

Philadelphia's Taxation of Limited Liability Companies for Business Privilege and Net Profits Taxes

Limited liability companies (“LLCs”) have recently emerged as an alternative to corporations and partnerships. Since the first law was enacted in Wyoming in 1977, the District of Columbia and all of the states have followed suit and adopted some form of LLC statute. This entity offers the limited liability of the corporate form, but allows conduit treatment of the tax attributes, avoiding the double taxation of C corporations. As an alternative to the S corporation, the LLC offers the same limited liability and conduit treatment, but without the strict limitations on ownership and the lack of shareholder basis due to the entity's debt. As an alternative to a partnership, the LLC offers limited liability to all owners, compared with limited liability for only some of the partners (i.e. limited partners) of a partnership since at least one general partner always suffers the burden of unlimited liability. Because LLCs are generally treated as partnerships for tax purposes, they enjoy all of the other advantages of partnership tax treatment.

Federal Classification of Limited Liability Companies

Under the current Federal “*check-the-box*” entity classification rules, a business entity that is not required to be classified as a corporation (an “*eligible entity*”) can elect its classification for tax purposes. (Note: *Examples of some business entities that will always be treated as corporations for tax purposes include insurance companies, state-chartered banking organizations where any deposits are FDIC insured and a business entity wholly owned by a state or political subdivision.*) If an eligible entity has at least two members, it can elect to be classified as an association taxable as a corporation or a partnership. If the eligible entity has a single member as owner (“SMLLC”), classification is limited to a corporation or to be disregarded as an entity separate from its owner. In the latter case, its activities are treated in the same manner as a sole proprietorship, branch or division of the owner. The taxable income of a “*disregarded entity*” will be reported on the owner's Federal income tax return.

Under the check-the-box rules, a default classification is available for an eligible entity. An election of entity status is only necessary if the default classification is undesirable or if the eligible entity changes its classification. A partnership is the default classification for an eligible entity with two or more members. An eligible entity with a single member is disregarded as an entity separate from its owner.

Under the entity classification rules in effect before the “*check-the-box*” system was promulgated (originally adopted in 1960), the IRS used a cumbersome four-factor test based on the historical differences under state law between partnerships and corporations.

The IRS considered these four factors when determining whether a non-corporate entity, such as an LLC was treated as a partnership or corporation for federal tax purposes:

1. Limited liability
2. Centralized management
3. Continuity of life
4. Free transferability of interest

If the entity possessed no more than two of the four characteristics, it was treated as a partnership.

Pennsylvania's Classification of Limited Liability Companies

On December 7, 1994, Governor Robert Casey signed the Limited Liability Company Act ("Act") into law. With the enactment of this statute, Pennsylvania joined the vast majority of other states that recognized an LLC. The Act set forth the rules applicable to three new types of entities:

1. Registered Limited Liability Partnerships ("RLLP")
2. Limited Liability Companies ("LLC")
3. Restricted Professional Companies ("RPC")

An RLLP is a general or limited partnership that registers with the Pennsylvania Department of State. A partner in an RLLP is not individually liable for the debts and obligations of the partnership that arise from any negligent or wrongful act or misconduct committed by another partner or representative of the partnership. A partner in an RLLP remains liable individually for any wrongful or negligent acts or misconduct committed by him/her or by any person under his/her direct supervision and control and for any debts or obligations of the partnership. An RLLP is not subject to tax at the entity level [i.e. Corporate Net Income Tax (CNI), Capital Stock/Franchise Tax (CSF)] but the partners are subject to the Personal Income Tax (PIT) on their distributive share of each category of income of the RLLP.

An LLC is a new form of entity that is created by filing a certificate of organization with the Pennsylvania Department of State. No member or manager of an LLC is liable for any debt, obligation or other liability of the LLC or for the acts or omissions of any other member, manager, agent or employee of the LLC (even if the member participates in the management of the LLC).

An RPC is a special class of LLC that performs only certain restricted professional services (i.e. medicine, dentistry, law, public accounting, psychology or veterinary medicine). All members and managers of the RPC must be licensed professionals. Prior to Act 7 of 1997, for the purposes of the imposition by the Commonwealth or any

political subdivision of any tax on any income, property, privilege, transaction, subject or occupation, an RPC was deemed to be a limited partnership and a member of such company a limited partner. This treatment applied regardless of how the RPC was classified for Federal income tax purposes. Act 7 repealed this treatment and an RPC will be taxed in accordance with its Federal classification as a partnership or corporation.

Prior to the effective date of Pennsylvania's Act 7 of 1997 (January 1, 1998), an LLC was deemed to be a "*corporation*" for CNI purposes and an "*entity*" for CSF purposes. This treatment was applicable even if the LLC qualified as a partnership for Federal income tax purposes. For tax years beginning on or after January 1, 1998, an LLC will be classified for CNI purposes as it is for Federal tax purposes. That is, if the LLC qualifies as a partnership for Federal tax purposes, it will not be subjected to CNI whereas if it is classified as a corporation for Federal purposes, it will be subject to CNI. The LLC still remains subject to CSF regardless of its Federal tax entity classification.

The Pennsylvania Department of Revenue's *Pennsylvania Tax Update* (May/June 1998 – Number 75) highlighted the Act 45 tax changes and clarified that effective for tax years beginning on or after January 1, 1998, a single member limited liability company (SMLLC) that is classified by the Federal government as a "*disregarded entity*" will not be subject to CNI.

Philadelphia's Classification of Limited Liability Companies

Given the aforementioned Federal and Commonwealth classifications of LLCs, how should the three- (3) new entities be classified for Philadelphia Business Privilege Tax (BPT) and Net Profits Tax (NPT) purposes?

Business Privilege Tax

Since LLCs, RLLPs, and RPCs doing business in Philadelphia will be subject to the BPT regardless of Federal or Pennsylvania classifications, it is best for the City of Philadelphia to treat them in accordance with their Federal tax entity classifications. The overwhelming majority of BPT filers report their net income under Method II (i.e. Federal taxable income), so it is only logical to recognize the Federal entity classification under which this Federal income is reported. LLCs, RLLPs, and RPCs will be treated for BPT purposes in accordance with their Federal tax entity classifications.

A single member limited liability company (SMLLC) "*doing business*" in Philadelphia that is a "*disregarded entity*" will create nexus for its owner. Since for Federal tax purposes the disregarded entity SMLLC does not file as a separate entity but "*merges*" its activity on the Federal tax return of its owner, there is no Method II income for the SMLLC per se. The overall net income of the owner will be apportioned to Philadelphia based on the business activity of the disregarded entity SMLLC.

Net Profits Tax

Classification of the various entities for Philadelphia tax purposes has historically been a NPT problem. Prior to Pennsylvania's Act 7, all LLCs were treated as "corporations" and therefore subject to CNI, regardless of whether they were classified as partnerships for Federal purposes. The Commonwealth's classification presented a unique problem for Philadelphia. The CNI levy by the Commonwealth effectively preempted the City of Philadelphia from imposing the NPT since the Sterling Act prohibits Philadelphia from imposing a tax on a privilege or transaction which is subject to a state tax or license fee. Since Act 7 (effective for tax years beginning on or after January 1, 1998) honors the Federal classification for CNI purposes, the NPT preemption issue has disappeared. For tax years beginning on or after January 1, 1998, LLCs treated, as partnerships for Federal tax purposes will be subject to the NPT. (Note: *As was previously noted, prior to Pennsylvania's Act 7 of 1997 an RPC was treated for Pennsylvania (and Philadelphia) tax purposes as a limited partnership. As such, an RPC would **not** be subject to CNI and therefore presented no preemption problem for the Philadelphia Net Profits Tax. An RPC (classified as a partnership under Federal tax law) will therefore be liable for the Net Profits Tax for tax years prior to January 1, 1998.*)