Testimony of Stuart L. Knade, Senior Director of Legal Services
Pennsylvania School Boards Association
Regarding House Bills 2256, 2257 and 2142
Before the House Finance Committee
October 5, 2016

Chairman O'Neill, Chairman Wheatley, members of the House Finance Committee, thank you for providing the Pennsylvania School Boards Association this opportunity to give you our input with regard to the Philadelphia "Super-Credit" problem created by ambiguity in Section 317 of the Local Tax Enabling Act, and how House Bills 2256 (P.N. 3642), 2257 (P.N. 3643) and 2142 (P.N. 3486) would affect that. I am Stuart Knade, Senior Director of Legal Services for PSBA. With me today are **Mark B. Miller**, PSBA President-Elect and school director from Centennial School District in Bucks County, and **Jason T. Confair, Esq.**, a school attorney with the Lancaster law firm Kegel Kelin Almy & Lord who advises numerous school districts and Act 32 tax collection districts on taxation issues as well as other education law matters.

We'd like to start by giving you a brief overview of what the Super-Credit problem is all about, and what we believe the bills before you would or would not do about it, as well as what PSBA recommends. We will then ask for your questions, which will be best directed to Mr. Miller and Mr. Confair. Mr. Miller will be able to give you specifics about the financial impact the issues before you today have on his school district and others in the region. Mr. Confair will

be able to answer your questions about the Super-Credit problem, how best to fix it, and related issues at a more technical level.

As I'm sure the committee is aware, since 1932 a law known as the Sterling Act has authorized cities of the first class to levy a tax on wages earned within the city, without regard to whether the taxpayer is a resident of the city. Currently, in Philadelphia this wage tax is about 3.9% (rounded) for residents, and about 3.5% (rounded) for non-residents. Some years later, the 1947 predecessor to today's Local Tax Enabling Act (LTEA) extended similar authority to school districts and other municipalities. However, when the 1947 law was replaced in 1965 with the LTEA pursuant to Act 511, it included a provision prohibiting school districts of the second, third and fourth classes from taxing the wages of non-residents, which municipalities still can and do.

So that taxpayers are not locally taxed twice on the same wages, Section 317 of the LTEA has crediting provisions that generally entitle taxpayers to credit the amount of the resident wage tax they pay where they reside against any wage taxes imposed by a different municipality where they work. Thus, if a wage tax is imposed both where a person works and where they reside, the tax levied where they live has precedence over a wage tax levied on non-residents where they work. However, this is not true of wages taxes levied pursuant to the Sterling Act. As with the 1947 law, the first paragraph of Section 317 of the LTEA makes the crediting primacy work the other way around for wage taxes previously imposed under earlier laws, such that non-resident taxpayers working in Philadelphia are entitled to credit the amount of the Sterling Act wage taxes they have to pay to Philadelphia against the wage tax imposed where they reside.

Since the wage tax rate Philadelphia is authorized to levy is significantly higher than is allowed for any school district or municipality in the surrounding communities, many of those school districts and municipalities do not bother to levy a wage tax at all because so many residents earn all their income in Philadelphia that the revenue raised is not worth the cost of collection. Of the 62 school districts in Bucks, Chester, Delaware and Montgomery Counties, 24 do not currently levy an earned income tax.

Here's an illustration. Assume taxpayer Smith lives in the Borough of Downingtown in Downingtown School District which together impose a combined 1% EIT on residents. Smith's wages total $300,000, $100,000 of which is earned in Philadelphia, and $200,000 of which is earned in Downingtown. Before crediting, Smith owes $3,500 in wage tax to Philadelphia on wages earned in Philadelphia, and $3,000 in wage tax split by the school district and borough of residence on total earned income. It is not disputed that under Section 317, Smith is entitled to a credit for the wage tax he paid to Philadelphia on account of the $100,000 he earns in the city against the tax upon <u>those</u> wages otherwise owed to his place of residence, which reduces Smith's resident tax liability to his place of residence to zero on that $100,000. Thus, Smith would owe only $2,000 in resident wage tax on account of the wages earned in Downingtown.

But under the disputed "Super-Credit" interpretation of Section 317, Smith further claims to be entitled to take credit for what he paid to Philadelphia against <u>all</u> wage taxes otherwise owed to his school district and borough of residence even on account of wages <u>not</u> earned in Philadelphia, thereby reducing his wage tax owed at home to zero. As a result, Smith pays no wage taxes <u>at all</u> on the $200,000 he earned in Downingtown (because the Philadelphia wage tax does not apply to that $200,000), and other tax-paying Downingtown residents generally must subsidize Smith's personal wage tax liability to Philadelphia. Unfortunately, the Commonwealth

Court adopted Smith's interpretation several years ago, in *Berks County Tax Collection Committee v. Pennsylvania Dept. of Community and Economic Development*, 60 A.3d 589 (Pa. Commw. Ct. 2013), affirmed per curiam, 623 Pa. 205, 82 A.3d 405 (2013).

So, what's the best way to fix this? The bills under consideration today take very different approaches. House Bill 2257 does three distinct things. First, it would eliminate the Super-Credit problem by amending Section 317 of the LTEA to clarify that credit for non-resident wage taxes paid elsewhere can be taken only against taxes imposed on the same wages. This would affect only the amount of wage tax that Smith pays in Downingtown, and would have no effect whatsoever on the amount of wage taxes that Smith and others like him pay to Philadelphia.

However, House Bill 2257 would also delete completely the first paragraph of Section 317, the provision that since 1947 has given crediting primacy to wage taxes imposed under earlier statutes such as the Sterling Act. Although this too would fix the Super-Credit problem by making it moot, it also would result in a significant reduction in the non-resident wage taxes paid to Philadelphia, because non-residents working in Philadelphia could credit all the wage taxes they pay to their home school district and municipality against what is owed to Philadelphia. In the illustration above, Mr. Smith would pay Downingtown Borough and School District a combined $3,000 in resident wage tax on all $300,000 of his earned income, which he could credit against the $3,500 in wage tax owed on account of the $100,000 he earned within the City, reducing his Sterling Act wage tax liability to $500. And in the case of Smith's neighbor Mr. Jones, who earns $100,000 annually entirely within the City, Jones' Sterling Act wage tax owed to Philadelphia would be reduced from $3,500 to $2,500 as result of a $1,000 credit for the wage tax he pays in Downingtown.

This of course would be bad news for the City of Philadelphia, and potentially bad news for the city's capacity to maintain the approximately $100 million contribution the city currently makes to the Philadelphia School District's annual budget. It could be good news for many of the surrounding school districts, but for the third of districts that do not currently levy a wage tax, this may not offer a realistic opportunity to take some pressure off of property taxes, because those districts could not levy a new wage tax without voter approval in a referendum under Act 1 of 2006.

PSBA anticipates that this aspect of House Bill 2257, which also is the focus of House Bills 2256 and 2142, will be a matter of extremely contentious debate. We are greatly concerned that this may mean what otherwise could be a very clean and simple fix for the Super-Credit problem, which the City of Philadelphia has no reason to oppose, will get bogged down in the other debate and never get done. Accordingly, PSBA suggest that House Bill 2257 be focused solely on fixing the Super-Credit problem, so that the Sterling Act crediting primacy issue can be debated separately.

Unfortunately, House Bill 2257 would do something else that would adversely affect local revenues of municipalities and school districts alike, not just in the Philadelphia area, but all across the Commonwealth, by expanding the crediting base, meaning expanding the resident tax liability against which residents can credit taxes they have paid where they work, including out of state and in Philadelphia. The bill does this by deleting the words "under the authority of this chapter" in multiple places throughout Section 317.

It is not clear whether the significance of those words has been fully understood. What is important to remember on this point is that the total wage tax rates that school districts and municipalities levy often include more than just the 1% combined that may be levied under Act

511 alone, pursuant to other laws providing a revenue stream for specific purposes, such as to relieve municipal financial distress, shore up municipal pension systems or preserve open space, or as what was intended to be a revenue-neutral tradeoff for the elimination of various nuisance taxes. For example, school districts were permitted under Act 24 of 2001 and later under Act 130 of 2008, with approval by voters at referenda, to replace the hated occupation tax with an additional earned income tax at a rate generating an equivalent amount of revenue. Because these earned income taxes are not levied pursuant to Chapter 3 of the LTEA, they are not currently subject to the LTEA crediting provisions for wage taxes paid in other jurisdictions, including out of state. Expanding the crediting base through House Bill 2257 would disturb those special purpose revenue streams and counter the intent of revenue neutral tradeoffs approved by voters, as well as divert more revenue out of state.

Accordingly, PSBA recommends that House Bill 2257 be amended to so as to avoid these problems by leaving the words "under the authority of this chapter" in Section 317 just as they are. If we can make it so House Bill 2257 simply fixes the Super-Credit problem without creating other problems, it will be a clean bill that should not be controversial and which PSBA would fully support.

Lastly some brief comments about House Bills 2256 and 2142, each of which attempt to undo the ultimate result of the Sterling Act's crediting primacy, without directly dealing with the Super-Credit problem, but take approaches that are very different from each other and from House Bill 2257. PSBA takes no position on these bills, except to express the same concerns noted earlier about the potential indirect financial impact on the School District of Philadelphia, and the unlikely nature of any direct benefit in the one-third of surrounding school districts that currently do not levy an earned income tax. We also wish to direct the Committee's attention to

some technical issues in the wording that could cause implementation problems or even defeat the purpose entirely.

Neither House Bill 2142 nor House Bill 2256 would amend the LTEA or deal directly with the Super-Credit problem, meaning Smith could still use the Super Credit to wipe out his entire resident wage tax liability to Downingtown School District and Borough. Instead, the bills appear to be intended to make the resident School District and municipality whole at the expense of the City of Philadelphia by requiring it to pay over to Downingtown School District and Borough some amount based on the resident EIT levied by the School District and Borough. But as currently drafted, it is difficult to discern what that amount would be or whether it would be any amount at all.

The result in our example under House Bills 2256 and 2142 would be a wash for Downingtown School District and Borough, but Philadelphia gives up $2000 of the $3500 it collects in non-resident wage tax from taxpayer Smith, and Smith still avoids paying any wage taxes on the $200,000 earned in Downingtown. Interestingly, in the event a taxpayer like Smith fails to claim the credit, Downingtown School District and Borough would receive double what their resident EIT would have produced on its own. Unfortunately, as currently drafted, neither House Bill 2142 nor House Bill 2256 actually accomplish this, and they would need to be amended in order to do so.

The glitches in each bill produce quite different results. House Bill 2142 says that the city's non-resident wage tax "shall be reimbursed to the taxpayer's resident political subdivision at a rate equivalent to that which would have been collected from that political subdivision". Assuming that "collected by" the political subdivision was meant rather than "collected from", and further assuming that the rate would be applied to only the wages taxed by Philadelphia, the

first problem with this language is that the rate at best in our example would be 1% on $100,000, or $1,000, short of the $2,000 in revenue lost due to the Super-Credit. The second problem is that due to the Super-Credit, the effective rate that "would have been collected" would be zero either way, so arguably the City would not have to pay over anything to Downingtown School District and Borough.

The language used in House Bill 2256 would require the city to "remit" to the resident school district and municipality "an amount equal to the amount of tax imposed on earned income and net profits by the nonresident's resident municipality and school district". The way this is written, in our example the amount would be the entire amount of the resident wage tax levied by the school district and borough on all $300,000 of Smith's wages, $3,000, not just the tax due on account of the portion he earned in Philadelphia. Thus, Smith would pay $3,500 to Philadelphia on account of the $100,000 he earns in the city, and Philadelphia would pay $3,000 of that to Downingtown School District and Borough. Smith would still pay no resident tax on wages earned in Downingtown due to the Super-Credit, and Downingtown School District and the Borough would receive between them $1,000 more than what the Super-Credit is now costing them.

We thank you for your attention and this opportunity to speak to you today, and look forward to responding to your questions.