Rights and Privileges

Look for Reform of Business Privilege Tax And Its Undue Burden on Law Firms

As lawyers living in and/or practicing within Philadelphia, we all pay taxes to the City, either the wage tax or the net profits tax and/or the business privilege tax. The complexities involved with the calculation of these taxes and the interrelationship among these taxes is by itself a disincentive to growth and expansion. When the complexities combine with one of the highest, if not the highest, local tax rates in the United States, however, the City's business taxes drive businesses from the City.

Apart from tax rates being among the highest (if not the highest) local tax rates in the United States, the manner by which the business privilege tax is imposed is unquestionably unfair and inequitable to unincorporated businesses, like solo practicing lawyers and lawyers practicing as partnerships (a professional corporation is not subject to net profits tax). The problem is not limited to lawyers, however; it extends to all unincorporated businesses. To understand the magnitude of the system's inequity, consider the following example:

Two lawyers, one a resident of the City and one a nonresident of the City, formed a partnership that earned gross revenue of $2,000,000, and net income was $750,000. The partnership's business was performed entirely within the City. The partnership would be subject to business privilege tax and net profits tax totaling $52,639 and the partners would not be subject to wage tax. Instead of operating as a partnership, however, if the partners formed a professional corporation, the corporation would be subject to business privilege tax and the shareholder employees of the professional corporation would be subject to wage tax. The combined business privilege tax and wage tax liability of the professional corporation and its shareholders would be $33,159. By not incorporating, the unincorporated law firm would pay $19,480 more than the incorporated law firm. The partnership's tax liability would be 159% greater than the corporation's tax liability, even though in each case the only difference was the form of the entity. The same two attorneys still resided where they had, one within the City and one outside the City; the same two attorneys were still performing the same work within the City; and the same two attorneys were earning the same fees and, other than the tax obligations to the City, were incurring the same expenses.

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This is just one of the inequities of the current business tax system, and this is one of the inequities the Tax Reform Commission attempted to correct when it began its work in January 2003. The Commission, in its report offered in November of that year, made two significant recommendations that would address both issues, "leveling the playing field" between unincorporated businesses and incorporated businesses, and reducing/eliminating the disincentive to doing business within the City. First, it recommended allowing the unincorporated business to deduct compensation paid to the owner of the proprietorship or the partners of the partnership ("Owner Compensation") from net income when calculating the unincorporated business' business privilege tax liability. By allowing the unincorporated business to deduct Owner Compensation, the unincorporated business would be receiving the same deduction the corporation already had when the corporation deducted the compensation paid to its shareholders. Also, to reduce/eliminate the business disincentive, the Commission recommended repeal of the business privilege tax.

The Commission received economic reports from experts who predicted that, if the Commission's recommendations were implemented, thousands of new jobs would be created, the taxes on which would offset the revenue lost by implementing the recommendations. The key word is "predicted." Of course, no one could guarantee when and/or if the new jobs would happen. As a result, the Commission needed to address the question of what to do if the good results expected from implementing its recommendations did not occur. To buffer against the possible failure to achieve the good results, the Commission recommended a phase-in of the Owner Compensation deduction and a phase out of the business privilege tax in its entirety.

The initial Owner Compensation deduction was to be fifty percent of Owner Compensation. During the following five years, the amount of the Owner Compensation deduction would increase by ten percentage points each succeeding year. The phase-out of the entire business privilege tax was to take ten years, and was to include both the existing effort contained within the City's budget to incrementally reduce the gross receipts portion of the business privilege tax, as well as an eventual and gradual reduction of the net income portion of the business privilege tax.

Upon receiving the Commission's report, Mayor John Street praised the Commission for its work and expressed support for the precepts it followed. With a few exceptions, however, during the remaining years of Mayor Street's term of office very few of the Commission's recommendations were initiated. Mayor Street agreed that the gross receipts portion of the business privilege tax should be eliminated and signed legislation each year implementing gradual reductions of the gross receipts tax rate. Mayor Street neither supported the phase in of the Owner Compensation deduction nor supported the phase out of the net income portion of the business privilege tax,. During the remaining years of Mayor Street's administration numerous efforts were made to phase in some type of rate reduction for the net income portion of the business privilege tax. Every effort was unsuccessful. Even when the Bill passed City Council, the Mayor vetoed the Bill and City Council did not have the votes to override the Mayor's veto.

Both Mayor Street and the members of City Council who supported Mayor Street based their opposition to the Commission's recommendations upon the belief that implementation of the Commission's recommendations was not fiscally sound and would have caused reductions to City services. Fourteen of the Commission's fifteen members believed otherwise and voted to support the Commission's recommendations.

As one of the fourteen Commissioners who supported the Commission's recommendations, I respectfully submit the Commission was correct. Consider: (1) that, during the four years since the Commission issued its report, notwithstanding only small Wage Tax, Net Profits Tax and Business Privilege Tax (Gross Receipts portion only) rate reductions that were enacted, the City's tax revenues from these taxes consistently increased; (2) that the Commission was, by law, prohibited from examining the expense side of the City budget; (3) that, notwithstanding the legal prohibition to consider the expense side of the City budget, there was total agreement that the City could operate more efficiently without reducing City services; and (4) that there were ways to otherwise increase City revenues. As one example, the Commission considered whether the City could improve collection of its existing taxes. When the Commission posed this question to the City's then-Revenue Commissioner, she advised the Commission that the City collected $2 billion dollars of tax revenue annually and that represented 90 to 91 percent of the taxes due the City each year. If the City were able to improve collections by one percentage point to 91 to 92 percent of the taxes due the City each year, the increased tax yield to the City would have been $20 million dollars annually or $100 million dollars during the City's five-year financial plan.

The promise of true reform may be on the horizon, however. Philadelphia now has a new mayor. Mayor Michael Nutter campaigned upon a platform that included business privilege tax reductions, and, as part of his first budget, Mayor Nutter continued the rate reductions for the gross receipts portion of the business privilege tax, and introduced small but meaningful rate reductions for the net income portion of the business privilege tax as well. Mayor Nutter's proposal is encouraging and represents the first real effort to reduce the tax rate for the net income portion of the business privilege tax since the rate was increased to its present level for tax year 1989.

Additionally, Philadelphia Bar Association Chancellor A. Michael Pratt recognized that what is good for the City's business community is also good for the lawyers who practice in the City. The Chancellor made a commitment to all lawyers in Philadelphia to make it a major plank of his administration to pursue local tax reform. Toward that goal, the Chancellor appointed a Task Force co-chaired by Robert Archie of Duane Morris and me, and composed of a past Chancellor of the Philadelphia Bar Association, a former member of City Council, several former City Solicitors and several local tax professionals. The Task Force has been charged with developing a strategy for the implementation of local tax reform. The Task Force has begun its work and we hope to meet with the Mayor and members of City Council to discuss how local taxes can be further reduced and be made less unfair. ■

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COMING THIS FALL

Look for another viewpoint on this issue from Community Legal Services General Counsel and former Tax Reform Commission member Jonathan M. Stein in the fall issue of *The Philadelphia Lawyer*.