

PART 1 - NET INCOME

IRREVOCABLE ELECTION OF "NET INCOME" COMPUTATION METHOD

The taxpayer **must** elect one of two methods for computing net income on the first Business Privilege Tax Return they file. The **same method** must then be used by the taxpayer in all subsequent years.

Net Income Method I and II

Method I Income is the net gain (or loss) from the operation of a business (revenue minus allowable expenses) according to the business's accounting system. Income taxes may not be deducted from this amount. Taxpayers who elect this method should complete Schedule A.

Method II Net Income is the net profit (or loss) properly reported to the Federal Government. Taxpayers who elect this method should complete Schedule B.

Partnerships, joint ventures, associations, syndicates, pools and "S" Corporations should use ordinary taxable income as reported to the Federal Government on Form 1065 or Form 1120S and modified by the specific adjustments which are outlined in Section 404 of the Business Privilege Tax Regulations.

DEDUCTIBILITY OF TAXES TO COMPUTE THE BUSINESS PRIVILEGE TAX

Method I: Taxpayers electing Method I may **not** deduct taxes based on Net Income such as Philadelphia Net Profits Tax, other local, state and Federal income taxes, but may deduct the Business Privilege Tax and all other taxes that are considered to be ordinary and necessary business expenses.

Method II: Taxpayers electing Method II (Income as properly returned to and ascertained by the Federal Government) may deduct all taxes which are considered ordinary and necessary business expenses in accordance with the Internal Revenue Code and Regulations.

Taxes which are **not** deductible under Method II include but are not limited to the following:

- 1) For Individuals: Philadelphia Net Profits Tax, State and Federal Income Taxes. The Philadelphia Net Profits Tax and State Income Tax are personal deductions for individuals under the Internal Revenue Code, not business expenses.
- 2) For Partnerships: Taxes described in Internal Revenue Code Section 901, paid or accrued to foreign countries and to possessions of the United States.
- 3) For Corporations: Corporation Federal Income Tax and (for prior years) excess profits tax.

Apportionment of Income (Section 408)

Property Factor

The taxpayer's net income after adjustments and allocation of nonbusiness income is apportioned to Philadelphia on Schedule C-1 through a three part formula composed of a property factor, payroll factor and receipts factor.

The property factor includes all real and tangible personal property (except coin and currency) owned or rented by the taxpayer which was used or was available for use during the income year in the regular course of business. Property or equipment under construction are not included. However, raw materials and reserve inventories of materials must be included. Property used in connection with the production of nonbusiness income is excluded from the property factor.

Payroll Factor

The payroll factor includes all compensation paid or accrued by the employer in the regular course of business. Such compensation includes wages, salaries, commissions and any benefits which are classified as employee income by the Internal Revenue Code. However, compensation does not include payments to employees in connection with the production of nonbusiness income.

Receipts Factor

The receipts factor should include all business receipts (as defined in Section 301 of the regulations) received from operations everywhere. Receipts associated with nonbusiness income should not be included.

Averaging of Factors

The percentages for the includible factors should be added together and divided by the number of includible factors. This average is then multiplied by the net income (or loss) after adjustments and allocation of nonbusiness income.

Excludible Factors

If any of the factors has a denominator which is zero, that factor should be omitted from the computation. If the numerator is zero, then the resulting factor is zero and should be included in the computation.

Other Methods of Apportionment

If the apportionment method does not fairly represent the taxpayer's business activity in Philadelphia, the taxpayer may request, or the Revenue Department may require, certain variations on the apportionment method. See Section 408 of the Regulations if you feel that the above formula results in an apportionment factor that does not fairly represent your Philadelphia business activity.