



Not-for-profit

# TaxAlert

## Philadelphia Business Privilege Tax now applies to unrelated business activities and rental income of not-for-profit organizations

Prior to January 1, 2009, the City of Philadelphia had exempted **all** activities of a nonprofit organization from its city-wide gross receipts tax – not just those activities related to the organization’s exempt purposes. However, effective January 1, 2009, the City has amended its Philadelphia City Business Privilege Tax (BPT) regulations to *exclude* only “those activities conducted by a nonprofit corporation or association organized for religious, charitable or educational purposes, if such activities are directly related to its religious, charitable or educational purposes.”

The regulations have been amended to provide that Philadelphia will only exclude those receipts that are directly related to the organization’s religious, charitable or educational purposes. As such, activities pursued by the nonprofit organization in a manner similar to those of competing for-profit businesses will be considered unrelated and hence subject to the Philadelphia BPT requirements. It is worth noting that unrelated activity will be subject to the BPT, regardless of whether or not it produces a profit, and even if the proceeds from the activity are used exclusively in furthering the organization’s purposes as a not-for-profit entity.

While taxes imposed on unrelated activities are not out of the ordinary for nonprofit organizations, the BPT seems to go a bit further. In reading the proposed regulation as currently written, the definitional language is more expansive than the concept of “unrelated business income” as defined in the Internal Revenue Code because it seems to include *all* rental income – *even* if the rent is not treated as unrelated business income for federal income tax purposes. The troubling language in the context of the regulation is shown in bold and underlined below.

### For more information

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While the tax is imposed on business in general, the regulation provides that "business" shall **not** include the following:

*Those activities conducted by a nonprofit corporation or association organized for religious, charitable or educational purposes, if such activities are directly related to its religious, charitable or educational purposes. Unrelated business activities of a nonprofit organization fall under the definition of a business and the income derived from such activities is subject to the BPT.*

*The organization is deemed to generate unrelated business income if:*

- *it conducts a trade or business,*
- *the trade or business is not substantially related to the nonprofit purpose of the organization, and*
- *the trade or business is pursued in a manner similar to competing nonexempt organizations.*

*An activity does not need to produce a profit to fall under the definition of business. Also, income from unrelated trade or business used exclusively for carrying on the nonprofit organization's purpose is still considered unrelated business income for the purpose of the BPT. **For the purpose of this tax, income generated by a nonprofit organization from rental of any residential or commercial real estate is deemed income derived from unrelated business activity.***

Another troubling aspect of the language above is that it does not seem to provide an exception for situations where rental income may be related to an organization's tax-exempt purposes, (e.g., rental of college dormitories).

The BPT has two components, a gross receipts tax and a tax on net income. Not-for-profit entities are subject to both components presumably based on the amounts shown on Form 990-T, if any. However, a complicating factor is the application of the BPT to the rental income of a nonprofit since the regulations now apparently impose the tax on any rent from residential and commercial real estate. For tax-exempt nonprofit organizations, rent is generally excluded from classification as unrelated business income unless it constitutes debt-financed income or is received from a controlled entity in certain circumstances. If the rent is not treated as unrelated business income for federal income tax purposes, it would not be reported on Form 990-T. Therefore, it would have to be taken into account as an adjustment when preparing the BPT return.

### **Calculating apportionment**

While certain specific calculations for nonprofit organizations need clarification, organizations with multiple locations will need to allocate income among jurisdictions. The tax on gross receipts requires an analysis of the source of taxable gross receipts. As stated above, not-for-profit organizations are also subject to the net income tax portion of the BPT. Therefore, they must apportion their net unrelated business income to the City of Philadelphia.

Generally, taxable income is apportioned to Philadelphia based on the ratio of the organization's property, payroll and receipts within the City, relative to its property, payroll and receipts everywhere. Once the apportionment percentage is calculated, it is applied to taxable income to determine the amount of "apportioned taxable income" that is taxable for purposes of the BPT. It is worth noting that under the net-income tax portion of the BPT, rental income should not be apportioned to the City but rather is specifically allocated to the jurisdiction in which the property that generated the income is located. Therefore, only rental income generated from property that is located within the City of Philadelphia will be subject to the net-income portion of the BPT.

### **Stay tuned**

Hopefully Philadelphia will consider revising certain language in the proposed regulation in the near future.

### **Questions?**

For additional information, please contact [Greg Goller](#), partner in charge of Grant Thornton's national Not-for-Profit Tax practice, at 703.637.2680; or [Cory Barwick](#), Philadelphia state and local tax manager, at 215.814.1746.

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