<u>PA's New Budget and its Affect on the Capital Stock Tax</u>

Once you decide to start a business, one of your next major decisions is what type of business entity to choose. In Pennsylvania, your choices of business entities include, but are not limited to, a corporation (either as a "C" corporation or an "S" Corporation), a general partnership, a limited partnership, and a limited liability company. There are many issues to consider before deciding which type of business entity to select; one issue to consider is the range of taxes that your business entity will be required to report and pay.

Of renewed concern in evaluating the taxes to which your business may be subject is the Capital Stock and Foreign Franchise Tax (the "Capital Stock tax"). The Capital Stock tax was due to phase out in 2011; however the 2009-2010 state budget that was signed by Governor Rendell on October 9, 2009 delayed the phase out. Therefore, this tax should still be taken into account when you are considering what type of business entity to choose.

The Capital Stock tax is a tax imposed on certain business entities. Under the Capital Stock tax statute, these businesses include joint-stock associations, limited liability companies, business trusts, and entities that are classified as corporations for Federal income tax purposes ("covered businesses"). The tax applies to covered businesses that are formed under the laws of Pennsylvania or under the laws of another state but doing business in Pennsylvania.

The Capital Stock tax is classified as a property for domestic businesses and a tax on the privilege of doing business for foreign businesses, and is derived from a specific formula. The formula takes into account both a business's average net income and net worth. The average net income is calculated using up to a five-year average. The net worth of a business (in most cases) is equivalent to the shareholders' equity at the end of the tax year.

This tax can quickly become an issue for a business that intends to own property (and thus has net worth). For example, say a small bar and restaurant has assets with a net worth of $1,000,000 and an average net income of $50,000. In 2010, this restaurant may be subject to a Capital Stock tax of approximately $434.00. If that same business were to have assets with a net worth of $2,000,000, it may be subject to a Capital Stock tax of approximately $770.00. While this may not seem like a huge tax burden, this is not the only tax to which this restaurant and bar is subjected.

Because not all business entities are subject to the Capital Stock tax, but because the Capital Stock tax will not phase out in 2011, it is a tax that should be taken into consideration when choosing a business entity, particularly if that business will own valuable assets. For more information regarding this and other business formation issues, please do not hesitate to contact our office to schedule an initial consultation at 717-657-7770.

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