with its corporate headquarters located in New York and its manufacturing facilities located in Connecticut and California. Clairol did not possess a certificate to do business in Pennsylvania. It had no offices, plants, warehouses, or bank accounts within the Commonwealth. All shipments of merchandise entered Pennsylvania by common carrier. There were, however, thirty-one (31) sales people who operated from their individual homes and performed myriad duties within Pennsylvania (i.e. solicitation, sales promotions etc.). Clairol raised a Commerce Clause challenge to the imposition of the Pennsylvania Capital Stock/Franchise Tax stating that insufficient nexus existed between Clairol and the Commonwealth to justify an exercise of Pennsylvania's taxing power. The Supreme Court of Pennsylvania stated that Clairol's contention was ***"without merit"***. The Clairol court stated in its opinion, "***It is a truism that the mere act of carrying on business in interstate commerce does not exempt a corporation from state taxation***." The court continued, " ***It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business."***

The Due Process Clause prevents the states from depriving ***"any person of life, liberty, or property without due process of law.***" With respect to State and Local taxation, the Due Process Clause prevents a state (or political subdivision thereof) from imposing a tax unless there is some definite link or connection between a state and the person, property or transaction that it seeks to tax. The U.S. Supreme Court has stated, in general, the jurisdictional requirement under the Due Process Clause necessitates only minimum contacts between the out-of-business and the state. The active presence nexus standard will satisfy this "minimum contact" requirement of the Due Process Clause.

Federal Statutes – U.S. Public Law 86-272 (15 USC § 381 et. seq.)

This statute has been addressed above. Suffice it to say that the active presence nexus standard does not violate this statute. In fact, the new standard is very cognizant of the statute and complies with it. Those business entities, which are protected under P.L. 86-272, will only be subject to the gross receipt portion of the Business Privilege Tax.

Pennsylvania's Constitution

PA CONST Art. 8, s1 states, ***"All taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax…"*** The Commonwealth's constitutional requirement does **not** require that all taxpayers be treated in a uniform manner, but that within a **class** of subject taxpayers, all be treated uniformly. The new nexus standard recognizes that there are distinct classes of taxpayers, those that are located within Philadelphia (subject to full taxation) and those protected by P.L.86-272 (subject to gross receipt taxation). Since there is a legitimate distinction between the

classes that provides a nonarbitrary, reasonable, and just basis for the difference in tax treatment (i.e. Philadelphia business vs. non-Philadelphia business) the constitutional requirement of uniformity is met.

Other Thoughts

There may be criticism of the new nexus standard as it relates to the Commonwealth's constitutional uniformity requirement and intrastate business entities. There are those who may say that the Department of Revenue is required under the Commonwealth's constitution to subject an intrastate business (i.e. outside Philadelphia/inside Pennsylvania) to the full measure of the Business Privilege Tax (i.e. gross receipt and net income bases) since P.L. 86-272 governs **only** interstate commerce **not** intrastate commerce. Legally, the distinction is correct and Philadelphia could impose the full measure of the tax on an intrastate business entity. However, the Pennsylvania Constitution requires uniformity upon a class of subjects " ***within the territorial limits of the authority levying the tax***." By treating an intrastate business located outside the territorial limits of the City as if it were "similarly situated" to one engaged in interstate commerce, the Department is preserving uniformity of class taxation within and without the territorial limits of the City of Philadelphia.