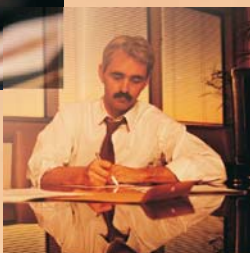
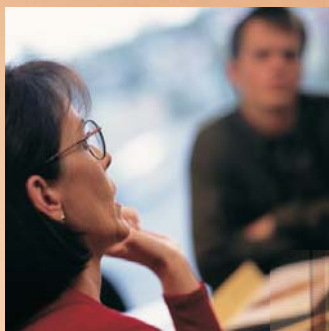


Pennsylvania's Earned Income Tax Collection System

*An Analysis
with Recommendations*

August 2004



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EXECUTIVE SUMMARY

A fragmented and dysfunctional local earned income tax collection system causes the loss of over \$100 million annually and increases the cost of doing business in Pennsylvania. Earned income tax collection, which involves the collection and distribution of almost \$1.7 billion annually for almost 2,900 municipalities and school districts, is not working efficiently or fairly.

The current system suffers from a lack of cooperation among its approximately 560 tax collectors and is fraught with disputes, inconsistencies and bureaucracy. Underlying the problem is an ambiguous law and a lack of enforcement or oversight of the system. Collection is complex, uncoordinated and inefficient. Taxing jurisdictions use different definitions of earned income, different tax rates, different rules and requirements and different processes to collect the tax.

As a result, excessive administrative burdens are placed on employers and taxpayers. The multitude of tax rates, tax collectors, rules and exceptions to rules is a major burden on employers, who are required to withhold and remit the tax.

More than 80 percent of the 560 earned income tax collectors collect the earned income tax for only one or two taxing jurisdictions. This fragmentation creates duplicative work for collectors, inflates collection costs and reduces the amount of tax revenues available to local taxing jurisdictions - taxpayer dollars that could otherwise be used for delivering municipal services and educational programs or reducing property taxes.

The earned income tax collection system should be overhauled to prevent continuing losses of municipal and school revenues and to reduce the negative impact of the system on business. This can be accomplished through consolidation and reform of the current system or by piggybacking earned income tax collection on the earned income portion of the state personal income tax.

State collection would create the fairest and most efficient system for the taxpayers of the Commonwealth. Central administration of the state and all local income taxes would provide more uniform tax administration and customer service. Taxpayers would only be required to file one income tax return instead of two or three. Employers would only have to withhold and report to one collector in the state instead of two or more. Most jurisdictions would receive more tax money at a lower cost.

County-wide consolidation would provide some of the same advantages that state collection provides. Tax collection is already consolidated on a county-wide basis in ten counties, and nearly a reality in another 26 counties. Consolidation would eliminate duplication, reduce administrative and overhead costs and achieve economies of scale. Consolidation simplifies withholding for employers by reducing the number of local tax collectors with whom employers must do business. Besides being more efficient, fewer collectors means fewer problems with coordination and distribution of nonresident tax monies.

Whether the earned income tax is collected by the State or on a county-wide basis, administrative reforms will be needed. The definitions of earned income and net profits should be revised to mirror the state definitions of compensation and net profits. A dispute resolution mechanism will be needed to resolve disputes between the State and local taxing jurisdictions if the tax is collected by the State, or to resolve disputes between collectors if the tax is collected on a county-wide basis. In addition, the *Earned Income Tax Register*, which is the official source of local tax withholding information for employers, must be modernized to make withholding easier for employers by providing more timely, accurate and consolidated withholding information. (Funding to modernize the Register was included in the Fiscal Year 2004-05 Budget.)

If earned income tax collection remains decentralized through county-wide collection, withholding and distribution requirements need to be made clearer, simpler and more uniform. Employers should be required to withhold taxes for all their employees and remit those taxes only to the jurisdiction where their facility is located. Tax collectors should be required to distribute nonresident tax monies to the appropriate taxing jurisdiction and be adequately compensated for this service, ideally through the imposition of a uniform flat fee on taxes distributed. To make distribution easier, tax collectors should also be required to use standard forms and procedures.

The statutory requirements for the administration and enforcement of a county-wide earned income tax collection system would also need to be revised and standardized. Uniform rules and regulations should be established to govern the administration and operations of earned income tax collection offices. The reporting and audit requirements for earned income tax collection should be strengthened to provide enough information so that the public and taxing jurisdictions can accurately track the flow of public monies in a timely manner. Tax collectors who violate the law should be subject to fines and penalties, and the Commonwealth's Board of Finance and Revenue should be given jurisdiction to arbitrate complaints concerning earned income tax collection.

INTRODUCTION

As the custodian of the *Earned Income Tax Register* (the *Register*), the official source of earned income tax withholding information for employers,¹ the Governor's Center for Local Government Services receives numerous calls daily from employers, employees, tax collectors and legislative offices expressing confusion over earned income tax collection.

After receiving numerous complaints about the administration of the earned income tax, the Governor's Center created a work group in 2001 to review these complaints, study the issue and make recommendations for improving the system. Representatives from the Department of Community and Economic Development's Policy Office, the Department of Revenue, the Department of Education, the Governor's Policy Office, the Governor's Action Team, Team Pennsylvania and the Local Government Commission also participated in the development of this study. In addition, staff from the Governor's Center met with staff from the Auditor General's Office, who provided valuable background and insight.

The work group was tasked with making recommendations for improving the earned income tax collection system for taxpayers, municipalities, school districts and employers. The work group's goals were to make the system simpler, clearer, more efficient, more business-friendly and as seamless as possible. The group believed that meeting these goals would make the system more fair and understandable for taxpayers and employers.

To better understand tax collection methods and practices, the Governor's Center sent a four-page Earned Income Tax Collection Survey (the Survey) to the 565 municipal tax collectors listed in *Register of Earned Income Taxes* in February 2002. By the end of March 2002, 32 percent of the tax collectors had responded to the Survey. Survey responses provided insight into tax collection practices across the Commonwealth and helped identify the issues and recommendations presented in this report.

The Governor's Center distributed a Discussion Draft of this report in September 2002, inviting various organizations to review it and comment on it. The Governor's Center would like to thank the following organizations for providing comments on the Discussion Draft and providing assistance and guidance with understanding the earned income tax collection process and system:

- Pennsylvania Earned Income Tax Officers, Administrators and Collectors Association (PEITOAC),
- Local Earned Income Tax Association (LITA),
- Pennsylvania Institute of Certified Public Accountants (PICPA),
- Pennsylvania State Association of Township Supervisors (PSATS),

¹ The *Register*, which is available on the Internet, lists resident, nonresident and school earned income tax rates for each municipality.

- Pennsylvania State Association of Boroughs (PSAB),
- Pennsylvania School Boards Association (PSBA),
- Pennsylvania Association of School Business Officials (PASBO)
- Pennsylvania Chamber of Business and Industry (the Chamber),
- Pennsylvania Business Roundtable (the Business Roundtable)
- Pennsylvania Manufacturers Association (PMA),
- York Area Earned Income Tax Bureau,
- Berkheimer Tax Administrator,
- Central Tax Bureau of Pennsylvania, Inc.,
- City of Pittsburgh,
- Auditor General's Office and
- Local Government Commission.

Homeowner Tax Relief Act (Act 72 of 2004)

At approximately the same time that this report was finalized, the Homeowner Tax Relief Act, Act 72 of 2004, was approved by the Legislature and signed by Governor Rendell. Act 72 allows school districts to reduce property taxes through a homestead exclusion. The homestead exclusion will be financed by a combination of state gaming funds and new or additional school earned and personal income taxes.

The existing system of collecting income taxes at the local level is likely to prove inadequate as a vehicle for accomplishing property tax reform. Act 72 will exacerbate all the problems described in this report by creating a local option for additional earned and personal income taxes. Where school districts select a personal income tax, duplicative collection mechanisms will have to be established. Moreover, substantial revenues that could be used for homeowner tax relief will be lost if the current collection system is not reformed. However, because the initial property tax reductions and new school income taxes will probably not take effect until at least July 1, 2006, there is enough time to enact legislation to reform the local income tax collection system and provide for an orderly transition if the initiative is taken now.

In addition, the General Assembly approved funding in the FY 2004-05 Budget to create a parallel personal income tax register, to modernize the *Earned Income Tax Register* and train employers and tax collectors on these changes. Modernization of the *Register*, a first step toward reforming income tax administration, will make employer withholding simpler and easier.

BACKGROUND

Most political subdivisions in Pennsylvania, excluding counties but including all cities, boroughs, towns, and townships (collectively, municipalities), and all school districts other than the Philadelphia School District may, by ordinance or resolution, enact an earned income tax. Except for the City of Philadelphia and the Pittsburgh School District, whose authority comes from separate legislation,¹ the authority to impose this tax arises under the Local Tax Enabling Act, Act 511 of 1965² (Act 511). The tax is levied on wages, salaries, commissions, net profits from the operation of a business, or other compensation.

Generally, the rate of the tax is limited to 1 percent. Where both a municipality and a school district levy the earned income tax, in most cases the 1 percent limit must be shared on a 50/50 basis, unless otherwise agreed to by the taxing bodies. A municipality may tax nonresidents employed in its jurisdiction in addition to its own residents. However, except for the City of Philadelphia, jurisdictions imposing any earned income tax on nonresidents must grant a credit for any earned income tax paid by residents of another jurisdiction.³ School districts are not permitted to tax nonresidents.

Not all taxing jurisdictions are limited to a 1 percent earned income tax rate. There is no absolute limit on the Philadelphia wage tax, although the rate on nonresidents is generally restricted to less than the rate on residents.⁴ The earned income tax rate is limited to 2 percent for the Pittsburgh School District⁵ and 1 percent for the Scranton School District.⁶ There are also exceptions to the 1 percent limit for home rule municipalities,⁷ financially distressed municipalities,⁸ municipalities with financially distressed pension systems,⁹ municipalities that purchase and preserve open space,¹⁰ school districts that by

¹ The authority of the City of Philadelphia to impose an earned income tax arises under the Sterling Act, Act 45 of 1932 (Sp. Sess.) (53 P.S. §15971 *et seq.*). The School District of Philadelphia has no authority to impose an earned income tax separate from that imposed by the City of Philadelphia. The Pittsburgh School District, as a First Class A school district, has authority to impose an earned income tax not exceeding 1 percent on residents under section 2 of Act 508 of 1961 (24 P.S. §588.2) and an additional 1 percent on residents under Section 652.1 (a)(2) of the Public School Code, Act 14 of 1949 (24 P.S. §6-652.1 (a)(2)).

² 53 P.S. §6901 *et seq.*

³ Second paragraph, Section 14 of Act 511 (53 P.S. §6914). Because the Sterling Act predates Act 511, the first paragraph of section 14 of Act 511 requires that any other municipality grant credits against their earned income taxes for earned income taxes paid to Philadelphia, including taxes paid by that municipality's residents who are employed in Philadelphia and taxes paid by Philadelphia residents employed in another municipality.

⁴ Sterling Act, Act 45 of 1932 (Sp. Sess.) (53 P.S. §15971 *et seq.*). Section 359 of the Tax Reform Code of 1971, Act of March 2 of 1971 (72 P.S. §7359), restricts the Philadelphia nonresident wage tax rate to 4 5/16 percent, unless the resident rate exceeds 5 3/4 percent, in which case the nonresident rate is restricted to 75 percent of the resident rate.

⁵ See note 1 above.

⁶ Section 8 of Act 511 (53 P.S. §6908).

⁷ Section 2962 (b) of the Home Rule Charter and Optional Plans Law (53 Pa.C.S. §2962 (b)).

⁸ Section 123 (c) of the Municipalities Financial Recovery Act, Act 47 of 1987 (53 P.S. §11701.123(c)).

⁹ Section 607 of the Municipal Pension Plan Funding Standard and Recovery Act, Act 205 of 1984 (53 P.S. §895.607 *et seq.*).

referendum enact an earned income tax under Act 50 of 1998¹¹ and school districts and municipalities that adopt an earned income tax by referendum under the Optional Occupation Tax Elimination Act, Act 24 of 2001.¹² Only the City of Philadelphia, distressed municipalities and municipalities with distressed pension systems are permitted to impose earned income taxes on nonresidents at a rate in excess of 1 percent, the other exceptions to the 1 percent limit described in this paragraph apply only to residents.

Pennsylvania has more local jurisdictions levying income taxes than all other states combined.¹³ In January 2004, 95 percent of the 2,565 municipalities in the Commonwealth levied an earned income tax with rates ranging from 0.28 percent (in Fairview Township, Erie County) to 2.4 percent (in the City of Chester, Delaware County and the City of Scranton in Lackawanna County).¹⁴ More than 92 percent of the 500 school districts having the authority to levy an earned income tax did so.¹⁵ While the combined earned income tax rate was 1 percent in 81 percent of the municipalities with an earned income tax, there were 446 municipalities where the combined rate exceeded 1 percent. **Figure 1** on page 7 shows the variation in earned income tax rates across the Commonwealth.

Tax Collection

While there are very specific statutory guidelines establishing the process for collecting property taxes in Pennsylvania, Act 511 gives municipalities and school districts wide latitude to choose how the earned income tax will be collected. Municipal, school and county property taxes are generally collected at the municipal level by an elected tax collector. Each municipality and school district has the right to appoint its own earned income tax collector under Act 511, including joint tax collection agencies, serving multiple jurisdictions, and third-party tax collectors.¹⁶

¹⁰ Section 7.3 of Act 442 of 1968 (32 P.S. §5007.3).

¹¹ 53 Pa.C.S. §8701 *et seq.*, added by Act 50 of 1998.

¹² Act 24 of 2001, as amended to include municipalities by Act 96 of 2002, (53 P.S. §6927.1 *et seq.*).

¹³ In 1994, the last year for which the Advisory Council on Intergovernmental Relations (ACIR) kept track of local income taxes, Pennsylvania accounted for over two-thirds of local income taxes imposed in the United States. At that time, there were 2,830 jurisdictions in Pennsylvania and 1,281 jurisdictions in 12 other states that imposed local income taxes. An update of this information in April 2004 by the Governor's Center, shows that Pennsylvania, with 2,858 jurisdictions, still accounts for over two-thirds of the 4,335 local income taxes imposed in the nation.

¹⁴ Including the City of Philadelphia, there were 2,416 municipalities in Pennsylvania that levied an earned income tax in January 2004. Technically, the City of Philadelphia has the highest local income tax rate at 4.5635 percent on residents and 3.972 percent on nonresidents. However, Philadelphia was not included in this analysis, because unlike other municipalities in the Commonwealth, the authority for Philadelphia's income tax is not in Act 511. The highest combined municipal and school district earned income tax imposed under the authority of Act 511 is in the City of Scranton, Lackawanna County, where the city levies a 2.4 percent tax and the school district a 1 percent tax for a total 3.4 percent tax.

¹⁵ There are 501 school districts in Pennsylvania, but the Philadelphia School District does not have authority to levy an income tax. The City of Philadelphia is responsible for levying local taxes dedicated for the school district. In January 2004, 463 school districts levied an earned income tax.

¹⁶ Section 10 of Act 511 (53 P.S. §6910).

Combined Municipal and School District E.I.T. Rates by Municipality

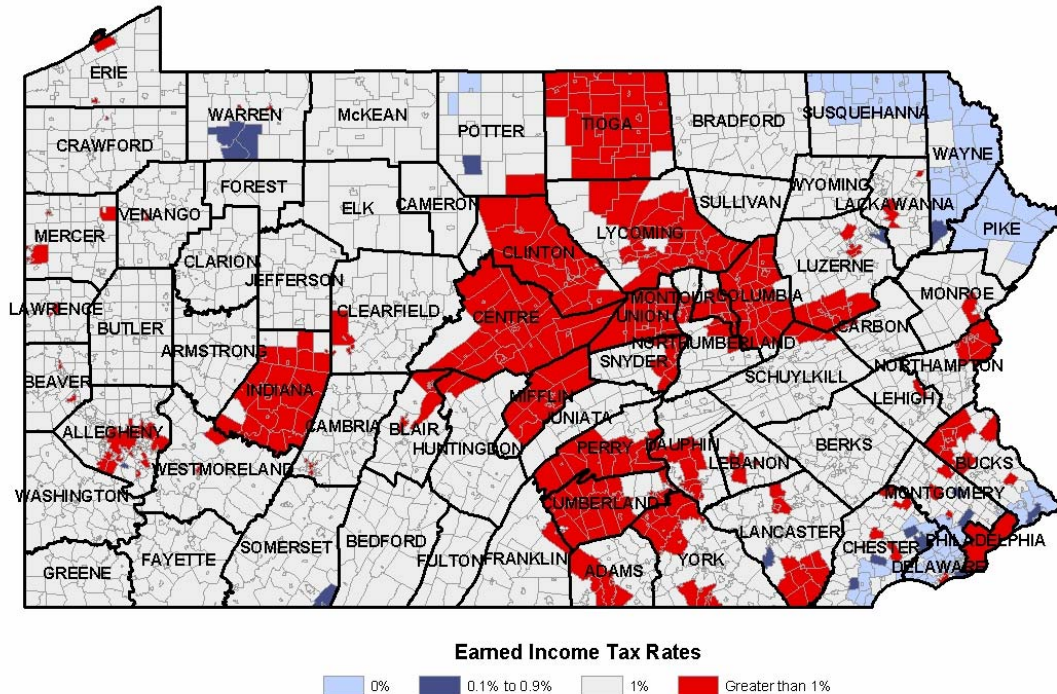


Figure 1 – Earned Income Tax Rate by Municipality - January 2004

Tax Collectors

As a result of the broad authority provided by Act 511, there is a great deal of diversity in local tax collection in Pennsylvania. In some jurisdictions, municipal or school employees collect the earned income tax. In others, the tax is collected by nonprofit joint tax collection agencies created and run by more than one taxing jurisdiction. Other taxing jurisdictions contract with the elected property tax collector, a private for-profit collector or another jurisdiction's collector to collect the tax. Most earned income tax collectors also collect other Act 511 taxes, such as the per capita, occupational privilege and business gross receipts taxes. Some earned income tax collectors also collect the real property tax.

As of January 2004, there were approximately 560 earned income tax collectors in Pennsylvania.¹⁷ The largest collects taxes for 667 taxing jurisdictions. More than 80 percent of the collectors collect taxes for two or fewer taxing jurisdictions.¹⁸ About 50 joint or other governmental tax collection agencies collect taxes for four or more taxing

¹⁷ A list of tax collectors can be obtained from the Governor's Center for Local Government Services. This list is based on an analysis of information in the January 2004 *Register of Earned Income Taxes*. The number of taxing jurisdictions using different collectors may be overstated if the names of the same collector varied in the *Register*. Efforts were taken to overcome slight differences in name, such as comparing addresses and phone numbers. However, the accuracy of this information was not verified.

¹⁸ Thirty-six percent collect taxes for just one jurisdiction, and 45 percent collect taxes for two jurisdictions.

jurisdictions in the Commonwealth. Ten of the joint collection agencies collect taxes on a countywide basis. **Figure 2** shows the number of tax collectors operating in each county.

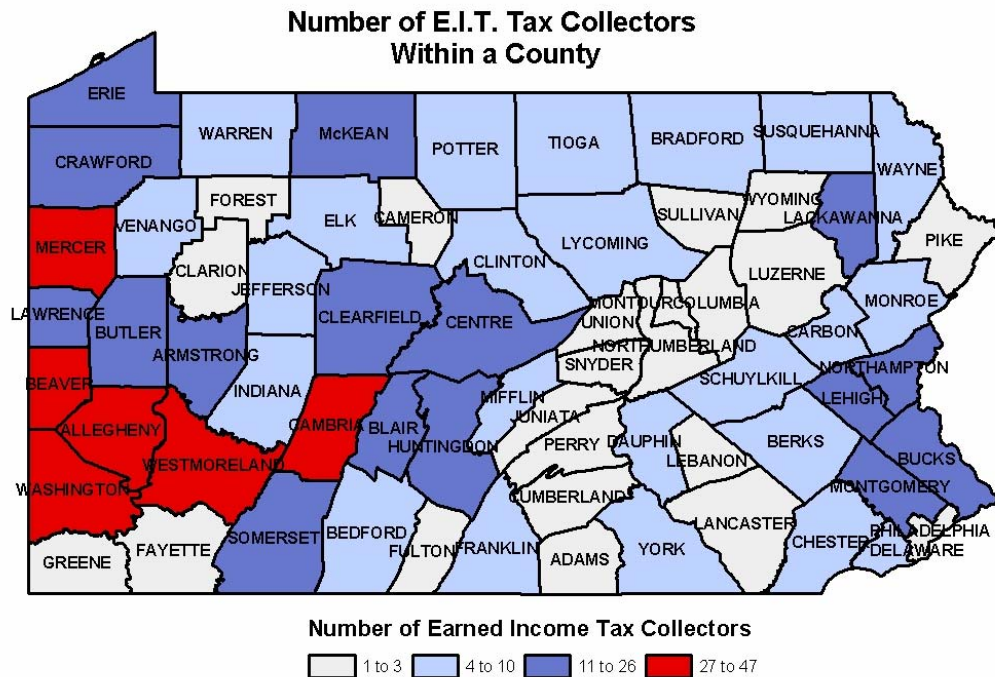


Figure 2 – Number of Earned Income Tax Collectors in Each County – January 2004

Withholding and Distribution of Taxes.

Act 511 requires employers to withhold and remit earned income taxes levied only by taxing jurisdictions where their workplaces are located.¹⁹ Employers have no legal responsibility to withhold taxes levied by jurisdictions where they have no workplace, except for earned income taxes levied by the City of Philadelphia and the Pittsburgh School District, which must be withheld from Philadelphia and Pittsburgh School District residents by all employers doing business in Pennsylvania.²⁰ Employers are required to withhold the earned income tax from all their employees if the municipality where the employer's workplace is located levies a nonresident tax.²¹ However, if the municipality levies a resident-only tax, the employer is only required to withhold the earned income tax from those employees who are residents of the municipality.

¹⁹ Section 9 of Act 511 (53 P.S. §6909).

²⁰ Section 359 of the Tax Reform Code, Act 2 of 1971 (72 P.S. §7359) and section 4(f) of Act 508 of 1961 (24 P.S. §588.4(f)).

²¹ Except for businesses employing residents of the City of Philadelphia and the Pittsburgh School District.

Because Act 511 requires that taxes only be withheld and remitted to the jurisdiction where an employer's workplace is located, and many employees live in jurisdictions other than where they work, a substantial portion of earned income taxes collected by municipalities that levy nonresident taxes must ultimately be redistributed to jurisdictions where employees live. This is because Section 14 of Act 511 requires the jurisdiction where a taxpayer works to grant a credit for any tax levied by the jurisdiction where the taxpayer lives.²² Section 13 V (h) of Act 511²³ requires that tax collectors distribute earned income taxes to the "appropriate political subdivision" at least quarterly.

Nonresident tax monies are taxes withheld by an employer and remitted to the jurisdiction where a taxpayer works, which frequently belong (in part or whole) to the taxing jurisdiction where the taxpayer lives. Most municipalities that levy resident-only taxes will not accept or distribute nonresident tax monies. In these municipalities, the employer may voluntarily withhold and remit earned income taxes to the jurisdictions where their nonresident employees reside. Otherwise, employees must pay estimated taxes quarterly or pay a significant lump sum at the end of the year, depending upon the regulations governing collection in the employee's local taxing jurisdiction.

Administrative Requirements.

Both Act 511 and Act 50 of 1998 establish administrative procedures and requirements for tax collection. Act 511 also establishes the duties of the tax collector, requires that collectors be bonded, permits taxing jurisdictions to adopt rules and regulations, permits tax collectors to audit taxpayers, requires that taxpayer information be kept confidential and requires that tax collectors distribute nonresident monies to the appropriate political subdivision quarterly without being requested.²⁴ In addition, Act 511 requires an annual examination of the records of the tax collector by an independent accountant appointed by the taxing jurisdiction.²⁵

Act 511 also permits tax collectors to sue in the name of the taxing authority to recover taxes, establishes time limitations for different types of suits, and establishes a three-year time limit for initiating suit to collect taxes from taxpayers unless fraud is involved.²⁶ It establishes fines and penalties for violations and interest and penalties for the late payment of taxes.²⁷

Act 50 of 1998 created the Local Taxpayer Bill of Rights Act,²⁸ which requires taxing jurisdictions that impose taxes under Act 511 to inform taxpayers of their rights and adopt rules and regulations. These rules and regulations must establish appeals processes, procedures for processing refund claims and enforcement and collection procedures. The Local Taxpayer Bill of Rights Act requires local taxing authorities to

²² Section 14 of Act 511 (53 P.S. §6914) also requires that other taxing jurisdictions provide a credit for the Philadelphia Wage Tax.

²³ 53 P.S. §6913 V (h).

²⁴ Section 13 V of Act 511 (53 P.S. §6913 V).

²⁵ Section 11 of Act 511 (53 P.S. §6911). Second class cities are exempted from this provision.

²⁶ Section 13 VII of Act 511 (53 P.S. § 6913 VII).

²⁷ Section 13 VIII-IX of Act 511 (53 P.S. §6913 VIII-IX).

²⁸ Chapter 84 of 53 Pa.C.S.

pay interest on overpayments at the same rate paid by the Commonwealth. It also establishes higher fines than Act 511 for violations of taxpayer confidentiality.²⁹

²⁹ 53 Pa.C.S. §§8421-8438. 53 Pa.C.S. §8437 permits imposition of fines of no more than \$2,500 or imprisonment for no more than a year for confidentiality violations compared to a maximum fine of \$500 and no more than 30 days imprisonment for confidentiality violations under Act 511.

ISSUES

Pennsylvania's fragmented and inefficient local tax collection system inflates collection costs, reduces tax revenues available to school districts and municipalities and increases the cost of doing business in Pennsylvania.

Research by the Governor's Center reveals that at least \$100 million in local earned income tax revenues is lost annually due to inefficiencies created by the lack of uniformity and fragmentation of the system.¹ This fragmentation creates additional tax collection burdens and duplication between collectors. In addition, tax monies are not uniformly withheld, which hinders compliance. Compounding the problem is a lack of coordination between many collectors in the distribution of nonresident tax monies, and tax monies sent to the wrong collector by an employer or another collector.

Revenue is also lost because of the absence of accountability, oversight and enforcement, particularly with regard to nonresident tax distribution. Furthermore, it is doubtful whether many of the smaller collectors have the resources or capacity to track and capture all taxable income and keep up with the complexities of different kinds of income, net profits and business operations, further reducing the collection of revenue.²

Revenue is also lost from inflated collection costs due to the additional work created from inconsistent withholding and the lack of cooperation among tax collectors. Besides paying what might be unnecessarily high collection costs, many local taxing jurisdictions are not maximizing revenues from the earned income tax by closely monitoring tax collections, fines, penalties and interest earnings by tax collectors. Fines, penalties and interest earnings on tax revenues can generate significant revenues. One tax collection bureau, which uses the interest earnings on collections, fines and penalties to fund its operations, has not charged a fee since its inception over 35 years ago.

The cumbersome earned income tax system is also a major burden to employers who are required to withhold and remit the earned income tax. The Governor's Center receives daily calls from employers regarding their difficulties withholding the earned income tax. Over two months in the Fall of 2003, the Governor's Center received calls from Siemens, Verizon Wireless, CIGNA, Sunoco, Allegheny Energy, Black & Decker and Kraft Foods, as well as numerous smaller businesses. The large number of rates, tax collectors and rules is, at best, a major annoyance to employers who are required to withhold and remit the tax.

¹ The estimate is based on the difference between school earned income tax collections reported to the Department of Education for Fiscal Year 2000-01 and an estimate of local earned income based on compensation and net profits reported on State personal income tax returns in calendar year 2000. The estimate of local earned income was adjusted to reflect differences in the base, crediting, time period and reporting methods.

² Some of the collectors' responses to the Center's *Survey of Earned Income Tax Collectors* indicated they were not familiar with different forms of income and accounting methods. A description of the Survey can be found in the Introduction on p. 3.

Only 10 other states permit local income taxes. The local income tax is collected by the state in five of those states. Of the six states where the local tax is collected locally, only three besides Pennsylvania, Ohio, Kentucky and Michigan, permit smaller units of local government to collect local taxes. The remaining three (Delaware, Kentucky and Michigan) limit local collection to major cities. Figure 3 shows the number of local jurisdictions that impose income taxes in Pennsylvania and other states. Pennsylvania's complex and fragmented system for collecting the local income tax thus contributes to the perception that Pennsylvania is a difficult state in which to do business, hindering its ability to attract and keep needed jobs.

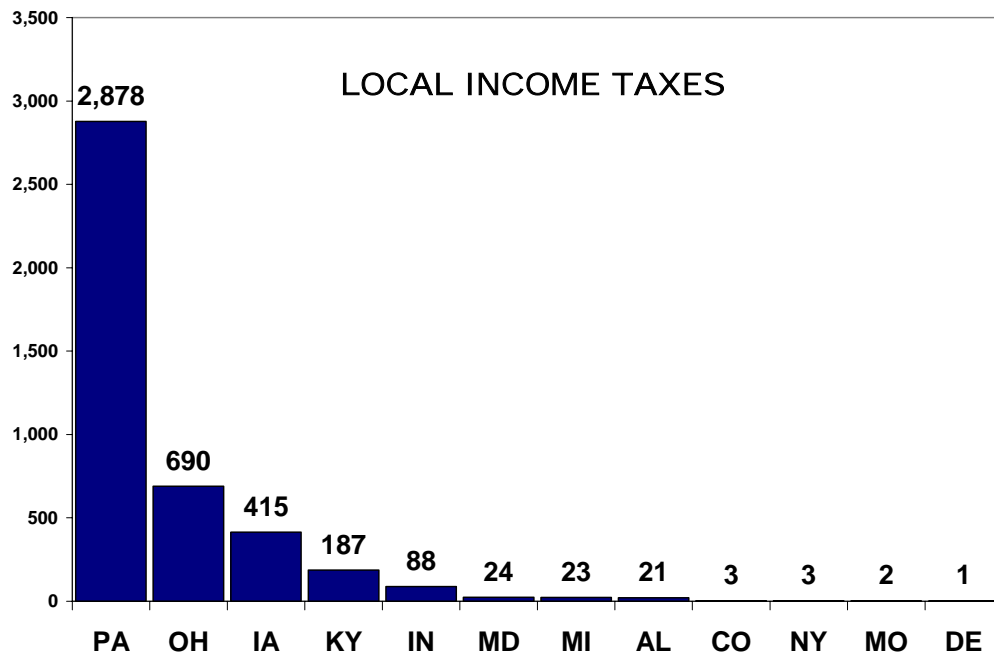


Figure 3 – Local Income Taxes in Pennsylvania and Other States

Ambiguous reporting requirements and operating processes exacerbate both the burden on business and the loss of revenue. Some tax collectors have created their own rules, which conflict with existing law and compound the problem. Uniform procedural requirements and a system of accountability, which are critical for the smooth operation of a complex and interdependent system of tax collection, do not exist for earned income tax collection in Pennsylvania.

The system's revenue losses and burden on business are caused by four main factors, a description and analysis of each follows:

- Fragmentation,
- Complex and inconsistent withholding rules,
- Nonresident tax distribution, and
- Ambiguity in Act 511.

Fragmentation

Earned income tax collection in Pennsylvania is fragmented because the law permits almost 2,900 local taxing jurisdictions to use different definitions of earned income, different collectors, different tax rates and different methods of collection. Pennsylvania has more local taxing jurisdictions levying income taxes than all other states combined.³ Unlike most states where taxpayers and employers only have to deal with the federal and state tax collectors, in Pennsylvania, taxpayers and employers must deal with three or more collectors: federal, state and at least one at the local level.⁴

Varying Definitions of Earned Income

Act 166 of 2002⁵ generally incorporates the definitions of “compensation” and “net profits” from the Pennsylvania personal income tax⁶ as the definitions of “earned income” and “net profits” in Act 511, with certain exclusions and limitations. Although Act 166 of 2002 has helped to provide a uniform and stable definition of earned income and net profits at the local level, differences between the state and local definitions of compensation and net profits remain. In addition, Act 511 does not apply to earned income taxes of the City of Philadelphia or the Pittsburgh School District,⁷ and some ambiguities still exist regarding what is and what is not taxable at the local level.

Areas in which local definitions of earned income still differ from the state definitions include the exclusion from local earned income of compensation of active-duty military personnel and housing allowances for clergy. Compensation of active-duty military personnel and clergy housing allowances are taxable as compensation at the state level but not the local level.

In addition, there are differences in computing farming income, net profits from investment earnings and business losses. With regard to the treatment of business losses, the Commonwealth only allows losses to be offset in the same class of income. Conversely, court decisions have prohibited the offset of business gains by business losses at the local level, but permitted business losses to offset compensation.⁸ After Act 166 was enacted, a number of local taxing jurisdictions began following the state

³ Research by the Governor’s Center shows that Pennsylvania with 2,858 jurisdictions accounts for over two-thirds of the 4,335 local income taxes imposed in the nation.

⁴ Often there are two tax collectors at the local level, one for the municipality and a separate collector for the school district.

⁵ Act 24 of 2004 amended Act 166 of 2002 which amended Section 12 of Act 511 (53 PS. §6913).

⁶ Interest and dividends, which are taxable under the state personal income tax, are still not taxable at the local level.

⁷ Act 166, because it amends Act 511, applies to the City of Pittsburgh, but not the Pittsburgh School District. See Note 1 in Background on page 5. As a result, the City and School District have two different statutory definitions of earned income and net profits, which has caused confusion for employers, and unnecessary costs and work for the City and School District.

⁸ In *O’Reilly v. Fox Chapel Area School District*, 555 A.2d 1288, 521 Pa. 471, 1989, the Pennsylvania Supreme Court permitted taxpayers to deduct business losses from wage and salary income. However, the Court let stand *Aronson v. City of Pittsburgh*, 485 A.2d 890, 86 Pa.Cmwlth 591, 1981, that taxpayers could not apply net losses from one business against net profits from another business.

treatment of losses, but others are still following the rules established by those court decisions.

Investment income is taxable at the state but not the local level. Distributions from an S corporation are included in taxable income at the state level. At the local level, most distributions passed through to a taxpayer by an S Corporation are considered investment income and not subject to the earned income tax, unless the distributions are based on services provided by the taxpayer. Similar rules apply to rental income. While Act 511 specifically prohibits the taxation of corporations and investment income, there are varying local interpretations regarding exactly how these exemptions should be applied. Act 166 also retained the exemptions for farming income at the local level that are either not available or limited at the state level. For taxpayers engaged in farming, Act 511 excludes from the definition of net profits interest earned on working capital, gains from the sale of farm machinery, most livestock and the capital assets of the farm that are reinvested in the farm.

Finally, Act 166 refers to Section 303 of the Tax Reform Code and 61 Pa. Code Part I Subpart B Article V, which cover over 100 pages. Neither the law nor the regulations provide a clear enumeration of what types of state taxable income are taxable at the local level. This frustrates local tax collectors and employers and results in different interpretations of what is and is not taxable. This uncertainty is exacerbated because there is no statewide arbiter of exactly what is taxable and not taxable at the local level under Act 511. This results in uneven and unfair application of the local tax to individual taxpayers.

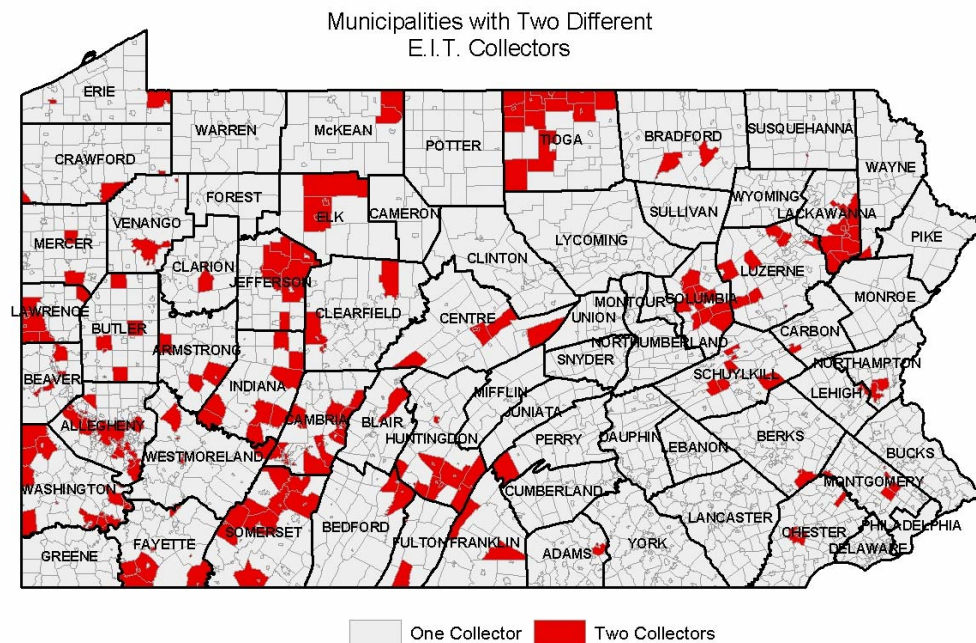


Figure 4 – Municipalities with Two Earned Income Tax Collectors – January 2004

In January 2004, there were approximately 560 different tax collectors in Pennsylvania, with more than 80 percent collecting for only one or two taxing jurisdictions. In the 290 municipalities highlighted in **Figure 4** on page 14, different entities collected earned income taxes for the municipality and school district. Employers located in these municipalities are thus required to withhold the earned income tax for, and remit taxes to, two different local tax collectors. Residents of these municipalities are required to file two separate local tax returns. In addition, the Governor's Center has received complaints that some of the tax collectors for these municipalities returned to employers the school district's portion of the taxes rather than remitting the taxes to the school district, which created additional work for the employer, tax collector and taxpayer.

School Districts within a County with More than One E.I.T. Tax Collector



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Different Rates

Different earned income tax rates create withholding challenges for employers and distribution challenges for tax collectors, and complicate administration of the tax. Although the earned income tax rate is 1 percent in 81 percent of the municipalities, the rate differs in 470 municipalities,¹⁰ and an additional 126 municipalities do not impose an earned income tax.

As a result of Act 50 of 1998¹¹ and the Optional Occupation Tax Elimination Act, Act 24 of 2001,¹² the number of municipalities that have earned income tax rates other than 1 percent has more than quadrupled in three years. Act 50 authorizes school districts, with the approval of the voters, to levy earned income taxes of up to 1.5 percent. Any increase must be offset by the repeal of the occupation, occupational privilege and per capita taxes and a reduction in the real estate tax. School boards were authorized to initiate this process in 1999. As of December 2003, voters in four school districts had approved taxes under the provisions of Act 50.

Similar to Act 50, Act 24 of 2001 permits school districts and municipalities, with the approval of voters, to impose earned income taxes as a replacement for occupation taxes.¹³ In the three years since Act 24 was enacted, voters in 58 school districts and four municipalities have approved higher earned income taxes to replace occupation taxes. **Figure 6** shows the impact of Act 24 by comparing combined municipal and school earned income tax rates between March 2002, right after Act 24 was enacted, and July 2004, when new tax rates approved in the November 2003 election will take effect.

Municipalities with a Municipal or School Earned Income Tax				
	<i>March 2002</i>		<i>July 2004¹⁴</i>	
	Total	Percent	Total	Percent
Combined Tax Rate Equals 1%	2,328	96%	1,969	81%
Combined Tax Rate Greater than 1%	79	3%	446	18%
Combined Tax Rate Less than 1%	25	1%	24	1%
Combined Tax Rate Other than 1%	104	4%	470	19%
Total Municipalities w/ Earned Income Tax	2,432	100%	2,439	100%

Figure 6 – Number of Municipalities with an Earned Income Tax

The number of different tax rates will increase dramatically when the property tax reductions and new school income taxes authorized in Act 72 of 2004 take effect, which will create an additional strain on a system that is already not working well. More mistakes are made when tax rates are changed. Some employers withhold at the wrong rate or withhold at the old rate, which affects distribution to surrounding taxing

¹⁰ The 470 municipalities include municipalities within school districts in which voters in November 2003 approved an increase in the rate of earned income tax rates effective July 2004.

¹¹ Chapter 87 of 53 Pa.C.S.

¹² 53 P.S. §6927.1 *et seq.*

¹³ In 2002, Act 24 of 2001 was amended by Act 96 to permit municipalities to also replace occupation taxes with increased earned income taxes. (53 P.S. §6927.1 *et seq.*)

¹⁴ Includes municipalities within school districts in which voters in November 2003 approved an increase in the rate of earned income tax rates effective July 2004.

jurisdictions. Moreover, when the rate is changed in the middle of the calendar year, collection becomes even more complicated. For instance, the shift to a higher earned income tax under Act 50 in a school district in Central Pennsylvania during 2000 resulted in a 50 percent increase in errors in both employer withholding and taxpayer returns. In addition, because the rate increased at the beginning of the school's fiscal year, which is in the middle of the calendar year, income for the first and second halves of the year had to be split so two different tax rates could be applied. Creating a simple tax form to accomplish this was challenging.

Joint Tax Collection

Although earned income tax collection is generally fragmented, there are some excellent examples of cooperation and efficiency in the ten joint tax collection bureaus, most of which operate on a county-wide basis in the south-central part of the state. Most of these operations charge their members minimal or no fees for tax collection. Many of these operations use penalties and investment interest to finance their operations. A board of local officials overseeing each bureau enhances accountability and oversight. The model joint tax collection bureau is actively governed by a board of directors on which there is representation by every taxing jurisdiction. The Governor's Center has also identified another 40 tax collection agencies in other parts of the State that are joint collection bureaus or other governmental agencies that collect for four or more jurisdictions.

Complex and Inconsistent Withholding

Many businesses consider Pennsylvania's local government system frustrating and confusing because they must contend with a multitude of local government boundaries, rules, regulations and taxes. Earned income tax withholding and collection is a leading example of local red tape in Pennsylvania, creating more headaches for employers than any other local tax issue. Indeed, the multitude of earned income tax rates permitted under different laws complicates employer-withholding requirements and erodes employer compliance and cooperation. Besides a variety of rates, different collectors and different withholding approaches, a complex and cumbersome Register of Earned Income Tax Rates complicates withholding.

Different Collectors

Unlike most states where taxpayers and employers only have to deal with one tax collector, in Pennsylvania, they have to deal with at least two different tax collectors (at the state and local levels) and, in some cases, two or more different local tax collectors. In fact, employers with multiple locations who deal with only one collector in most other states may have to deal with hundreds of local tax collectors in Pennsylvania.

Different Withholding Approaches

Although normally employers are only required to withhold taxes levied by the municipality in which each of the employers' workplaces is located, there are two major exceptions to this rule: the City of Philadelphia and the Pittsburgh School District. Two different state laws require all employers doing business in the Commonwealth to withhold the earned income tax from residents of the City of Philadelphia and the

Pittsburgh School District.¹⁵ Accordingly, in addition to withholding the income tax for the taxing jurisdiction(s) where each of their workplaces are located, employers must also determine if any of their employees live in the City of Philadelphia or the Pittsburgh School District, and if so, also withhold and remit income taxes to these jurisdictions.

In addition to the exceptions for Philadelphia and Pittsburgh, different policies with respect to the taxation of nonresidents complicate withholding. While school districts cannot tax nonresidents, municipalities can impose a tax of up to 1 percent (and in some cases more) on nonresidents.¹⁶ As illustrated in Figure 7, a little over 54 percent of the municipalities with an earned income tax taxed nonresidents in January 2004. The remaining municipalities only taxed residents. In jurisdictions that do not tax nonresidents, the tax collector may refuse to accept nonresident tax monies withheld by employers located there.

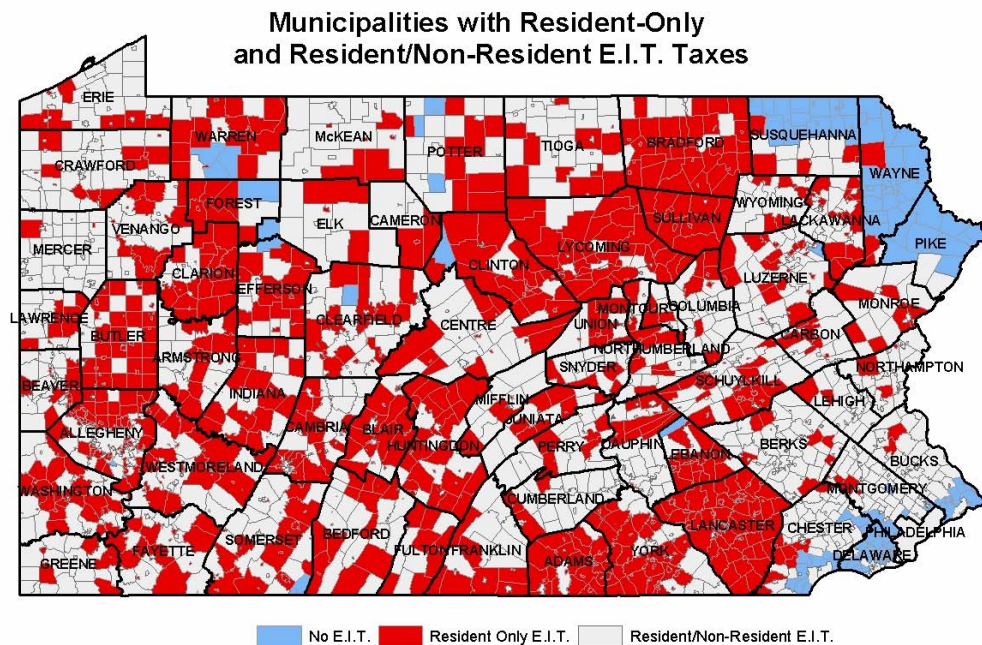


Figure 7 – Municipalities with Resident-Only Taxes – January 2004

Most employers prefer to withhold for either all or none of their employees. Separate rules for residents and nonresidents create additional work. Besides the additional administrative work, employers do not like be forced to explain why some employees are treated differently than others. As a result, even though employers located in “resident only” jurisdictions are not required to withhold and remit taxes based on where their

¹⁵ Section 359 of the Tax Reform Code, Act 2 of 1971 (72 P.S. §7359), and Section 4 of Act 508 of 1961 (24 P.S. §588.4).

¹⁶ Municipalities that have been declared distressed under Act 47 of 1987 (53 P.S. §11701.101 *et al*) or those with distressed pension systems under Act 205 of 1984 (53 P.S. § 895.101 *et al*) can exceed the 1-percent rate limit on nonresident taxation.

employees live, many employers do this for their own convenience or that of their employees.

When jurisdictions will not accept or distribute taxes withheld for nonresident employees, additional work is created for employers, employees and tax collectors. Employers wishing to withhold taxes for the convenience of their employees must report and remit to multiple jurisdictions. Otherwise, employees must pay estimated taxes quarterly or pay a large lump sum at the end of the year depending upon the regulations governing collection in the employee's local taxing jurisdiction.

The City of Pittsburgh has unique earned income tax withholding and distribution requirements. Although the earned income tax ordinance for the City of Pittsburgh provides for a tax on nonresidents,¹⁷ the City only levies a tax on nonresidents who work in the City of Pittsburgh if the jurisdiction where the nonresident lives does not have an earned income tax, or if the earned income tax rate is less than 1 percent. If the combined rate for the nonresident's home jurisdiction is less than 1 percent, the nonresident is required to pay to the City of Pittsburgh the difference between 1 percent and the rate of their home jurisdiction.¹⁸

For Pennsylvania residents who work in the City of Pittsburgh but live outside the City, the City encourages employers to withhold for the proper jurisdiction and submit the tax directly to that jurisdiction. The City also makes every effort to help employers identify the jurisdiction where their employees reside. However, if an employer erroneously withholds a nonresident's tax and sends the tax to the City, the City will not forward the tax withheld to the proper jurisdiction. In order to receive a refund, nonresident taxpayers must provide the City with a residency certification from their local tax collector.

Register of Earned Income Taxes

The official source of withholding information for employers is the *Earned Income Tax Register*, which is maintained by the Governor's Center. The *Register*, which is available on the Internet, lists each taxing jurisdiction's tax rates on residents and nonresidents and the tax collector. Employers are only required to withhold earned income taxes if the tax is listed in the *Register*.¹⁹ Because of the diversity of withholding approaches, a variety of rates, and outdated technology, employers find the *Register* difficult to use and follow. Indeed, many employers find withholding rules in Pennsylvania difficult to follow and the identification of their employees' taxing jurisdiction troublesome.

Determining their employees' municipality and school district of residence and related information for reporting purposes can be challenging and time consuming, especially for employers or payroll companies that are located outside of the Commonwealth. The addresses for many Pennsylvania residents are post office names that are not the same as

¹⁷ Section 245.02 of the Pittsburgh Code

¹⁸ The City of Pittsburgh also imposes the earned income tax on persons who work in the City of Pittsburgh but live in a state other than Pennsylvania or another country.

¹⁹ Section 9 of Act 511 of 1965 (53 P.S. §6909).

the municipality. In addition, the names of many townships are duplicated throughout the Commonwealth. Moreover, the rules for combining school district and municipal rates, and resident and nonresident rates can be confusing.

Another problem related to the *Register* is that dates by which rates are required by Act 511 to be available on the *Register* are not adequately synchronized with municipal and school tax years. Act 511 requires that rates be made available on July 1,²⁰ which is six months after the municipal tax year begins. Act 511 and Act 50²¹ also establish different dates for availability of new or changed rates. As a result, withholding at the new rate may not occur for as long as six months after a tax is enacted or increased, affecting local cash flow and making tax compliance more difficult. The July 1 availability date does not provide any lead-time for employers to adjust their payroll so that withholding will be at the proper rate by the effective date of July 1.

Another *Register*-related problem for employees and employers is that some taxing jurisdictions do not provide the Governor's Center with accurate rates, or do not notify the Governor's Center when earned income tax rates change. For example, the Governor's Center received a complaint about a township tax collector billing nonresident workers for three years of back taxes. The earned income tax rate for nonresidents, although part of the township ordinance, was not reported to the Governor's Center for that time period. Thus, the *Register* did not show a nonresident tax for this jurisdiction. Since the nonresident tax was not listed in the *Register*, employers did not withhold the tax from their employees who resided outside the township. In 2001, the tax collector billed nonresidents for back taxes plus penalties and interest. This created anger and confusion for nonresident employees in the township, many of whom directed their anger at their employer, because they were not notified about the tax for three years.

As a related issue, even though Section 9 of Act 511 provides that employers are only required to withhold the earned income tax at the rate listed in the *Register*, some tax collectors have told employers that they are required to withhold based on a local ordinance that is not listed in the *Register*. Moreover, the Governor's Center is aware of at least one employer who was told to ignore what was listed on the *Register*. In fact, tax collectors have demanded and received fines from employers for not withholding based on a tax rate that was in an ordinance but not listed in the *Register*, a practice which the Department of Community and Economic Development believes is contrary to the law.

Distribution of Nonresident Taxes

The earned income tax is usually collected by the tax collector for the jurisdiction where a taxpayer works²² (the nonresident jurisdiction) and forwarded to the collector for the jurisdiction where the taxpayer lives.²³ Cooperation between tax collectors is critical to

²⁰ Section 9 of Act 511 of 1965 (53 P.S. §6909).

²¹ 53 Pa.C.S. §8914.

²² Section 9 of Act 511 (53 P.S. §6909) requires employers to only withhold the earned income tax from all their employees if the municipality where their workplace is located levies a nonresident tax.

²³ Frequently the tax withheld belongs to the jurisdiction where the taxpayer lives, because Section 14 of Act 511 (53 P.S. §6914) requires that jurisdictions imposing earned income taxes on nonresidents grant a

ensure that tax monies are distributed to the proper jurisdiction, but disputes inevitably arise over amounts owed by one jurisdiction to another. Disputes also arise over tax collectors not forwarding *nonresident tax monies*²⁴ to the proper collector. In addition, disputes arise over tax collectors requiring other collectors to file a claim for nonresident tax monies, establishing time limits on the distribution on nonresident tax monies and the charging of fees for the distribution of nonresident tax monies.

Problems with the distribution of nonresident tax monies are widespread.²⁵ They are highlighted by a January 2002 Report of the Auditor General's Office,²⁶ a suit by six municipalities and a school district in Mercer County objecting to the charging of fees by the City of Meadville and Greenwood Township of Crawford County, in which a decision was granted in favor of the plaintiffs;²⁷ and a dispute between the City of Erie and Millcreek Township over millions of dollars in earned income tax receipts that was recently settled for a payment of \$3 million.

Auditor General's Reports

The January 2002 Report by the Auditor General's Office concerned an inquiry about earned income taxes owed to six school districts in Western Pennsylvania.²⁸ The original inquiry in 1999 involved more than \$150,000 in earned income taxes that were collected by a private tax collection agency from taxpayers who lived in neighboring jurisdictions but worked in the jurisdiction represented by the agency. The funds had not been distributed to the school districts where the employees in question lived. Some of the funds had not been distributed for as long as two years.

The tax collector distributed most of the funds in question after being contacted by the Auditor General's Office. The inquiry also found the agency was imposing a three-year time limitation for distributing taxes to nonresident taxing jurisdictions. Moreover, based on the inquiry, the Auditor General's Office concluded that Section 13 V (h) of Act

credit for any tax levied by the jurisdiction where the taxpayer lives. Section 13 V (h) of Act 511 (53 P.S. §6913 V (h)) requires that tax collectors distribute earned income taxes to the "appropriate political subdivision." Almost all tax collectors have interpreted Section 13 V (h) to mean that nonresident tax monies must be distributed to the jurisdiction where the taxpayer lives if the home jurisdiction imposes an earned income tax.

²⁴ Taxes withheld by an employer and remitted to the jurisdiction where a taxpayer works, which usually belong to the jurisdiction where the taxpayer lives.

²⁵ Nineteen percent of the tax collectors responding to the Center's 2002 *Survey of Earned Income Tax Collectors* indicated that they did not distribute nonresident monies to the place of residency. See Introduction on p. 3 for more information on the March 2002 *Survey of Earned Income Tax Collectors*.

²⁶ Department of the Auditor General, *Summary Report – Distribution of Earned Income Tax Funds to School Districts and Other Local Government Taxing Jurisdictions*, January 2002. (<http://www.auditorgen.state.pa.us/Department/Info/Investigations/index.html>)

²⁷ *Commodore Perry School District v. City of Meadville*, A.D. No. 2000-709, 2004 (Court of Common Pleas, Crawford County) Memorandum and Order entered January 21, 2004, appeal filed February 18, 2004, 367 C.D. 2004 (Commonwealth Court).

²⁸ According to Peter J. Smith, Director of the Office of Special Investigations in the Department of the Auditor General, the lack of complete information in the records of the taxing jurisdictions and the refusal of the subject tax collection agency to provide complete information prevented the Auditor General's Office from conducting a complete investigation.

511,²⁹ which requires tax collectors to distribute unclaimed funds to the jurisdictions from which the taxes were collected within one year of collection, was being ignored.

In addition to the late distribution of earned income tax collections, the Auditor General's January 2002 report found a number of other questionable activities on the part of the private tax collection agency, including:

- Not remitting taxes or providing records to taxing jurisdictions;
- Not disclosing sources and amounts of funds to taxing jurisdictions;³⁰ and
- Hiring their own auditors or CPAs to perform required annual audits.

In September 2001, right before January 2002 report was released, the Auditor General's Office found that four of the school districts that made the original complaint were still claiming that approximately \$276,000 was due them from the private tax collection agency. This incident prompted the Auditor General to issue a notice to school districts regarding earned income tax collection.³¹ One year after that report was issued, over \$200,000 of the funds held by the private tax collection agency was still in dispute.³²

In April 2003, the Auditor General's Office released a status report that noted that it had received additional complaints concerning questionable practices and abuses in the handling and distribution of nonresident earned income tax funds extending far beyond those described in their original reports and involving other local governments and tax collectors.³³ Most of the additional complaints regarding the distribution and disclosure of the earned income tax revenues were from Western Pennsylvania. The report concluded that the system for distributing nonresident earned income tax funds is seriously flawed and the requirements of the governing statute not being followed.

Quarterly Distribution

Section 13 V (h) of Act 511³⁴ requires that tax collectors distribute earned income tax monies to the appropriate taxing authority at least quarterly. Despite some ambiguity in this provision, practically all tax collectors agree that this section requires tax collectors to forward nonresident tax monies to a taxpayer's home jurisdiction when the taxes belong to the home jurisdiction. Nevertheless, many taxing jurisdictions, especially in Western Pennsylvania, do not receive tax monies that were withheld by employers from their residents but remitted to jurisdiction where the residents work.

²⁹ 53 P.S. §6913 V (h).

³⁰ The Auditor General's Report noted that the tax collector did not disclose to its clients the sources from which funds were received, dates funds were received or amount of any refunds.

³¹ Pennsylvania Department of the Auditor General, *Notice to School Districts*, January 2002.

³² The April 2003 Status Report by the Auditor's General Office indicated that an additional \$40,000 had been distributed to other taxing jurisdictions by the private tax collection agency, but \$213,000 was still in dispute.

³³ Pennsylvania Department of the Auditor General, *Status Report: Distribution of Non-Resident Earned Income Tax Funds*, April 2003, p. 1.

(<http://www.auditorgen.state.pa.us/Department/Info/Investigations/index.html>)

³⁴ 53 P.S. §6913 V (h).

Tax collectors experience many of the same difficulties as employers with matching postal addresses with municipalities and school districts. However, the problem is often exacerbated for tax collectors because these matching problems often cause employers to provide incorrect taxing jurisdictions in their reports to tax collectors.

Section 13-V (h) of Act 511³⁵

The officer shall, at least quarterly, distribute earned income taxes to the appropriate political subdivisions. The political subdivisions shall not be required to request the officer to distribute the funds collected but shall at least annually reconcile their receipts with the records of the officer and return to or credit the officer with any overpayment. If the officer, within one year after receiving a tax payment, cannot identify the taxing jurisdiction entitled to a tax payment, he shall make payment to the municipality in which the tax was collected.

Claims

In addition to not making the required timely distributions of tax monies, many tax collectors require that nonresident jurisdictions submit claims for funds to which the nonresident jurisdictions are entitled, even though Section 13 V (h) also stipulates that funds be distributed without request. The Auditor General's Office found that this practice "results in delays, retention of earned income tax funds without disclosure of earned interest, and in some cases, the almost complete breakdown of the system."³⁶ Many tax collectors simply do not treat nonresident tax monies with the priority and attention that public monies should be given.

Time Limits

Despite the fact that there is no authority in Act 511 to do so, some tax collectors impose time limits on the distribution of nonresident monies. Some tax collectors have cited Act 162 of 1943 as authority to impose a three-year statute of limitations.³⁷ However, Act 162 of 1943 was intended to apply to a refund request from an individual taxpayer.³⁸ Even if Act 162 applied to claims by other taxing jurisdictions, it would be superceded by Section 13 V (h) of Act 511, which stipulates that nonresident funds be distributed quarterly without being requested, and was enacted after Act 162.

Fees

There is no express statutory authority for a municipality to impose a fee for remitting nonresident monies to a jurisdiction of residence. However, some collectors have been unilaterally charging fees for remitting nonresident taxes. For example, six municipalities and a school district in Mercer County sued two other taxing jurisdictions and their collectors in Crawford County for unilaterally imposing collection fees on

³⁵ 53 P.S. §6913 V (h).

³⁶ Department of the Auditor General, *Status Report – Distribution of Non-Resident Earned Income Tax Funds*, April 2003, p. 3.

³⁷ If a political subdivision is paid and holds taxes to which it is not legally entitled, Act 162 of 1943 (72 P.S. §5566b) requires that a claim for such tax must be made in writing with the political subdivision within three years of payment of the taxes.

³⁸ Act 162 addresses the situation where "a person or corporation...pay[s]...into the treasury of a political subdivision...taxes...to which [a] political subdivision is not entitled," by requiring "refund of such taxes."

nonresident taxes.³⁹ The Crawford County Court of Common Pleas found that there was no right for the nonresident jurisdiction to demand fees for collecting and remitting nonresident monies, and ordered the nonresident collectors to pay over the full amount of nonresident monies with interest to the jurisdictions where the taxpayers lived.⁴⁰ Nevertheless, the additional work involved with handling and distributing nonresident tax monies justifies the charging of fees. Some taxing jurisdictions have a high proportion of nonresidents employed in their jurisdiction.

City of Erie and Millcreek Township

The City of Erie and Millcreek Township in Erie County argued about earned income tax distributions for years before settling on an aggregate of \$3 million in claims in November 2003. Each municipality purportedly held millions of the other's nonresident tax monies. Apparently, both of these taxing jurisdictions have been requiring other jurisdictions to file claims for nonresident tax monies and imposing five-year time limits on claims. The Governor's Center concludes, based on complaints received from other tax collectors, that the practices of requiring claims for nonresident tax monies and imposing time limits on those claims are widespread, at least in Western Pennsylvania.

Tax Collector Turnover

A number of cases have been brought to the attention of the Governor's Center in which tax collectors were not able to recoup their residents' taxes from another jurisdiction when the tax collector changed, because the new collector was not given the former collector's records. It is not clear how often such problems occur, but this issue surfaces frequently in complaints to the Governor's Center. The *EIT Collection Survey* and changes to the *Register* reveal periodic turnover due to resignation or replacement of tax collectors.⁴¹ Missing records when a tax collector changes not only create problems with the proper distribution of nonresident monies to neighboring jurisdictions, but also create bookkeeping problems for the jurisdiction that changed collectors. In a few municipalities, new collectors have billed taxpayers that already paid their taxes, because the new collectors were not given all the records from their predecessors.

Lack of Enforcement

Contributing to the poor cooperation between tax collectors is the lack of a grievance process for disputes, absence of oversight by a higher authority and failure of the law to provide penalties for tax collectors who violate Act 511. Most disputes between tax collectors grow out of the distribution of nonresident tax monies. However, disputes between taxing jurisdictions and their collectors regarding tax reporting and remittance also arise. Although many of these disputes are local in nature, most cross municipal lines, some cross county lines and a few have involved disputes between parties in different parts of the Commonwealth. Essentially, the only way to resolve tax collection

³⁹ *Commodore Perry School District v. City of Meadville*, A.D. No. 2000-709, 2004 (Crawford County, January 21, 2004)

⁴⁰ Memorandum and Order, January 21, 2004. Defendants filed a notice of appeal to Commonwealth Court on February 18, 2004 (367 C.D. 2004). As of March 29, 2004, the court had not filed a briefing schedule.

⁴¹ See p. 3 of the Introduction for more information on the March 2002 *Survey of Earned Income Tax Collectors*.

disputes is to file suit in the Court of Common Pleas, a costly and time consuming process.⁴²

With no oversight, enforcement or penalties for violations, the law is frequently ignored and funds are misappropriated. While Act 511 establishes penalties for taxpayers and employers who fail to disclose tax information or remit taxes, no corresponding penalties exist for current or former tax collectors who fail to disclose records or disburse tax monies belonging to another taxing jurisdiction.

Local taxing jurisdictions that do not oversee the practices and activities of their collectors are also responsible for many of the problems with local tax collection. Many are not utilizing written contracts, asking the right questions, requesting important information, using independent auditors or providing proper oversight. Not surprising in light of this lack of attention, investigations by the Auditor General documented failures to collect and remit tax funds promptly and appropriately. While some tax collectors are ignorant of the law, others are taking advantage of the situation by creating their own rules and not cooperating with other collectors and taxing jurisdictions.

The Governor's Center has also received a number of complaints about collectors failing to cooperate with other collectors and taxing jurisdictions. The current system, where each taxing jurisdiction can appoint its own tax collector, depends upon cooperation between collectors to run smoothly. The absence of an enforcement mechanism and a prompt and cost-effective dispute resolution process creates an uneven playing field, a situation in which players with more resources can dominate those with fewer resources.

Statutory Ambiguities

Many of the problems previously discussed, such as varying definitions of earned income tax, problems with the *Register* and disputes regarding the handling and distribution of nonresident earned income tax, are a result of ambiguities and gaps in Act 511. Compounding these problems are vague, outdated or nonexistent procedural and reporting requirements, requirements that are critical for the smooth operation of a complex and interdependent system of tax collection that involves the collection and distribution of large amounts of public monies. A description of these problems, and other shortcomings in Act 511, follow.

Identifying Employees' Local Taxing Jurisdictions

Employers are dependent upon accurate and complete address information from each of their employees to properly withhold the local earned income tax; however, this information is not required or specified in Act 511. Tax collectors are also dependent upon this information to properly distribute nonresident tax monies. The Governor's Center provides a sample Certificate of Residence form to help employers obtain complete and accurate residency information from employees.

⁴² Suits involving less than \$5,000 can be filed with a district justice.

Tracking of Nonresident Monies

It is difficult for tax collectors to determine where nonresident tax monies should be distributed, because there is no requirement for an employee's address to be included with quarterly taxes withheld, remitted and reported by employers. Section 13 IV (b) of Act 511⁴³ requires that employers' quarterly reports include the taxing jurisdictions imposing the tax on an employee, but not the postal address where the employee lives. Frequently, employers list incorrect municipalities and school districts on the quarterly form because employees do not provide or know their home municipality and school district. It would be easier for tax collectors to identify or verify the correct municipality and school district of an employee from the quarterly reports if employers provided tax collectors with their employees' home addresses on the reports.

Because of vague and incomplete reporting requirements in Act 511, it is difficult for tax collectors to track where their resident's tax monies were remitted. This is because employers are required by Section 13 IV (c) of Act 511 to report in the annual W-2 withholding statement the taxing jurisdiction imposing the tax and the amount of tax remitted to the tax collector, but not the taxing jurisdiction to which the employer remitted the tax. Frequently employers list the wrong jurisdiction imposing the tax or remit to the wrong jurisdiction.⁴⁴ In addition, tax collectors sometimes distribute nonresident monies to the wrong collector. The annual statement does not list where the collector sent the tax monies. Collectors are not required to keep and provide records on where they distribute tax monies. As a result, it is frequently impossible for tax collectors to determine what happened to their taxpayers' taxes.

Distribution of Nonresident Monies

Many of the disputes over the distribution of nonresident tax monies are caused by ambiguities in Act 511. Section 13 V (h) plausibly may be interpreted to require forwarding of nonresident monies to taxpayers' home jurisdictions, but it could also be interpreted to require distribution of funds only among political subdivisions who have appointed a particular tax collector. Even if Section 13 V (h) of Act 511 is interpreted to require distribution of nonresident taxes to taxpayers' home jurisdictions, section 13 V (h) is ambiguous and there is a lack of guidance in Act 511 regarding fees, claim requirements and time limits. There are few specifics regarding the quarterly distribution of nonresident monies in Section 13 V (h) of the Act 511. For instance, Act 511 requires that nonresident monies be distributed quarterly, but there is no deadline.

Lack of Reporting Requirements

Tax collector reporting requirements in Act 511 are weak and clearly not adequate for a system that involves the collection and distribution of almost \$1.7 billion in public funds annually. For example, when the Auditor General's Office investigated complaints about tax collectors not distributing funds, they found there was no audit trail to review. Indeed, there are few requirements for any kind of accountability or disclosure in Act 511.

⁴³ 53 P.S. §6913 IV (b).

⁴⁴ Employers that withhold and remit the tax to employees' home jurisdictions can make mistakes. In addition, out-of-state employers sometimes withhold and remit taxes to the wrong work location.

Section 11 of Act 511,⁴⁵ Audits of Earned Income Taxes, provides that “the governing body of each political subdivision [shall] provide for not less than one examination each year of the books, accounts and records of the income tax collector, by a certified public accountant appointed by the governing body.” There are no statutory standards for the audit, or specifics provided on what is to be audited.

Section 13 V (a)⁴⁶ provides that it is the duty of the tax collector “to keep a record showing the amount received by him from each person or business paying the tax and the date of such receipt.” There are no standards for this reporting or specifics on what is to be reported. There is no requirement for disclosure to taxing jurisdictions or breakdown of monies collected from all sources and all monies disbursed. Nor is there a time period for reports (i.e., weekly, monthly, quarterly or annually), a requirement that they be filed with the taxing jurisdiction or a deadline for filing the reports. There is no tracking or reporting of nonresident monies, fines, late taxes, delinquent accounts or interest on tax monies. In addition, there is no ability for taxing jurisdictions to compare the efficiency of tax collectors or the cost of collection.

Lack of Uniformity

A major reason for the lack of uniformity in the earned income tax system is the ability of each taxing jurisdiction to create its own rules and regulations. This lack of uniformity creates frustration and additional work for employers, tax preparers and tax collectors; unfairness to taxpayers and confusion for everyone. Both tax collectors and employers complain that reports, forms, and municipal and school codes are not uniform or accessible. This results in frequent mistakes in reporting and distribution of taxes. In addition, there is no prescribed formula for allocating income between taxing jurisdictions when taxpayers move in the middle of a tax year.

Delinquent Collection

Some taxing jurisdictions hire separate tax collectors to collect delinquent earned income, per capita or occupation taxes. This process is not addressed in Act 511. A July 2001 report of another inquiry by the Auditor General’s Office identified problems with disclosure by delinquent tax collectors. The inquiry was in response to a complaint regarding delinquent taxes collected by a private tax collector for a school district in Central Pennsylvania. After the school district terminated the tax collector, it discovered that the collector had failed to remit, report and account for delinquent tax payments totaling at least \$22,500. The tax collector remitted the missing funds after being contacted by the Auditor General’s Office.

Although the Auditor General’s Office found many questionable financial practices on the part of the tax collector, it also found substantial weaknesses in the school district’s management and oversight of delinquent tax collection activities, including: lack of a written contract with the delinquent tax collector or written policies or procedures for management or oversight of the delinquent tax collection process. Nevertheless, the

⁴⁵ 53 P.S. §6911.

⁴⁶ 53 P.S. §690913 V (a).

school district indicated that its policies concerning delinquent collectors were no different than those used by most other school districts – a claim supported by similar complaints to the Governor’s Center about the lack of guidance for and oversight of delinquent tax collectors in Act 511.

Compliance Tools

One of the tools that tax collectors use to maximize taxpayer compliance is state personal income tax information from the Department of Revenue. Section 2514.1 of the Public School Code⁴⁷ requires that the Department of Revenue provide to school districts an annual list of all taxpayers who have indicated on their state income tax return that they reside in the school district. The purpose of this provision is to verify that individuals reside in a school district, for purposes of the school subsidy formula.⁴⁸ School districts are required to verify this information within 20 days.

Section 356 of the Tax Reform Code⁴⁹ permits the Department of Revenue to share relevant state income tax records with tax collectors for municipalities and school districts as long as the tax collectors agree to provide confidentiality of the records. The sharing of records is generally limited to school districts, because the Department of Revenue does not keep track of the municipality where a taxpayer resides.

The Department of Revenue will sell to school districts a computerized list of taxpayers claiming residence in the district and relevant earned income tax information.⁵⁰ However, the information is of necessity at least two years old when local tax collectors receive it. A number of collectors have asked if this information could be provided in a timelier manner; however, the Department of Revenue’s ability to respond to these requests is limited by the need to obtain federal tax data and reconcile it with the Department’s records. Some tax collectors have also complained that collectors for school districts do not always share the information with municipalities.

⁴⁷ Act 80 of 1981 (24 P.S. §25-2514.1)

⁴⁸ School districts with a higher proportion of the state’s taxable income receive a lower subsidy amount, so school districts are given an opportunity to remove the names of individuals who they can prove are not residing in their district.

⁴⁹ Act 2 of 1971 (72 P.S. §7356)

⁵⁰ The information includes each taxpayer’s reported address, social security number, and income from compensation and net profits. The cost for a CD is \$200; a magnetic tape, \$300; and printout, \$400.

RECOMMENDATIONS

Coordination, cooperation and uniformity are critical for the success of a complex system that involves the exchange of large amounts of public revenues. Moreover, competence and efficiency on the part of those entrusted with the operation of the system are important for maintaining public confidence and taxpayer compliance. The Governor's Center suggests two options for reducing the administrative burden of the current earned income tax collection system on employers and stemming municipal and school revenue losses:

- (1) State collection of the local earned income tax; or
- (2) Reform of the current system of collecting the earned income tax;

Both of these options would integrate the system, simplify collection, increase local tax revenues and provide significant relief to employers. Both options will require legislation.

State Collection of the Earned Income Tax

State collection of the local earned income tax would be the highest level of consolidation, and the most efficient form of collection from the perspective of most employers and tax preparers. Collection of the local income tax by the Department of Revenue would streamline the system and virtually eliminate problems with coordination and inconsistency among collectors. State collection of local earned income taxes would maximize the simplicity of collection, increase the efficiency and fairness of the system and provide significant relief to employers. Employers would only be required to withhold, report and remit state and local income taxes to one entity. The administrative burden of state and local tax administration on employers would be considerably reduced, and Pennsylvania would no longer stand out as the state with the most complicated and onerous system of state and local income tax collection in the nation.

Nonetheless, the benefits of state collection will not be realized if any local taxing jurisdictions are permitted to opt out and collect the income tax locally. In addition, there are a number of administrative and uniformity issues that need to be addressed if the State Department of Revenue is to collect and administer local income taxes. A discussion of these issues is in on page 46. Also, the cost of state collection needs to be calculated and a means of funding startup costs and recouping operating costs identified before a decision to move to statewide collection could be made.¹ The increase in the

¹ State collection of local income taxes would increase the volume and complexity of income tax collection for the Department of Revenue. The Department of Revenue would need additional phone capacity, office space and administrative staff for processing, analysis and customer service. Additional staff space and resources would be needed to process more complicated forms, distribute and reconcile local income taxes and handle additional inquiries. Also, additional resources would be needed at the Board of Appeals to handle local income tax appeals.

cost of centralized tax administration would be more than offset by the elimination of the cost of income tax administration and collection at the local level.

Preliminary estimates by the Department of Revenue indicate 1 percent of earned income tax revenues would cover the annual cost of state collection; however, different variables will affect the cost such as how often revenues are distributed to local taxing jurisdictions. This estimate also assumes that all the issues raised by the Department on page 46 are addressed.² To the extent that all the issues are not addressed, existing problems with the local collection would be transferred to the state level, and the cost would be higher. If none of the problems with the current system are resolved, it is not clear how much it would cost, and there might not be any cost savings over the current system. One-time upfront funding would also be needed to modify systems and forms and create office space for additional staff.

Reform of the Current System

If the current system of local tax collection is maintained, it should be modernized, streamlined and made more efficient and effective. To accomplish these goals, local tax collection operations should be standardized and consolidated. To create uniformity and cohesiveness across the Commonwealth, definitions and reporting requirements should be clarified and operating procedures should be established where they do not exist. An affordable and accessible enforcement mechanism, including appropriate penalties, is needed to improve accountability and resolve disputes. Finally, education and training are needed to improve income tax collection knowledge and practice among tax collectors and local governments.

The Governor's Center recommends reforms in seven areas to improve the efficiency and operation of the existing earned income tax collection system:

- (1) Consolidation of tax collection operations,
- (2) Employer withholding,
- (3) Distribution of nonresident tax monies,
- (4) Reporting requirements,
- (5) Administration,
- (6) A consistent base of the earned income tax, and
- (7) Education and training.

Most of these recommendations will require changes to Act 511. The provisions governing earned income tax administration in Act 511 have not been revised in a comprehensive manner since 1965. The matrix on page 49 identifies recommendations that will require legislative action.

² In comparison, a January 2004 survey of the members of the Pennsylvania Association of School Business Officials (PASBO) shows that school earned income tax collection costs average 3 percent of earned income tax revenues. PASBO used 160 responses from school districts with an earned income tax to calculate average collection costs.

In addition to the specific recommendations in these seven areas, the Department of Community and Economic Development, in consultation with the Department of Revenue, should be given statutory authority to promulgate regulations regarding the distribution, oversight and management of a reformed earned income tax collection system. Such rule-making authority would provide a more appropriate, flexible and rapid mechanism for fine-tuning and adjusting requirements in the future than amending the law. Standard rules and regulations for both the collection of earned income taxes and the operating procedures of earned income tax offices will make the system more efficient and reduce disputes.

Consolidation

Tax collection should be consolidated on a county-wide basis and taxing jurisdictions should be permitted and strongly encouraged to expand tax collection boundaries to include several counties in a region. Funding should be provided for grants to be made available for the start-up or expansion of nonprofit governmental joint tax collection bureaus operating on county-wide or broader basis.

The Governor's Center recognizes the advantages of local control and determination inherent in the Commonwealth system of local government, but in this case different local rules have created an earned income tax collection system that is fragmented and dysfunctional. The present system has left us with over 80 percent of the collectors collecting for only one or two taxing jurisdictions, and 560 local income tax collectors. If consolidation is going to occur, the Commonwealth needs to be a more active proponent. It is critical to remember that in this regard that the tax collector appointed by each taxing jurisdiction directly affects earned income tax collection in other taxing jurisdictions. Consolidation will generate more cooperation and make the system easier, more efficient and more effective for taxpayers, employers, taxing jurisdictions and tax collectors.

Consolidation will reduce inter-office disputes and improve cash flow to municipalities and school districts. In addition, consolidation will eliminate duplication, reduce administrative and overhead costs and achieve economies of scale. Increased efficiencies realized through consolidation will free resources that can be used to increase sophistication and capacity, making operations still more effective and efficient. As a result, tax revenues for local jurisdictions will increase and help reduce the need for property tax increases.

Consolidation will also mean more uniform service to taxpayers and employers, and better communication among tax collectors. Moreover, county-wide consolidation will equalize the size and resources of tax collectors, further advancing cooperation among collectors.

Consolidation will simplify withholding for employers by reducing the number of local tax collectors with they must do business, which will improve Pennsylvania's business climate. Fewer collectors will also mean fewer problems with coordination and distribution of nonresident tax monies.

To minimize the division of taxing jurisdictions, school districts that cross county lines should be included in the county in which a majority of the people in the district lives. Similarly, municipalities that are in two or more school districts should be included in the school district in which a majority of the people in the municipality lives.

Tax collection is already consolidated on a county-wide basis in ten counties.

Consolidation is nearly a reality in another 26 counties. In the remaining 30 counties, there are many different ways that county-wide consolidation could be structured and accomplished. For instance, each taxing jurisdiction imposing an earned income tax within a county could be given one vote in the selection of the county's tax collector. Alternatively, each taxing jurisdiction could be given a vote weighed by its population. Whatever process is used, it should ensure that all taxing jurisdictions are adequately represented so they can ensure that the tax collector chosen is responsive to their needs.³

No matter what alternative is chosen, an entity or entities with sufficient authority and interest in consolidation, such as county commissioners, are needed to oversee the consolidation process in each area. In addition, a deadline and a default provision, such as court intervention, are needed if the taxing jurisdictions in an area are unable to agree on a tax collector, tax collector responsibilities and tax collector remuneration.⁴

One of the main advantages of county-wide collection is that county boundaries are more commonly used and known by taxpayers and employers than school district boundaries. There is at least one municipality in each county that levies an earned income tax, but there are 37 school districts that do not levy an earned income tax. Neither the school district nor its municipalities levy an earned income tax in 21 of those school districts. This recommendation would dramatically reduce the number of earned income tax collectors in the Commonwealth from about 560 to no more than 66.

The Governor's Center believes that efficiency and simplicity are lost if the number of tax collectors is not reduced below 66. In addition, problems with coordination, uniformity and tax distribution will be reduced considerably if the number of collectors is reduced below 66. Moreover, a few of the recommendations in this report, such as reciprocal tax information sharing with the Department of Revenue, will not be practical if the number of collectors is not reduced below 66.

³ Another alternative that has been proposed by both tax collector organizations (PEITOAC and LITA) is to require the collection of earned income taxes on a school district basis. Collection on a school district basis is not recommended because the number of collectors would only be reduced from about 560 to approximately 300, instead of 66 with county-wide collection.

⁴ Act 12 of 1997, which amends the Second Class County Code, Act 230 of 1961, (16 P.S. §1301 *et seq.*) mandated that Penn Hills Township and Penn Hills School District agree on the appointment of a joint tax collector. The Act provided for arbitration if the township and school district could not agree, and the appointment of one tax collection by the court of common pleas if the arbitration failed. Apparently this Act has not achieved joint collection between Penn Hills Township and its school district, because in 2001, Representative DeLuca introduced House Bill 1298 to require that Penn Hills Township use the school district's tax collector. Although this bill passed the House, it died in the Senate in the 2001-2002 Legislative Session. A similar bill, House Bill 197, was introduced in 2003, which has passed the House and was under consideration in the Senate Appropriations Committee as June 2004.

Finally, only six other states permit local collection of income taxes and three of those states limit local collection to major cities. Reducing the number of collectors from 560 to 66 or less would show multi-state employers that Pennsylvania wants to reduce their burden, and improve Pennsylvania's business climate.

Grants should be made available for existing joint collection agencies to receive training and purchase software and hardware needed to further computerize their operations and make greater use of the Internet. Additional funding for peer-to-peer assistance⁵ to local taxing jurisdictions interested in pursuing a joint tax collection operation or jointly negotiating with a private collector to collect for all taxing jurisdictions within a county should also be provided.

Withholding

Withholding requirements should be made uniform by mandating that employers withhold both resident and nonresident taxes and remit the withheld taxes to the jurisdiction where the employers' workplace is located. Tax collectors should be required to distribute nonresident tax monies to resident taxing jurisdictions where appropriate, and be adequately compensated for this service, ideally through the imposition of a uniform fee on taxes distributed. Employers should continue to be required only to remit taxes withheld to the jurisdiction where their workplace is located, but at the appropriate rate for where the employee lives and works. The *Earned Income Tax Register* should be enhanced to furnish consolidated withholding information to employers.

Uniform withholding rules will streamline the process for withholding, distributing and paying taxes. Employers will only be required to withhold, remit and report to one local tax collector. In addition, Pennsylvania residents will no longer have to choose between making estimated payments of the local earned income tax and paying a substantial amount at the end of the year. Uniform withholding will reduce overpayments and underpayments, ease cash flow problems for taxpayers and taxing jurisdictions, and be more efficient for taxpayers, employers, taxing jurisdictions and tax collectors.

Currently many large employers withhold and remit directly to each employee's home jurisdiction as a service to their employees, although this practice is not specifically authorized in Act 511. If tax collection is consolidated on a county-wide basis and nonresident withholding and distribution required, it will be no longer be necessary for employers to provide this service.

Earned Income Tax Register

The 2004-05 Budget Request includes \$550,000 to modernize the *Earned Income Tax Register*. Part of the funding will be used make the *Register* more user-friendly by providing employers with an online summary of tax information based on the employee's

⁵ The peer-to-peer program matches experienced professionals with taxing jurisdictions in need of assistance and expertise.

home and workplace addresses. This information will include:

- The municipality and school district in which the employee lives,
- The municipality in which the employee works,
- Applicable earned income tax rates for each jurisdiction,
- The required rate of withholding for the employee,
- Relevant contact information for the tax collector where withheld taxes should be remitted.

This will require linking the information on the *Register* with a statewide database that identifies taxpayers' municipalities and school districts from their street addresses.¹ An enhanced *Register* will make withholding compliance much easier for employers. Making this information available will also help tax collectors to distribute nonresident funds quickly and accurately. An enhanced *Register* will be a significant improvement to the business climate because it will make the earned income tax collection process more user-friendly and streamlined for business. An enhanced *Register* is essential if employers are required to withhold at a tax rate based on where their employees live rather than where they work.

Changes are also needed to consolidate the *Register* requirements in Act 511, Act 50 and future laws authorizing additional local income taxes.² These changes should better synchronize the *Register* with municipal and school tax years and provide employers with enough time before the withholding changes are effective to change their payroll programs. Deadlines should take into consideration the needs of employers, tax collectors and local taxing jurisdictions.

Rates should be released semi-annually. Rates effective July 1 (when the school district tax year begins) should be available on the *Register* on June 15, and rates effective January 1 (when the municipal tax year begins) should be available on December 10. In between, the Governor's Center should update the *Register* with any other changes on a continuous basis; however, employers should only be required to withhold based on the rates in the *Register* on June 15 and December 10. Political subdivisions that want new or increased earned income taxes to be withheld starting on July 1 or January 1 should be required to notify the Governor's Center by November 10 if effective January 1, and

¹ A number of other state agencies, such as the State Department of Transportation, the State Police and PEMA, use or contract for geo-code address references and municipal and school district boundaries that the Center should be able to link to the *Register*.

² Section 9 of Act 511 (53 P.S. §6909) requires that taxing jurisdictions furnish their tax rates to the Department of Community and Economic Development by May 31, and that the *Register* be available by July 1. Act 50 of 1998 (Chapter 87 of Title 53 of the Pennsylvania Consolidated Statutes) requires that school districts furnish new or changed Act 50 tax rates to the Department by July 15 of each year, and that the *Register* be available by August 15. Currently, the Center updates the *Register* with the new tax rates by July 1, and on a continuous basis for the remainder of the year. The Center uses a *Tax Information Form* for municipalities and school districts to report earned income tax rates, as well as other tax rates, for the *Register* and other purposes. Municipalities, which utilize a January 1 to December 31 fiscal year, are required to submit their *Tax Information Forms* to the Center by January 15 of each year. School districts, which utilize a July 1 to June 30 fiscal year, are required to submit their forms to the Center by June 15.

June 1 if effective July 1, so the Governor's Center can make the rates available by June 15 and December 10.

The recommended deadlines (June 1 or November 10) for school districts and municipalities to submit new tax rates occur before budget deadlines (June 30 and December 31) for the following reasons:

- Changes to the earned income tax are usually known in advance since they must be submitted in advance to the voters or the courts for approval;
- Most local taxing jurisdictions will not be changing their earned income tax rates. Unlike property tax rates, earned income tax rates are not raised frequently, and are reconciled at the end of the year. It makes more sense to delay withholding for the minority of taxing jurisdictions, which do not meet the deadline, than the majority of jurisdictions, which approve new rates ahead of time or do not change their earned income rate; and
- Requiring employers to check the Register more than twice a year would be onerous.

Distribution of Nonresident Tax Monies

Act 511 should be amended to clearly require that tax monies collected by the jurisdiction where a taxpayer works be promptly forwarded to the proper taxing jurisdiction, and that tax collectors be adequately but uniformly compensated for this additional work. In addition, forms should be standardized. Under Act 511, the earned income tax is collected where an individual works but usually is due to the municipality and school district where the individual lives. Since most individuals live and work in different jurisdictions in Pennsylvania, earned income tax collection usually involves several taxing jurisdictions. Moreover, approximately 2.3 percent of Pennsylvania residents move between counties in the Commonwealth annually, emphasizing the need for coordination among tax collectors, coordination that is absent in many parts of the State. To make distribution easier, additional information should be provided from employers, and tax collectors should be required to use standard forms and procedures. In addition, penalties and an enforcement mechanism are needed to make sure tax collectors are following the law.³

Distribution

Nonresident monies should be distributed 30 days after employers are required to remit withheld taxes under section 13 IV (b).⁴ Clearer parameters are needed for distributing nonresident tax monies. Under the present system, there is an incentive to hold nonresident funds, because interest can be earned on such funds and no penalties accrue for non-distribution. Because the majority of the work in this process can be automated, a 30-day requirement is reasonable. However, tax collectors should be given an additional 60 days to distribute tax monies where there is inadequate or incorrect

³ Recommendations for penalties and an enforcement mechanism are on pages 41 and 42.

⁴ Section 13 IV (b) requires employers to remit withheld taxes by April 30, July 31, October 31 and January 31.

information for identifying the nonresident taxing jurisdiction. In addition, response time to claims for nonresident tax monies should be 30 days. Furthermore, tax collectors should be required to distribute actual rather than estimated taxes to other jurisdictions.

Fees

Tax collectors should be compensated with a uniform fee for collecting and distributing nonresident tax monies. Municipalities should be given some form of compensation for the additional work involved in the handling and distribution of nonresident monies, ideally through a flat fee.⁵ Fees should be uniform across the Commonwealth. Some have argued that interest earned on nonresident funds is sufficient compensation; however, this form of compensation is inconsistent and, as discussed above, creates incentives to delay the distribution of funds.⁶

Time Limits

A uniform seven-year time limit on claims for nonresident tax monies should be established.⁷ It makes sense to provide a reasonable statutory time limit on claims for nonresident tax monies so there is some finality for the nonresident collector; however, an unreasonably short statute of limitations will result in some earned income tax funds never being distributed to the appropriate local jurisdiction. A seven-year time limit would coincide with the schedule established under the Municipal Records Act.⁸ In addition, Act 511 should be amended to clearly override Act 162 of 1943,⁹ which requires that claims for refunds of taxes erroneously paid directly to a political subdivision be made within three years.

Uniform Forms

Tax collectors should be required to use uniform distribution, claims and response forms for nonresident tax monies. Distribution forms should include the tax year, the reporting period and the taxpayer's name, address, social security number, tax year, employer and tax amount and when monies were distributed. To further improve identification and remittance of nonresident tax monies, tax collectors should be required to use the Department of Community and Economic Development's municipal and school district codes. Tax collectors should be required to use distribution forms so tax monies can be tracked. The Governor's Center should develop uniform distribution, claims and response forms with the assistance of the Pennsylvania Earned Income Tax Officers, Administrators and Collectors Association (PEITOC) and the Local Earned Income Tax

⁵ A flat fee per taxpayer is recommended over a percentage fee on taxes distributed because a flat fee would be fairer and less costly. A percentage approach is not directly related to work load; rather, it is based on the income of individual nonresident taxpayers. Large individual nonresident tax remittances would produce more income for tax collectors while the workload would remain unchanged. However, a small percentage fee might be easier for tax collectors to determine and administer.

⁶ Others argue that fees will add to the cost of collection and create more bookkeeping. They also argue that fees will shortchange jurisdictions if refunds are necessary, since the taxpayer's home jurisdiction will be required to pay a fee for the distribution of the taxes to the taxpayer's work jurisdiction, but will not be able to recoup the fee from the taxpayer.

⁷ However, there should be no time limit in cases of fraud or misrepresentation.

⁸ 53 Pa.C.S. §1381 *et seq.*

⁹ 72 P.S. §55566 (b)

Association (LITA). The provision in Section 13 V (h) of Act 511¹⁰ that requires that tax collectors distribute unclaimed monies after a year to the municipality from which the tax was collected should remain in effect.

Residency Considerations

A procedure to deal with taxpayers who move to another taxing jurisdiction or otherwise change their domicile within Pennsylvania during a calendar year should be developed. Uniform rules for prorating taxes between municipalities should be established. There are essentially two choices for dealing with taxpayers who move. The simplest method for administrative purposes would be to pick a date, December 31st for example, to set residency for both the assigning of income and determining the rate to be applied. The second and more complex method is to allow for the pro-ration of income based on the exact dates of residency. By establishing a process for handling claims involving two taxing jurisdictions, the process for splitting taxes will be simplified for the taxpayer and tax collectors.

Employer Quarterly Returns

A quarterly form that corresponds with Federal Form 941 should be developed. Section 13 IV (b) of Act 511 should be amended to require that the employee's complete address, rather than the political subdivision imposing the tax, be included in the quarterly returns to reduce mistakes when identifying the jurisdiction where an employee lives. Presently, Section 13 IV (b) of Act 511¹¹ requires that employers file a return and remit earned income taxes quarterly. The quarterly return must include each employee's name, social security number, income for the quarter and tax withheld, as well as the political subdivision imposing the tax on the employee, but not the employee's postal address. Including the employee's complete address will ease distribution, because the political subdivision listed by employers is frequently wrong, and most tax collectors can determine the municipality and school district where a taxpayer resides from a postal address. Again, for consistency and uniformity, employers should be required to use the Department of Community and Economic Development's municipal and school district codes, which are available on the department's website. In addition, the reporting period and tax year should be specified on the return.

Employee W-2's

The withholding statement required under Section 13 IV (c)(2)¹² of Act 511 should also require that employers list the municipality to which the withheld taxes are remitted. Including this information on an employee's W-2 would clearly identify where tax monies were remitted, allowing tax collectors to track nonresident monies that have not been received from other tax collectors.¹³ Since there is limited space on the W-2 Form, PEITOAC and the Pennsylvania Institute of Certified Public Accountants (PICPA)

¹⁰ 53 P.S. §6913 V (h)

¹¹ 53 P.S. §6913 IV (h).

¹² 53 P.S. §6913 IV (c)(2).

¹³ *Reg. §31.6051-1(a)(1)(i), LK:NON: FEDREG S31.6051-1(A)(1)*; Instructions for Form W-2, Wage and Tax Statement (2003); *Announcement 90-99 LK:NON:RULINK ANN90-99, 1990-35 I.R.B. 71 (23)* provides for the optional inclusion of state and local tax information on the W-2.

should work with the Department of Revenue to determine how this information can be added succinctly to the W-2. This action, combined with uniform distribution, claims and response forms, as well as the addition of an employee's address to the quarterly returns, would help streamline and simplify the claims process, which will help to resolve and reduce tax disputes.

Certificate of Residence

An addendum to the Federal W-4 (Employee's Withholding Allowance Certificate) Form should be required to help identify where a taxpayer lives. The information on the addendum would be similar to the information included in the Certificate of Residence sample form developed by the Governor's Center. Employers should make these forms available to the tax collector where the employer remits taxes withheld and, upon request, to the tax collector where the taxpayer lives. Uniform adoption of this form would improve withholding and distribution by providing better information to help employers and tax collectors identify municipalities and school districts.

Reporting Requirements

Act 511's reporting and audit requirements for earned income tax collection need to be strengthened. While such obligations should not become so burdensome to the local tax collector that the cost of collection increases substantially, the reporting and audit requirements must provide enough information to allow public and taxing jurisdictions to promptly and accurately track the flow of public monies. In that regard, the following recommendations are made:

Monthly Reports

Earned income tax collectors should be required to provide local taxing jurisdictions with standardized monthly reports. This recommendation is consistent with the Auditor General's recommendation that political subdivisions should require that their tax collectors provide monthly reports to show all sources, amounts and dates of tax funds received, what is due to other taxing authorities, and distributions, as well as refunds, recoveries and overpayments. Such monthly reports would be similar to the reports required for real estate tax collectors under Section 25 of the Local Tax Collection Law.¹⁴ Taxing jurisdictions should be given the authority to impose fees for late reports and noncompliance. A standardized report should be developed that includes information for the prior month and year, such as:

- Taxes collected,
- Penalties and interest,
- Delinquent taxes,
- Interest from investment of tax receipts,
- Other revenues,
- Nonresident tax monies received,
- Nonresident tax monies distributed,

¹⁴ The Local Tax Collection Law, Act 394 of 1945 (72 P.S. §5511 *et seq.*).

- Costs of collection,
- Refunds,
- Disclosure of the amount of bonding under Section 13 V (b) of Act 511, and
- Any other information determined necessary for the proper functioning of the system.

The amount of interest earned on public tax monies should be disclosed to taxing jurisdictions.¹⁵ Standardized monthly reports will help local governments better understand the taxes that are remitted to them, as well as provide information necessary to comply with GASB 34.¹⁶

Audits of Earned Income Taxes

Section 11 of Act 511¹⁷ should be amended to require that the annual audit be done according to generally accepted government auditing standards and include a financial statement, compliance reporting and a management letter.¹⁸ The audit, which should be prepared for each tax collector at the tax collector's expense, should be provided to each taxing jurisdiction that uses that collector.¹⁹ For private, for-profit tax collectors, the audit should only include the "public side" of the tax collector's operation, that is, the receipt and dispensation of all public monies, including collection costs, by the tax collector. The corporate part of the collector's operation, such as payroll and other proprietary information, should not be subject to the audit.

More thorough audits will provide essential public management information for taxing authorities and their taxpayers, and will supplement the information needed to resolve disputes among tax collectors and taxing jurisdictions.

Annual Reports

Taxing jurisdictions should be required to complete a standardized annual report on tax collection activities. The Governor's Center should work with the associations representing local taxing jurisdictions, tax collectors and CPAs to develop a short list of standard questions that could be added to existing forms filed with the Governor's Center. Reports should include sufficient information for the Governor's Center to identify trends and compare the costs of collection among tax collectors. This

¹⁵ This recommendation is only that interest earned on tax monies be disclosed, and not that tax collectors be prohibited from earning interest on tax monies, or be required to forward any interest earned to taxing jurisdictions. Local taxing jurisdictions should be able to negotiate with tax collectors regarding whether or not interest earned on tax monies should be forwarded to taxing jurisdictions.

¹⁶ Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, which took effect June 15, 2003 for most local governments.

¹⁷ 53 P.S. §6911.

¹⁸ A synopsis that is prepared for management of issues identified in the course of an audit.

¹⁹ The January 2002 Report from the Auditor General's Office recommended that audit reports include listings of all earned income tax funds collected or held for distribution to other taxing authorities, the period of time such funds have been held, the reason the funds have been held, the reasons for holding the funds, and the interest earned on the funds.

information should be consistent with information provided in the monthly reports to taxing jurisdictions and verified by the annual audits under Section 11 of Act 511. The Governor's Center should publish selected data from these reports.

Administration

Statutory requirements and procedures for the administration and enforcement of the earned income tax collection system should be revised and standardized. In addition, penalties should be established for violations of Act 511 and an appeals process should be created. In that regard, the following changes are recommended:

Contracts

All taxing jurisdictions contracting with private collectors should be required to enter into written contracts. The Commonwealth should develop a template for contracts between taxing jurisdictions and tax collectors.

Rules and Regulations

Uniform minimum standards governing the administration and operation of earned income tax collectors should be adopted. Section 13 V (c) of Act 511²⁰ empowers tax collectors to adopt rules and regulations and provides that they are not enforceable unless approved by the taxing jurisdiction. In addition, the Local Taxpayer Bill of Rights Act requires that taxing jurisdictions adopt rules and regulations governing the practice and procedure for the administration, collection and appeals process for the earned income tax.²¹ Clear, accessible and uniform rules and regulations will benefit taxpayers, taxing jurisdictions and tax collectors. Minimum standards for such rules and regulations could be developed by the Governor's Center with the assistance of PEITOAC and LITA. Taxing jurisdictions should be able to adopt procedures exceeding but not conflicting with the minimum standards, including the establishment of appeals processes under the Local Taxpayer Bill of Rights Act.

Uniform Tax Return

Taxing jurisdictions should be required to use a uniform tax return form for earned income taxes. The Commonwealth should develop this form. Uniform tax returns will make collection easier, more streamlined and less confusing for tax collectors, tax preparers and taxpayers. A standard final return would provide clarity and uniformity and eliminate the need for tax collectors to develop their own forms, especially when tax rates change or taxpayers move within the Commonwealth.

Oversight

The Governor's Center and the Department of Education should undertake an outreach program to educate taxing jurisdictions regarding their responsibilities with regard to earned income tax collection. The relationship between a taxing jurisdiction and its collector involves other jurisdictions through the collection of nonresident taxes, and frequently significant taxpayer funds are involved. There are considerable weaknesses in

²⁰ 53 P.S. §6913 V (c).

²¹ 53 Pa.C.S. §8432.

the management and oversight of tax collection activities by local taxing jurisdictions throughout the Commonwealth. Ideally, the outreach program will encourage taxing jurisdictions to become more involved in the oversight, management and operation of their tax collection offices. Significant opportunities exist for taxing jurisdictions to maximize their revenues through closer monitoring of tax collection and the investment of tax revenues.

Compliance

The Department of Revenue should work with earned income tax collectors to develop a technology-based information exchange system. Better compliance could be achieved for both state and local governments by developing a reciprocal electronic tax information sharing system between the Pennsylvania Department of Revenue and local earned income tax collectors that provides more timely information. Because of security and confidentiality considerations, this kind of sharing is only feasible if the number of tax collectors is reduced to drastically.

Bonds

Information on tax collectors' bonds should be available to the public and other taxing jurisdictions to ensure bond amounts are adequate. Section 13-V (b) of Act 511 should be amended to require that copies of bonds be filed with each taxing jurisdiction and be made available upon request to those taxing jurisdictions and tax collectors who are dependent upon the collector for nonresident distributions.²² Some bonding problems occur due to a lack of oversight by taxing jurisdictions and a lack of disclosure by tax collectors. Therefore, taxing authorities should be permitted and encouraged to review and adjust the bond amount annually based upon monthly reports and the annual audit. In addition, as part of the annual examination under Section 11 of Act 511, auditors should confirm that the amount of each tax collector's bonds complies with Section 13 V. Bonds should be written in favor of resident as well as nonresident taxing jurisdictions, where there are nonresident taxes. Failure to obtain or maintain adequate bonding should be cause for prohibiting a tax collector from collecting public funds.

Record Retention

Act 511 should be amended to clarify that all tax collection records are the property of the taxing jurisdiction in which taxes are collected. In addition, tax collectors should be required to retain records for at least seven years, consistent with the guidelines issued by the Pennsylvania Historical and Museum Commission's Local Government Records Committee under the Municipal Records Act.²³

²² Section 13 V (b) (53 P.S. §6913 V (b)) provides that tax collectors carry bonds to cover the maximum amount of taxes that may be in their possession at one time. In effect, this provision ties the amount of the bond to the exposure or the time period for which a collector retains control over any non-deposited or non-invested cash or funds. Those collectors who remit funds daily do not have as great an exposure as those who remit funds weekly or less often, and therefore do not need as much bond coverage. Section 13 V (b) also provides that bonds are for the use of other persons for whom tax monies are collected, so bonds should cover taxing jurisdictions dependent upon nonresident monies.

²³ 53 Pa.C.S. §1381 *et seq.*

Tax Collector Penalties

Act 511 should be amended to establish tax collector fines and penalties for violations of Act 511. Violations would include not disclosing information, not remitting nonresident monies on time, imposing time limits on tax claims by other tax collectors, improperly imposing fees on claims by other tax collectors, or otherwise violating the provisions of Act 511. Since violations can involve significant amounts of taxes, the penalties for violations should be substantial. Section 13 IX of Act 511²⁴ establishes fines and penalties for taxpayers and employers not disclosing or remitting taxes, but does not establish fines for tax collectors violating its provisions. Consideration should be given to prohibiting from collecting public monies tax collectors who repeatedly violate the law or commit fraud.

Arbitration and Enforcement

The Commonwealth's Board of Finance and Revenue should be given jurisdiction to hear and arbitrate complaints from aggrieved tax collectors, municipalities and employers concerning earned income tax issues. The Board of Finance and Revenue, which is composed of five cabinet-level officials and chaired by the State Treasurer, reviews and decides on appeals of tax assessments and settlements made by the Department of Revenue and the Auditor General. In addition to ruling on earned income tax complaints from tax collectors, municipalities and employers, the Board should be given the authority to impose fines and penalties on tax collectors for violations. The Board should be given subpoena power and the authority to assign costs for its proceedings, including investigation and other costs, to the appropriate party.

Earned Income Tax Base

The definitions of earned income and net profits should be revised to more closely mirror the state income tax definitions of compensation and net profits. While Act 166 significantly simplifies earned income tax administration, the system could be made even clearer and simpler if the statute referred to specific items on the Pennsylvania Income Tax Return (PA-40) and defined both types of income as income that is “returned to and ascertained by the Department of Revenue.”²⁵

If the definition of earned income referred to “net compensation” reportable on line 1c of the PA-40,²⁶ and the definition of net profits referred to “net income or loss from the

²⁴ 53 P.S. §6913 IX.

²⁵ The Department of Revenue's assessment should govern the local income definition. Decisions about how much taxable income an individual has should be determined by the Department of Revenue's assessment and the only way to challenge that assessment should be to file an appeal through the process for appealing the state personal income tax assessments.

²⁶ The statutory definition should also include “or the comparable reporting item for “net compensation” on such other form as the Department of Revenue may from time to time promulgate for use in filing returns for the Pennsylvania Income Tax.”

operation of a business, profession or farm” reportable on PA –40 line 4,²⁷ employers, taxpayers, tax preparers and tax collectors would have a clearer and more concrete reference than the current definitions which are ambiguous and subject to interpretation. Likewise, if it would be preferable for exemptions (clergy housing, active-duty military pay and some farming income) from the local tax to be either added to the state definition or eliminated, so that the definitions remain uniform.

The only item of earned income subject to Act 511 for which it would not be practical simply to refer to a specific item on the Pennsylvania Income Tax Return is “rental income.” “Rental income” for purposes of the Pennsylvania Income Tax includes both passive rental income, such as rental income arising from an individual’s ownership of interests in a real estate investment trust, which is not subject to the earned income tax under Act 511, and rental income arising from real estate actively managed by the taxpayer, which is subject to the earned income tax under Act 511. To deal with this situation, Act 511 should define "rental income" as "net income from rents, royalties, patents or copyrights" reportable on line 6 of the PA-40.

The Department of Revenue should be designated the statewide arbiter of what is taxable and not taxable at the local level and charged with providing basic information on what types of compensation and net profits are taxable at the local level. These changes would greatly simplify local tax administration and compliance for taxpayers, tax collectors, employers, accountants and payroll consultants. In addition, the local audit process would be easier and more effective if state and local definitions of compensation and net profits were identical. Decisions about the amount of a taxpayer’s taxable income should be determined by the Department of Revenue assessment, so that the only way to challenge taxable income is to file an appeal against a taxpayer’s state taxable income with the Department of Revenue’s Board of Appeals.

Education and Training

The Governor’s Center should work with the Department of Education, the Department of Revenue and the associations representing municipalities, school districts and tax collectors to develop educational materials and provide classroom and web-based training to taxing jurisdictions and tax collectors. Training for taxing jurisdictions should include management and oversight of tax collectors and any new and/or existing requirements in Act 511. Training for tax collectors should include the requirements in Act 511, relevant case law, techniques for maximizing collections and revenues, and basic and advanced income tax law and accounting. The Governor’s Center should also work with PEITOAC and LITA to develop the training curriculum, to identify and compile best practices in the field and to develop model tax collector contracts.

²⁷ The statutory definition should also include “or the comparable reporting item for “net income or loss from the operation of a business, profession or farm” on such other form as the Department of Revenue may from time to time promulgate for use in filing returns for the Pennsylvania Income Tax.”

CONCLUSION

The present system of earned income tax collection is seriously flawed and in need of repair. Either state collection or county-wide collection will improve the efficiency of the system and ease the administrative burden of the local tax system on employers. Both will eliminate duplication of effort and be more cohesive. Whichever option is chosen, local tax collection and administration need to be made more uniform and streamlined. To succeed, both options require standardized reporting and definitions, clearly defined administrative procedures and dispute resolution processes.

State collection of local income taxes would create the fairest and most efficient system for the taxpayers of the Commonwealth. Income tax collection would be more fully consolidated and streamlined. Central administration of local income tax would provide more uniform tax administration and customer service. Taxpayers would only be required to file one income tax return instead of two or three. Employers would only have to withhold and report to one collector in the State instead of two or more. Most jurisdictions would likely receive more tax money at a lower cost.

County-wide consolidation would provide some of the same advantages that state collection provides. Local taxing jurisdictions would receive tax monies more quickly and on a more frequent basis.¹ Collectors would likely be more accessible to taxpayers and more responsive to the needs of municipalities and school districts. Although administration would not be as uniform, it would be less complicated than combining state and local taxes, which tax different types of income. In addition, county-wide consolidation would require a less disruptive and less difficult transition, because local collection is already completely or partially centralized in 36 counties.

The recommendations in this report are intended to be a basis on which the Administration and Legislature can proceed with appropriate legislative and policy changes. Either option will go a long way toward making the system more business friendly and preventing the loss of revenues. The Governor's Center recommends that legislation to overhaul the local income tax system be addressed as soon as possible, since the Homeowner Tax Relief Act (Act 72 of 2004) will place a much greater reliance on the local income tax and the existing tax collection system is not likely to withstand the additional strain.

The 2004-05 Budget Request includes funding to modernize the *Earned Income Tax Register* maintained by the Governor's Center. This change will enable employers to determine more accurately and easily the individual tax rates at which to withhold for their employees. This is a sound investment in a system that should assist in facilitating property tax relief and in the Department of Community and Economic Development's efforts to market a business-friendly environment.

¹ Tax distributions to local jurisdictions from local collectors vary from daily to once a quarter. Most likely, the Department of Revenue would distribute local tax monies quarterly and it would take more time to complete distributions for the entire State than it would for a smaller region of the State.

APPENDIX

Issues with State Collection

Many of the same issues that need to be addressed if the earned income tax collection system is reformed also exist if the Commonwealth collects the local tax, including:

- ***The Definition of Earned Income.*** Alignment of the state and local tax bases, described on page 42 to achieve more effective local collection;
- ***Residency Considerations.*** Allocating income when taxpayers move in the middle of a tax year described on page 36; and
- ***The Earned Income Tax Register.*** Relying on postal addresses and the *Register* for correct tax rates for each municipality and school district described on page 34.

There are a number of other administrative and uniformity issues described below that need to be addressed if the State is to collect and administer local income taxes.

Credits. Alignment of state and local credits will make State collection more efficient. The largest and most widely used credit on the state level is the Special Tax Provision for Poverty (SP), or what is also commonly referred to as Tax Forgiveness. Under Act 511, local taxing jurisdictions can exempt taxpayers whose income is less than \$10,000. By incorporating state tax credits at the local level, additional printing, administration and customer service costs will be prevented, and taxpayer confusion will be minimized. However, adopting the SP credit could reduce local tax collections by more than 3.9 percent in poorer school districts. While a portion of the revenue reduction is against unearned income, which is not taxable at the local level, the cost of local governments providing this credit must be balanced against the efficiency gained from adoption of this credit at the local level.

Domicile. The definition of domicile at the local level, which is used to determine residency, will need to follow the state definition if the State is to collect the local tax. Act 511 defines domicile as “the place where one lives and has his permanent home and to which he has the intention of returning whenever absent.” The definition of domicile is similar at the state level, but much more detailed. The definition of domicile for local tax purposes should mirror state law and regulations.

Electronic Filing. Large employers are required to withhold the state personal income tax and file reports electronically. To expedite distribution of monies to local taxing authorities and minimize the administrative burden on the Department of Revenue, these employers should also be required to use electronic filing and withholding for local income taxes.

Joint Returns. As a convenience to taxpayers, the Department of Revenue accepts joint returns from married couples. The Commonwealth allows taxpayers to file their tax returns on the same form, but unlike the federal government, does not allow taxpayers to file losses against each other's income. Nonetheless, joint returns facilitate the ability of taxpayers to file state and federal joint returns electronically. At the local level, some administrators accept joint or combined returns, while others do not. Failure to allow joint returns for local taxes would fragment and complicate state tax collection and increase the volume of returns. Therefore, if the state is to collect the local tax, taxpayers that file joint state income tax returns should be required to file joint local returns.

Appeals Process. The process for appeals is another issue that must be addressed if the State is to collect the local tax. Currently, the appeals process for the local income tax is broken down into two parts. First, there is an administrative process, which may be performed through a hearing officer or appeal board appointed by the taxing authority. That decision can then be appealed to the county Court Of Common Pleas. By contrast, the appeals system for state income tax begins with the Department of Revenue's Board of Appeals, then moves to the Board of Finance and Revenue, and finally to Commonwealth Court. These processes should be aligned, so there is consistency in decisions.

Tax Rate Changes. Changes to local tax rates that are made in the middle of the year will create administrative difficulties for the Department of Revenue. The Pennsylvania Income Tax Return would become extremely complicated, and more staff would be needed to reconcile rates with taxes withheld and collect underpaid taxes, greatly increasing administrative requirements for the Department of Revenue. Therefore, local taxing jurisdictions should be required to set their rates on January 1st of each year and prohibited from making mid-year rate adjustments.

Delinquent Tax Collection. If the State collects local income taxes, a formula for allocating delinquent income taxes collected by the Department of Revenue between the State, school district and municipality would need to be developed. For example, if the taxpayer owes the state \$1,000 and local taxing authorities \$500, and sends in a check for \$200, there should be a method for allocating the monies. The monies should be apportioned based on tax liability.

Offsets. The Department of Revenue currently runs two major offset programs. The first program is with the Internal Revenue Service (IRS). The Department of Revenue and the IRS offset each other's tax delinquency when the individual has a refund. For the second program, the Department of Revenue intercepts refunds from taxpayers who are delinquent in their child support, and forwards the funds to Department of Public Welfare. To minimize administrative costs, these offsets would also need to apply to local income taxes collected by the Department of Revenue.

Appeals. An appeals process would be needed to handle disputes between a local taxing authority and the Department of Revenue. Under current law, the Department of Revenue provides the Department of Education with a list of taxpayers residing in each

school district based upon the school district codes that individuals select on their Pennsylvania personal income tax return. That list is often disputed. No matter how accurate the address database used by the Department of Revenue to determine in which municipality and school district each taxpayer lives, similar issues will occur if the Department of Revenue administers the local income tax. Therefore, a process for resolving disputes will need to be developed and a sophisticated geo-coding system would be required so that municipal and school codes are correct.

Other State Agencies. Two other state agencies are involved with the administration of personal income tax that will need to be considered if the State collects the local income tax. First, the State Treasurer should be authorized to write refund checks for the local income tax. And, second, the Department of Revenue should be authorized to refer local income tax collection cases to the Office of Attorney General for enforcement.

Summary of Recommendations

<i>Recommendation</i>	<i>Statutory Change</i>	<i>Administrative Action</i>
1. Consolidation		
a. County-wide Consolidation	X	
2. Withholding		
a. Uniform Withholding Requirements	X	
b. Earned Income Tax Register	X	X
3. Distribution of Nonresident Tax Monies		
a. Distribution Deadline	X	
b. Uniform Fee	X	
c. Time Limits	X	
d. Uniform Forms	X	X
e. Residency Considerations	X	
f. Employer Quarterly Returns	X	
g. Employee W-2's	X	X
h. Certificate of Residence	X	X
4. Reporting and Audit Requirements		
a. Monthly Reports	X	X
b. Annual Audits	X	
c. Annual Reports	X	X
5. Administration		
a. Contracts	X	X
b. Rules and Regulations	X	X
c. Uniform Final Return	X	X
d. Oversight		X
e. Compliance		X
f. Bonds	X	
g. Record Retention	X	
h. Tax Collector Penalties	X	
i. Arbitration and Enforcement	X	
6. Earned Income Tax Base		
a. Mirror state definition of compensation and net profits	X	
7. Provide Education and Training For Taxing Jurisdictions and Tax Collectors		
a. Education and Training Program		X

Glossary

Act 166 of 2002	Act 166 of 2002 generally incorporates the definitions of “compensation” and “net profits” from the Pennsylvania personal income tax as the definitions of “earned income” and “net profits” in Act 511 with certain exclusions and limitations. (See page 13.) (53 PS. §6913.)
Act 24 of 2001	The Optional Occupation Tax Elimination Act. (53 P.S. §6927.1 <i>et seq.</i>) (See page 6.)
Act 50 of 1998	Omnibus local tax bill that permitted school districts, with voter approval to use increased earned income taxes to eliminate occupation taxes and reduce property taxes. (See page 6.) Also included Local Taxpayer Bill of Rights. (See page 9.) (53 Pa.C.S. §8701 <i>et seq.</i>)
Act 511	Act 511 of 1965, the Local Tax Enabling Act. (53 P.S. §6901 <i>et seq.</i>)
Governor’s Center	Governor’s Center for Local Government Services.
LITA	Local Earned Income Tax Association.
Local Taxpayer Bill of Rights	Requires taxing jurisdictions that impose taxes under Act 511 to inform taxpayers of their rights and adopt rules and regulations. (Chapter 84 of 53 Pa.C.S.) (See page 9.)
Nonresident tax monies	Taxes withheld by an employer and remitted to the jurisdiction where a taxpayer works, which frequently belong (in part or whole) to the taxing jurisdiction where the taxpayer lives. (See page 9.)
PASBO	Pennsylvania Association of School Business Officials.
PEITOAC	Pennsylvania Earned Income Tax Officers, Administrators and Collectors Association.
PICPA	Pennsylvania Institute of Certified Public Accountants.
PSAB	Pennsylvania State Association of Boroughs.

PSATS	Pennsylvania State Association of Township Supervisors.
PSBA	Pennsylvania School Boards Association.
<i>Register</i>	<i>Earned Income Tax Register</i> , the official source of earned income tax withholding information for employers. (See page 3 and 19.)
The Business Roundtable	Pennsylvania Business Roundtable.
The Chamber	Pennsylvania Chamber of Business and Industry.
The Survey	February 2002 Earned Income Tax Collection Survey sent to the 565 municipal tax collectors listed in <i>Register of Earned Income Taxes</i> to better understand tax collection methods and practices. (See page 3.)

8/12/04