December 22, 2016

In Re: Hilary Alger

Docket No: 16SIREFZZ9968

Statement of Record:

1. Hillary Alger (hereafter "Petitioner") filed a Petition for Refund Appeal with the Tax Review Board (TRB) on March 31, 2015 for School Income Tax (SIT) paid for the years 2011 through 2013 in the amount of [redacted]
2. The TRB held an administrative review hearing on November 5, 2015 which carried over to December 17, 2015 and April 5, 2016. At the conclusion of the hearing, the matter was taken under advisement for consideration by the Board.
3. A hearing was held on August 9, 2016 by the TRB for the purpose of rendering its decision to the parties. The decision of the Board announced at that time was to deny the petition for refund of the SIT paid by Petitioner for the years 2011, 2012 and 2013 as follows:
    a. The City of Philadelphia has the authority to levy the School Income Tax on distributive shares of Subchapter S Corporation income and properly promulgated regulations to do so.
    b. Treating C Corporations and S Corporations differently for tax purposes is not a violation of the State's Uniformity Clause. They are unique entities with different benefits and responsibilities.
    c. Comptroller of the Treasury of Maryland v. Brian Wynne et ux, 135 S.Ct. 1787 (2015) is not controlling in this circumstance as the Philadelphia School Income Tax is imposed on residents only and therefore would not result in double taxation for a taxpayer.
4. Petitioner filed a timely appeal the Philadelphia Court of Common Pleas.

Findings of Fact:

1. Petitioner was a resident of the City of Philadelphia for all years under appeal, 2011 through 2013.
2. During all years under appeal, Petitioner was also a shareholder of the Subchapter S Corporation known as Alger Associates. Petitioner was a shareholder both as an individual and through 2 trusts created by Petitioner.
3. Petitioner did not perform any work for Alger Associates.
4. Each year, Petitioner and each trust was allocated a pro-rata share of the corporation's income for that year based on their stock ownership. This pro rata allocation is also known as the shareholder's Distributive Share of income. The corporation had the discretion to retain or distribute some or all of the income in any year.
5. Petitioner received actual annual distributions from Alger Associates in each tax year which may not have been the full Distributive Share allocated to her by the corporation.
6. Petitioner timely filed Philadelphia SIT returns and remitted tax due pursuant to The Philadelphia Code and SIT regulations, beginning with the tax year 2004.

7. For the tax years that are the subject of this appeal, Petitioner's SIT returns and payments included SIT based upon the pro rata Distributive Share of income attributable to her ownership interest in Alger Associates.
8. Petitioner made the following SIT payments to the City of Philadelphia, now the subject of appeal:
   for the tax years 2011- [redacted]
   2012- [redacted]
   2013- [redacted]
   TOTAL PAID: [redacted]
9. Alger Associates is headquartered in New York City. It does not have any offices in Philadelphia.
10. Alger Associates earned income in multiple states, not including Pa. Petitioner filed state tax returns in these states as required. Any taxes due were paid by Alger Associates on Petitioner's behalf.
11. Petitioner requested a refund for the SIT payments and this request was denied by the Philadelphia Department of Revenue (Revenue) as, according to the department records, there was no credit or overpayment to be refunded.
12. Effective January 16, 2007, the Philadelphia Department of Revenue amended the SIT regulations to expressly state that the Distributive Share of S Corporation income of a Philadelphia resident was subject to SIT.

Conclusions of Law:

Petitioner is a shareholder in the S Corporation known as Alger Associates. This ~~type~~ of corporation takes its name from the Internal Revenue Code Chapter 1 Subschapter S which describes the entity for tax purposes. The income earned by a Subchapter S Corporation is not subject to an entity level tax at the federal level. Earnings are attributed to shareholders based on the percentage of ownership of the corporation's shares. No distinction is made at the federal level between earnings that are actually distributed to the shareholder during the year and earnings that are retained by the corporation and are the shareholder's Distributive Share, meaning notated as their pro rata earnings based on stock ownership but not actually distributed to the shareholder.

Petitioner paid the SIT for all years under appeal and included the pro rata share of S Corporation income attributable to her ownership interest in Alger Associates in the tax base. She subsequently requested a refund of the SIT paid on this income.

Petitioner argued for a full refund of the tax paid on the Subchapter S Corporation income and in the alternative, argued for a finding that the tax should only have been paid on any actual distribution of income to Petitioner and therefore a partial refund of SIT paid on any undistributed share of income.

Petitioner put forth several arguments in support of her refund request for SIT paid during the years 2011 through 2013.

1. Petitioner argued that the original grant of taxing authority to the City and School District of Philadelphia by the General Assembly through what has become known as the Little Sterling Act, 53 P.S. 16101(a), does not authorize the imposition of the School Income Tax on Petitioner's pro rata share of Subchapter S Corporation income. This enabling statute authorizes the City "to

impose a tax on income of all kinds from the ownership, lease, sale or other disposition of tangible and intangible real and personal property of persons who are residents of the school district, whether or not such income may be subject to tax by the city for general revenue purposes..." (emphasis added)

The local ordinance enacted pursuant to this state enabling statute provides similarly that "the Board is authorized to impose a tax... for general school purposes, on every person who is a resident of the School District of Philadelphia on the net income from the ownership, lease, sale or other disposition of real property and tangible and intangible personal property, received or credited to said person during the corresponding Tax Year..."
The Philadelphia Code §19-1804(2)(a).

The School District is expressly authorized to impose a tax on income derived from property ownership and this authorization includes ownership of stock in a corporation. The SIT is imposed on Petitioner's pro-rata share of the S Corporation income attributable to her share of the corporate stock and is not attributable to any other activity on her part. It is a tax on property owned by Petitioner as a Philadelphia resident.

This broad grant of taxation privileges is not subject to limitations with regard to whether the income is earned by the S corporation or the taxpayer through active or inactive, or passive, investments. At the TRB hearing, Tilahun Afessa, Director of Compliance for the Department of Revenue, provided the example of certain rental income derived from business activity that has been subject to the School Income Tax within the grant of taxing authority to the School District questioned in this appeal.

Assuming arguendo, that the Board was to find that the City did not have authority to levy SIT on income from business activity, it is well established that a shareholder's pro rata share of S Corporation income is unearned income based on the shareholder's passive ownership of corporate shares. The net profits passed through to an S corporation shareholder is unearned income. Scott v. Hempfield Area School District, 164 Pa. Commw. 588, 643 A.2d 1140 (1994).

2. As to the 2007 amendment to the Philadelphia SIT regulations that added the language to §202 and §203 regarding the taxability of the Distributive Share of Subchapter S Corporation income, Petitioner argued that these regulations could not be properly promulgated as they were outside the scope of the enabling legislation. As described above, the Tax Review Board finds that imposing the SIT on the Distributive Share of S Corporation income is not outside the scope of the enabling statute authorizing the implementation of the SIT.

Petitioner also argued that this amendment to the SIT regulations were invalid as the City could not produce the proofs of advertising to verify that the amendment was advertised as required during the promulgation process.

The Tax Review Board found that Petitioner did not meet her burden of proof to establish that these regulations were not properly promulgated, either as originally put forth in 1974 or as amended in 2007.

The City provided sufficient documentation to prove to the Board that all necessary steps, including the placing of advertising, was undertaken for the 1974 regulations. While the City did not provide the newspaper affidavits, it was able to provide copies of the actual advertising, which the TRB determined to be adequate proof that the City had placed the advertisements as required.

In addition, as the grant of taxing authority for the SIT is derived from the state statute and not the regulation, failure of the regulation would not negate the City's authority to levy the tax. Regulations are generally promulgated to carry out the purpose of a statute. They cannot expand the scope of the statute but only provide further clarity and a mechanism for following the intent of the legislation. A lack of regulations would not deny the City the right to levy the tax under the state statute and corresponding local ordinance.

3. Petitioner argued that the City's disparate taxation of C corporations and S corporations violates the Uniformity Clause of the Pennsylvania Constitution. The Uniformity Clause requires that similarly situated taxpayers be taxed in the same manner. Any classification must be reasonable and rationally related to a legitimate state purpose.
Lebanon Valley v. Commonwealth of Pa, 83 A.3rd 107,113 (Pa. 2013)

The designations of different corporations as "C" or "S" is reflective of how they are constituted for purposes of the Internal Revenue Code.

The finding of the TRB is that the City is not in violation of the Uniformity Clause when it enacts different taxing schemes for C corporations and Subchapter S corporations. Each of these corporate structures has unique characteristics that set them apart from each other. There are significant accounting characteristics that distinguish and separate the C corporation from the S corporation. As an example, C corporation net income is subject to federal and state tax at the corporate level, while the S corporation is not subject to an income tax at the federal and state levels but only as a pass through at the shareholder level.

Due to the difference in ownership structure, shareholders are assessed SIT in different ways.

C corporation shareholders may receive per share dividends as distributions from the corporate earnings, at such times as determined by the corporation. This distribution of dividends does not affect their ownership interest or cost "basis" for their share of the corporation. SIT is assessed on these dividends. S corporations are pass through entities and the entire net income of the corporation is annually assigned to its shareholders on a pro rata basis. This income is assigned to the shareholder regardless of whether the corporation actually distributes the income to the shareholder and while held in the corporation is part of the shareholder's investment in the corporation along with any initial contribution or investment. SIT may be assessed on the entire

pro-rata share of income of the individual shareholder. The shareholder's ownership interest or basis is impacted by this pro rata assignment of income.

Incorporators and shareholders pick and choose their preferred corporate structure for many reasons including differing tax considerations. They cannot at a later date decide to pick and choose which corporate characteristics they want to adopt or cry foul that a different entity is enjoying a consideration they chose to forego but now decide they would like to use. "S Corporations and C Corporations are not similarly situated taxpayers by virtue of the S election and the financial benefits for which the S election is made." DelGaizo v. Commonwealth, 8 A.3d 429, 433 (Pa. Commw. 2010) citing Scott Electric v. Commonwealth 692 A.2d at 292 (Pa. Commw 1997).

4. The Commerce Clause of the U.S. Constitution grants to Congress the authority to regulate interstate commerce and provides through the limitation known as the dormant Commerce Clause, a prohibition from discrimination against interstate transactions or business activities. A tax passes muster under the Commerce Clause if it satisfies a four-part test that was established in Complete Auto Transit v. Brady, 430 U.S. 274 (1977). For this matter, the relevant prong of the Complete Auto test is fair apportionment, and particularly, the internal consistency requirement. Internal consistency examines the tax structure to determine whether, if applied by every state, it would place taxpayers engaged in interstate commerce at a disadvantage. In Comptroller of the Treasury of Maryland v. Brian Wynne et ux, 135 S.Ct. 1787 (2015), the Court found Maryland's personal income tax scheme to be unconstitutional in that it did not provide residents a credit against Maryland tax for income taxes paid to other states. The tax failed the internal consistency test and is in violation of the dormant Commerce Clause because it resulted in multiple taxation if applied by each jurisdiction.

   The imposition of the SIT in this case is distinguishable from the tax imposed in *Wynne*. Unlike in *Wynne* which analyzed an income tax imposed on both residents and non-residents of Maryland, the Philadelphia SIT is imposed only on Philadelphia residents. In other words, the SIT is not a tax on economic activity but on the privilege of being a Philadelphia resident.

   As the City's SIT is based on the circumstance of Petitioner's Philadelphia residency only, a taxpayer could not be subject to multiple taxation if the Philadelphia SIT were imposed by all jurisdictions—which is the relevant internal consistency test. As such, *Wynne* does not require that the City provide the petitioner in this circumstance with a credit for taxes paid to other states.

   Concurred:
   Kaitlin McKenzie-Fiumara, Esq.
   George Mathew, CPA
   Joseph Ferla