

The Legal Intelligencer

Take the Time to Review Recent Tax Developments in Philadelphia

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By **Jennifer Weidler Karpchuk and Ilya A. Lipin** | August 07, 2019 at 02:40 PM



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Philadelphia’s ‘Wayfair’ Response

Pursuant to previous U.S. Supreme Court case law, *Quill v. North Dakota*, 504 U.S. 298 (1992), physical presence was required for a state to subject a company to sales tax collection obligations. During June 2018, the U.S. Supreme Court rejected physical presence precedent when it upheld a South Dakota law that imposed economic nexus upon taxpayers who lacked any connection to the state apart from sales within the state in excess of \$100,000 or 200 transactions annually, see *South Dakota v. Wayfair*.

In response to *Wayfair*, in January, Philadelphia amended its business income and receipts tax (BIRT) regulations to impose economic nexus. Philadelphia's BIRT is imposed annually upon every person engaging in any business in the city; it is a privilege tax, taxing for the "privilege" of doing business in Philadelphia, see Phila. Code Section 19-2603. The BIRT has two components: a net income component and a gross receipts component. Prior to 1998, both portions of the BIRT were subject to the solicitation plus standard—i.e., there must be "other activities" in addition to the solicitation of business to make a foreign corporation's conduct the doing of business. During 1998, Philadelphia enacted Bill No. 980005 that substantially changed the definition of when the BIRT was imposed upon gross receipts. Bill No. 980005 reduced the nexus standard for imposition of the gross receipts portion of the BIRT from the solicitation plus standard to maintaining an "active presence" within Philadelphia. Active presence meant purposeful, regular and continuous efforts in Philadelphia in the pursuit of profit or gain and the performance in Philadelphia of activities essential to those pursuits, see BPT Regs. Section 103(C)(1).

Pursuant to the newly amended regulations, beginning Jan. 1, the active business presence and solicitation plus standards were replaced with an economic nexus standard—a business with no physical presence in Philadelphia is considered to have nexus with Philadelphia, and therefore be subject to the BIRT, if it: has generated at least \$100,000 in Philadelphia gross receipts during any 12-month period ending in the current year; and has sufficient nexus with Philadelphia to establish nexus under the U.S. Constitution. If a taxpayer's activities are limited to the solicitation and sale of tangible personal property, a taxpayer should still be protected from the net income portion of the BIRT by Public Law 86-272—but such federal protection does not extend to the gross receipts portion of the BIRT.

While some states had imposed economic nexus standards for income and gross receipts purposes prior to *Wayfair*, Philadelphia was the first taxing jurisdiction to alter its income tax nexus provisions as a result of the Supreme Court's decision. Notably, Pennsylvania has not adopted an economic nexus provision for purposes of its income taxes and very few other taxing jurisdictions have been quick to follow Philadelphia's lead post-*Wayfair*. Further, there are questions over the validity of Philadelphia's position—including whether it meets constitutional muster under the commerce and due process clauses of the U.S. Constitution, or the uniformity clause of the Pennsylvania Constitution. Nevertheless, those businesses that have no contact with Philadelphia other than selling products or services to customers in Philadelphia should reevaluate their nexus with the city and potential liability for purposes of the BIRT.

Response to Federal Tax Reform

Through a series of advisory notices and frequently asked questions releases, Philadelphia's Department of Revenue addressed numerous questions pertaining to the impact of the Tax Cuts and Jobs Act of 2017 (TCJA) on the BIRT and net profits tax (NPT). Here are the highlights:

- **Bonus Depreciation**
(<https://www.phila.gov/media/20180801073155/Advisory-notice-bonus-depreciation-update-July-2018.pdf>): By law, Philadelphia is required to follow Pennsylvania's rules on federal bonus depreciation. As such, for BIRT and NPT purposes, Philadelphia does not adopt 100% bonus depreciation allowed by the TCJA, but permits depreciation pursuant to Internal Revenue Code (IRC) Section 167.
- **IRC Section 199A Deduction**
(<https://www.phila.gov/media/20190117124605/199A-Philadelphia-tax-impacts-Frequently-Asked-Questions-FAQs.pdf>): Philadelphia announced that for BIRT purposes it does not allow a

IRC Section 199A deduction, which is available at the federal level to partnerships, LLCs treated as partnerships, and S corporations.

Likewise, for NPT purposes, partnerships and LLCs treated as partnerships will not receive the IRC Section 199A deduction.

- **Repatriation Transition Tax (RTT):** For BIRT purposes, Philadelphia provides that the net RTT is eligible for a dividends received deduction if the dividends are received from another corporation of the same affiliated group, or the receiving corporation or partnership owns at least 20% of the voting power of all classes of stock and at least 20% of each class of nonvoting stock. Philadelphia does not provide for an election to pay RTT over the 8-year period.
- **Global Low Intangible Low-Taxed Income (GILTI):** For purposes of the BIRT, GILTI income is included in the BIRT income tax base as a dividend. Philadelphia does not conform to IRC § 250 deduction. However, to the extent receipts are received from another corporation of the same affiliated group, or if the receiving corporation or partnership owns at least 20% of the voting power of all classes of stock and at least 20% of each class of nonvoting stock, the GILTI income is excluded from the taxable receipts and net income tax bases, and sales factor for the apportionment of taxable income.
- **Foreign-Derived Intangible Income Deduction (FDII):** FDII is included in the BIRT income tax base. Philadelphia does not permit a deduction for FDII under IRC Section 250.
- **Net Interest Expense Limitation under IRC Section 163(j):** For purposes of the BIRT, the interest expense limitation is calculated on a separate entity basis. Thus, if the limitation is calculated on a consolidated group basis, another calculation will be required to determine the limitation on a separate entity basis for each BIRT filer.

For partnerships, the interest expense limitation is calculated at the partnership level.

‘Wynne’ in Philadelphia

Taxpayers residing in Philadelphia and working outside of Pennsylvania may be eligible for a refund of their Philadelphia Wage Tax as the result of a 2015 U.S. Supreme Court decision. However, the extent of the refund opportunity may be increased based on a pending case in Commonwealth Court.

During 2015, the U.S. Supreme Court issued its decision in *Comptroller of the Treasury v. Wynne*, 135 S. Ct. 1787 (2015) (*Wynne*), wherein it held that Maryland’s failure to allow its residents a credit for taxes paid to another taxing jurisdiction against the local portion of Maryland’s state and local income tax was an unconstitutional violation of the Commerce Clause of the U.S. Constitution. Based upon the decision in *Wynne*, Philadelphia grants a credit for taxes paid to other localities but does not grant a corresponding credit for taxes paid to other states. Thus, any Philadelphia resident working out-of-state and paying a local tax should file for a refund claim with the Philadelphia Department of Revenue for taxes paid to that locality.

However, Philadelphia’s position to only allow a credit against taxes paid to localities is being challenged. In a case currently pending before the Commonwealth Court, *Zilka v. Tax Review Board City of Philadelphia*, (*Zilka*), the taxpayer is arguing that the city’s failure to grant a credit for taxes paid to other states results in double taxation of income earned out of state and discriminates in favor of intrastate over interstate commerce in violation of the Commerce Clause and in violation of and contrary to the U.S. Supreme Court’s decision in *Wynne*. Any taxpayers that may be affected by the decision in *Zilka* should consider filing protective refund claims.

Takeaways

Philadelphia's recent significant tax developments warrant taxpayers' attention and reflection. Based upon the principles rooted in *Wayfair*, Philadelphia created a new economic nexus standard for its BIRT. However, neither Pennsylvania nor any other local jurisdiction in Pennsylvania provide for a similar standard for purposes of an income tax. Further, the department's proactive response to the TCJA through advisory notices has clarified numerous uncertainties pertaining to compliance with Philadelphia taxes. However, additional guidance is welcomed to cover more complex situations for multistate and multinational businesses. Finally, the city's interpretation of *Wynne* and its grant of a credit for taxes paid to other localities and denial of a credit for taxes paid to other states continues to affect Philadelphia residents working in neighboring states. Taxpayers should review and understand the important issues and opportunities highlighted in this article and discuss their potential application with tax advisers.

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