

How a Revised Business Tax will Support the Arts in Philadelphia

Bill Green 22 May 2012

Introduction

This fall, Philadelphia City Council took a significant step to improve the business climate for small and locally-based businesses, including the thousands of artists, freelancers, designers and other creative types who lend such vibrancy to the city's creative economy. Council implemented historic reforms to the business privilege tax (BPT) that will provide targeted relief for small businesses and locally-based businesses, including craftspeople, who sell goods outside of the city.

To this point, the conventional wisdom regarding business tax reform had been shaped by the interest of large businesses, often those based outside of the City. This "status quo" approach to tax reform provided relief to businesses with sophisticated tax planning strategies, while leaving local firms at a competitive disadvantage and small businesses saddled with a disproportionate share of the tax burden.

This approach ignored the simple fact that the majority of businesses in the City are small businesses. To put it

another way, the City had been pursuing a tax policy that helped the few and provided scant relief to the many. Before getting into the nuts and bolts of the new reforms, a brief overview of Philadelphia's business landscape may be helpful.

Philadelphia's Business Ecosystem: Small Businesses Predominate

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Of the 90,000 BPT filers in 2008, the most recent year for which data are available, close to 75,000 (83%) were businesses with under \$1M/year in sales. But even these striking figures may understate the size of the small business community. A recent report by the Sustainable Business Network (SBN) indicated that there are 93,000 small businesses (defined as businesses with fewer than 50 employees) in Philadelphia, of which 68,000 are non-employer businesses or self-employed individuals (Sustainable Business Network 2011). Not only do small businesses constitute the vast majority of going concerns, they also are the engine of job growth; according to the SBN report, 54 percent of jobs in Philadelphia are created by small businesses. Renowned Wharton Professor Robert Inman may have put it best when he concluded "small businesses are the heart of the Philadelphia economy" (Inman 2009, 12).

Furthermore, historic trends suggest that these businesses will be essential to Philadelphia's future growth. Census Bureau data indicate that following both the 1990-91 and the 2001 recessions:

Firms with fewer than 20 employees were the only ones with positive net job growth; the larger category of small businesses with under 500 employees, as well as large firms with 500 or more employees, both experienced net employment losses (Small Business Association 2009).

Nationally, in the period between 1993 and 2008, small businesses generated 64 percent of net new jobs (U.S. Small Business Administration), accounting for 60-80 percent of net new jobs annually (Small Business Association 2009). Recent research also highlights the importance of small businesses to economic growth. In a 2010 paper, Harvard professors reported their findings that "regional economic growth is highly correlated with an abundance of small firms" and "an abundance of small, independent firms is one of the best predictors of urban growth" (Glaser and Kerr 2010).

While Philadelphia surely has an abundance of small businesses, including those in the creative sector (OACCE 2010) [1], and thus is well-positioned to take advantage of this growth potential, the City's business taxation policy, as embodied in the BPT, had disfavored these very businesses.

Philadelphia's Business Tax Landscape: In a Word, Self-loathing

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By way of background, the BPT consists of two parts: the 0.1415 percent gross receipts tax (GRT) and the 6.45 percent net income tax (NIT). The low-rate GRT (fourteen cents on every \$100 of sales) is paid by all businesses that make sales in Philadelphia on those local sales, no matter where the business is based. The high-rate NIT (\$6.45 on every \$100 of net income) is paid primarily by businesses based in Philadelphia and applies even to their sales outside of the city, putting them at a competitive disadvantage when selling goods regionally, nationally and globally.

Notably, Philadelphia is one of only five cities in the U.S. to impose a local tax on business income. The other four are New York and Washington, D.C.—the financial and political capitals of the country, respectively—and Columbus and Detroit. Enough said, right? But there's more: Philadelphia is *the only city* to tax both business receipts and business income.

Clearly, the current BPT structure puts Philadelphia businesses at a competitive disadvantage: local businesses have to pay the high-rate NIT, but most out-of-city companies either are not subject to it (because

they do not have a sufficient connection to the city) or can use tax planning strategies to avoid paying it. What's more, the high-rate NIT acts as a "profitability penalty," discouraging businesses from locating in the city in the first instance and, for those start-up ventures that are incubated here, staying in the city once they become profitable.

To make matters worse for the creative sector, with its sizeable component of small, non-employer businesses and self-employed individuals, the current BPT structure stacks up the tax burden on small businesses. In 2008, the 54,000 BPT filers with up to \$100,000/year in sales paid the high-rate NIT on proportionally *five times* as much of their sales in the aggregate as the 2,200 BPT filers with \$10M-\$50M/year in sales. It seems unlikely that this is due to the small businesses being five times as profitable as multi-million dollar businesses. Far more likely, the larger firms are able to use tax planning strategies (such as out-of-state holding companies) to minimize their taxable income, opportunities that generally are not available to small businesses with a local base of operations.

This distorted tax structure has real-world consequences. In an introduction to the above-cited Creative Vitality report, the City's Chief Cultural Officer Gary Steuer noted:

Although there is much to celebrate, the [Creative Vitality Index] also shows areas where there is room for

improvement. Even though Philadelphia consistently employed over 17,000 people in creative occupations, we are 15 percent below the national average. Furthermore, certain aspects of creative participation, such as music, art gallery and photography store sales, are far below national levels (OACCE 2010).

The city's business tax structure is an important contributor to our relative under-population of creative economy workers. For example, a recent news report highlighted two rising opera stars, Ailyn Perez and Stephen Costello, who met, studied, and made their names in Philadelphia but moved out of the city specifically on account of the net income tax (Stearns 2011). The article noted:

Every place has taxes, but Philadelphia's business privilege tax results in a 6.5 percent tax total on Philadelphia income (compared with city wage tax alone, which is slightly under 4 percent). That's what motivated Perez and Costello to look elsewhere.

The two singers recently moved to Chattanooga, Tennessee, realizing annual tax saving of \$10,000 to \$20,000. Their experience highlights the fact that, at least for self-employed artists and artisans, our current tax structure makes Philadelphia an inhospitable place for the arts.

Data-based Tax Reform: Progress is

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Against this backdrop, my colleague, Councilwoman Maria Quiñones Sánchez, and I have worked together over the past three years to bring about progressive tax reform that levels the playing field for Philadelphia businesses, helps small businesses, encourages entrepreneurship and stimulates job creation. This collaborative effort is starting to bear fruit.

Our overarching proposal was to eliminate the NIT—the only change that will truly level the playing field for Philadelphia businesses and eliminate the “profitability penalty” for locating in the city. We initially proposed to accomplish this in a revenue-neutral way by increasing the low-rate GRT to off-set the loss of NIT revenue. This kind of game-changing reform requires the support of the administration and, unfortunately, the Nutter Administration opposed the change.

We were able to reach agreement with the Administration on two key interim reforms:

1. Exempting the first \$100,000 in business receipts from both the gross receipts and net income prongs of the BPT. The legislation uses a pro rata formula to exempt from taxation net income that is attributable to a filer's first

\$100,000 in receipts. Including the net income tax in the exclusion is an essential part of how the reform helps small businesses, which have a disproportionately high net income tax burden. This across-the-board exclusion provides unprecedented tax relief for the city's existing small businesses, which, as noted above, are both key to the City's economic growth and paying more than their fair share under the current structure.

2. Implementing single sales factor apportionment. Under single sales factor apportionment, local businesses that sell tangible goods will no longer have to pay the NIT on their sales outside of the City. Export-based sectors including manufacturing and wholesaling will operate on a more level playing field when competing with businesses located outside of the City. Based on analysis performed by the Revenue Department, in the aggregate, this reform will result in tax savings for Philadelphia-based businesses across *all industries*, including creative economy sectors.

These reforms stand in sharp contrast to what has been tax reform orthodoxy. Until this year, the City's plan was to eliminate the low-rate GRT, which is paid by all businesses, wherever based, on their sales in Philadelphia. This so-called "reform" would have exacerbated the competitive disadvantage faced by Philadelphia-based businesses: out-of-City businesses making sales in the City would have not paid any BPT, while Philadelphia businesses would still have to pay a 6

percent NIT. The legislation passed this fall is an important first step in fundamentally changing the city's BPT reform strategy.

Ground-level Impact: Targeted Tax Relief by the Numbers

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Councilwoman Sánchez's and my BPT reform legislation will provide over \$50M/year in tax relief for Philadelphia-based businesses, a historic amount of tax relief. The business tax burden on Philadelphia-based businesses in the aggregate will be reduced by 20 percent. Importantly, this relief is focused on the small businesses and Philadelphia-based industries that are particularly disadvantaged under the current BPT structure. By full implementation [2] of our bill:

- Over 30,000 of the 90,000+ current BPT filers will have no business tax liability whatsoever (i.e., \$0 BPT and \$0 net profits tax [3]). This includes tens of thousands of freelancers and others working in the creative economy.
- An additional 25,000 filers will have \$0 BPT liability.
- The business tax burden on micro-enterprises (those with under \$100K per year in sales) will be reduced by 50 percent.

The below chart highlights how the reform makes Philadelphia's tax structure much more progressive by targeting tax relief toward small businesses.

BPT filers by size (annual sales)	BPT costs in 2008 (i.e., gross receipts tax plus net income tax)	New business tax costs (adjusted for reduced credit vs. net profits tax)	% change in overall business tax burden (BPT + net profits)
Up to \$100K	\$23,598,437	\$11,351,528	-51.9%
>\$100k and <=\$250k	\$18,871,922	\$11,794,761	-37.5%
>\$250k and <=\$500k	\$15,331,877	\$12,216,790	-20.32%
>\$500k and <=\$1M	\$17,145,471	\$15,142,839	-11.68%

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The legislation passed this fall is an important first step in fundamentally changing the city's BPT reform strategy. The conversation has turned from the now discredited conventional wisdom to a data-based discussion of how best to achieve our policy priorities. But the only way to address this issue completely is to eliminate the net

income tax, as proposed last year. This would result in Philadelphia businesses having the same BPT costs as their competitors [4], thereby creating a level playing field and removing the “profitability penalty” to locating in the city. To maintain focus on the needed overall reform, I plan to re-introduce legislation in 2012 to phase-out the NIT over ten years.

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Footnotes

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1. According to a 2010 report by the City's Office of Arts, Culture, and the Creative Economy (OACCE), in 2008 there were close to 18,000 people employed in Philadelphia's "creative economy" (i.e., 36 selected occupational categories "highly correlated with measured skill sets in thinking creatively, originality and fine arts knowledge").
2. In recognition of ongoing pressure on the city's

finances, the tax relief measures contained in our bill are being phased in over a five-year period. The \$100K exemption is being phased-in as follows: a \$50K exemption will be available for 2014; a \$75K exemption will be available for 2015; and the full \$100K exemption will be available for 2016 and thereafter. Single sales factor apportionment will be phased in starting in 2013 and will be fully in place by 2015.

3. The net profits tax is the analog to the wage tax paid, for example, by partners who do not draw a salary.
4. On their sales in the city, Philadelphia businesses and their competitors from outside the city would pay the same low gross receipts tax; on their sales outside of the city, Philadelphia businesses would pay \$0 BPT, just like their competitors.