



UNDERSTANDING THE TAXPAYER RELIEF ACT:

*Act 1 of Special
Session 2005–2006*



\$ ACT 1



Introduction

During spring 2006, Pennsylvania legislators passed a bill intended to provide significant local tax relief. Titled “Act 1 of Special Session 2005–2006,” the bill creates new opportunities for local taxpayers and school districts, including targeted tax relief for some groups of taxpayers and the ability for voters to approve (or disapprove) major local school tax increases. Because Act 1 relies on local action and voter approval, it is important that citizens learn about the act, what it does and does not do, and how they can influence its implementation in their own communities.

What Is Act 1?

Act 1 is intended to reduce the real property tax burden on homeowners and farmers and involves several important components:

1. Targeted real property tax reductions via the homestead and farmstead exclusions
2. Real property tax and rent rebates for low-income seniors
3. Reimbursement to school districts who lose income tax revenues to Philadelphia
4. Wage tax reductions in Philadelphia
5. Voter approval for future large tax increases (called the “back-end” referendum)

The tax reductions and reimbursements will be paid for with state gaming revenues, and with higher local income taxes in districts who choose to provide larger reductions. It is important to note that Act 1 is a tax shift rather than an overall tax cut since the targeted reductions are paid for by these two sources of new revenue.

Act 1 is very similar to the earlier Act 72 of 2004, but it differs in a few significant ways. Unlike Act 72 (and other earlier major tax reform bills, Act 50 of 1998 and Act 24 of 2001), all local school districts automatically are subject to Act 1’s provisions, with no local choice about whether to participate. The three earlier local tax reform bills were voluntary, giving school districts an additional local tax option that the school board (and voters) could choose to adopt if they believed the change was the best option for their own school district. Act 1 instead mandates changes in how all Pennsylvania school districts operate, with little local option to opt out.

In addition, unlike the earlier tax reform acts, Act 1 provides school districts the option of shifting to a personal income tax similar to that used by the Commonwealth. Some tax reform advocates believe this change will make

local taxes fairer since it would include interest and investment income, instead of just earnings income.

One optional choice school districts do have under Act 1 is whether to increase their local income tax rate to provide even larger real property tax reductions than would be possible solely with state gaming monies. School districts are required to ask voters in the May 2007 primary election whether they want to raise the income tax (or levy the personal income tax) for this purpose, but the outcome of the election solely affects the tax rate and, thus, the size of the homestead and farmstead exclusions that will be provided in each school district, not whether the district itself should participate in Act 1. School districts are still subject to Act 1’s back-end referendum and other provisions regardless of whether voters approve the tax change in the May election.

Act 1 creates several opportunities for citizen participation in local school district decisions, so it is important that residents understand the act and its implications.

Act 1 is complex with many different components. This publication is intended to help local taxpayers and residents understand the provisions of the Taxpayer Relief Act. By learning its potential impact on your school district and local taxes and how it can be carried out in your own community, you will be in a better position to make informed decisions about it.

Where Will the Money for Tax Reductions Come From?

Since Act 1 is a tax shift rather than an overall tax cut, the source of the funds it uses for tax reductions is important to understand. Some people will pay more so that others will pay less. Act 1 relies on a combination of (1) state gaming revenues and (2) optionally higher local income taxes to pay for the targeted tax reductions it provides. Each source of new revenue will be explained in turn.

State Gaming Revenues

The Commonwealth will accumulate gaming revenues in a state Property Tax Relief Fund, from which it will make distributions to school districts. Distributions will not occur until the fund has reached at least \$400 million. Act 1 says that disbursements from the fund must first go to reimburse school districts for foregone income tax revenues of residents who work in Philadelphia (who pay income tax to the city rather than their home community), and to cover all supplemental claims under the Senior Citizen Property Tax and Rent Rebate program. After these disbursements, remaining funds will then be distributed statewide to school

districts for real property tax reductions. (In Philadelphia, these real property tax reduction dollars must instead be used to reduce the wage tax.)

Reimbursement for Local Income Tax Revenues Lost to Philadelphia

Under the Sterling Act, people who work in the Philadelphia pay income tax to the city and, if they live outside the city, receive a “credit” for this payment on their local income tax. Some school districts and municipalities outside the city thus lose a lot of potential local income tax revenue.

Act 1 uses state gaming revenues to reimburse school districts for this foregone revenue due to the Sterling Act, but the districts can only use these reimbursements for real property tax reductions through homestead and farmstead exclusions. To receive the reimbursements, school districts must certify the amount of tax credits they are due to the Department of Education by December 15 each year.

Senior Citizen Tax and Rent Rebates

Act 1 provides funds to supplement the Senior Citizen Tax/Rent Rebate Program, which previously has been funded solely through state lottery revenues. The amount provided by state gaming revenues will vary depending on the number of claimants in the program. (These rebates are discussed more fully in the “What Are the Tax Savings Under Act 1?” section of this publication).

Real Property Tax Relief

All school districts will be eligible to receive the state money for property tax relief, unless their school board and voters explicitly reject such funds. The amount of state money allocated will vary across school districts based on a state formula using a mix of factors, including a district’s personal income valuation per student, market value/income ratio, equalized millage, and the ratio of local tax revenues to personal income valuation in the school district. Philadelphia must use the Property Tax Relief Fund money it receives to reduce the wage tax for residents and nonresidents. School districts will be told by May 1 of every year how much they have been individually allocated. School districts must use all such money received solely for tax reductions and cannot use it for operations or other expenses.

A school board can refuse state property tax reduction allocation by passing a resolution to do so, but such a refusal must be endorsed by the voters in a local referendum. If the voters disagree, the district again becomes eligible to receive such funds the following years.

What If State Property Tax Relief Fund Allocations Vary from Year to Year?

If the amount of state money varies from year to year, districts are allowed to adjust the size of the homestead and farmstead exclusions to compensate. If the amount of money they receive from the state and from their new local income tax exceeds the maximum allowable size of homestead and farmstead exclusions, they must use the “surplus” funds to either (1) reduce their local income tax rate or (2) lower their real property tax rate. The following are clearly different implications of these two choices under Act 1:

- **If the school district reduces its earned or personal income tax rate**—A school district with surplus tax relief funds and that is already providing the maximum possible homestead and farmstead exclusions can choose to sufficiently reduce their earned income or personal income tax rate to eliminate the surplus. Such an action would return the tax dollars back to the residents who helped pay for the surplus, essentially saying “we raised our local income tax rate too much.”

A school district that reduces its local income tax rate because it has such a surplus may in a later year raise its income tax rate back to its original level without voter approval if the district no longer has sufficient money to fully fund homestead and farmstead exclusions. Such a shortfall could occur if state funds fall one year, local income tax collections fall (such as may occur if a major employer closes), or if the number of homestead and farmstead properties increases significantly. The school district thus retains flexibility under this option to adjust the income tax rate to continue to fully fund homestead and farmstead exclusions.

- **If the school district reduces the real property tax rate**—Alternatively, a school district with surplus tax relief funds can keep their local income tax rate the same and instead reduce the real property tax rate for all properties in the school district. As opposed to reducing the local income tax, if in a later year a school district no longer has sufficient money to fully fund homestead and farmstead exclusions, the district cannot return the real property tax rate back to its original level without voter approval. This is very different from the flexibility they have if they instead adjust their local income tax rate.
- There also are very clear differences between these

two approaches in who receives tax reductions and how much tax savings individual taxpayers receive. Reducing the real property tax rate gives a tax break to every property owner in the school district, including local businesses, nonresident property owners, industrial properties, and camps. In addition, the dollar tax break for each individual property owner will vary directly by the value of their property; properties that are worth more will receive larger dollar tax breaks than properties that are worth less. The large “big box” retail store, for example, will receive a significantly larger tax break than will a typical homeowner or small business because the assessed value of the store is much more than the value of a typical home or small business. Expensive homes similarly will get larger dollar tax breaks than will low-income housing.

Such tax reductions from a lower real property tax rate would be paid for, in part, through the higher income taxes paid by residents. Indeed, about 26 percent of such tax reductions would go directly to businesses statewide. Concern about the fairness of such tax breaks is one major reason the General Assembly chose to rely on the homestead and farmstead exclusions for most of Act 1’s reductions since the exclusions target tax reductions directly to homeowners.

Optionally Higher Local Income Tax Revenues

Each individual school district (other than Philadelphia) has the opportunity under Act 1 to increase their earned income tax rate to pay for larger real property tax reductions. If a school district increases their local income tax under Act 1, all new revenues they generate from the higher tax rate must be used for real property tax reductions through the homestead and farmstead exclusions. (In later years after adopting the higher local tax rate, the school district must devote the same amount of income tax money to these tax breaks, but they may use any natural growth in this tax for other purposes.)

School districts have the option of instead levying a personal income tax for the same purposes. If they choose to levy it, the personal income tax replaces their existing earned income tax, so the tax rate must be adjusted to be revenue neutral, not providing a windfall to the district. As with the earned income tax, all new revenues from the tax must be used solely for real property tax reductions. The choice of whether to use an earned income or personal income tax under Act 1 has important implications for tax fairness and should be carefully considered.

Each school district was required to create a Local Tax

Study Commission during fall 2006 to analyze the district’s local tax situation and to make a recommendation about which local income tax to use and what tax rate to levy for the purpose of real property tax reductions through homestead and farmstead exclusions. Their recommendation is nonbinding on the school board, who can choose another option but must make a decision by March 13, 2007. Voters within the school district have final approval on the proposed tax and tax rate increase during the 2007 primary election on May 15.

Act 1 states that any credits taxpayers receive for income taxes paid to other states do not apply to local income tax increases for real property tax reductions. Under previous law, taxpayers who live in Pennsylvania but work in several other states, such as New York and New Jersey, could receive a credit for the income tax they pay to those other states. Since tax rates in New Jersey and New York tend to be higher than in Pennsylvania, this essentially meant that those taxpayers paid little or nothing in local income tax to their home school district or municipality. These credits have been a concern with previous local tax reform bills in Pennsylvania since they meant that any increased income tax burden would only fall upon taxpayers who work in Pennsylvania, and that Pennsylvania taxpayers working outside the state wouldn’t be paying their share of such an increase. Act 1 explicitly says that such income tax credits do not apply to any local income tax increases intended for real property tax reductions, so all Pennsylvania taxpayers will be equally subject to local income tax increases intended for reducing real property taxes, regardless of where they work.

How Much Can the Tax Rate Be Increased to Pay for Tax Breaks?

School districts are required by Act 1 to propose a local earned income tax rate increase for real property tax reductions sufficient to provide homestead and farmstead exclusions of 25 percent or more, with the exception that Act 1 does not require them to propose greater than a 1 percent earned income tax rate, but they may voluntarily propose such a higher rate if they choose. In addition, the proposed rate cannot be more than the amount necessary to fund exclusions of 50 percent, which is the constitutionally set maximum allowable for homestead and farmstead exclusions.

Can the Tax Rate Be Increased or Changed Later?

In 2009 or later years, a school district can increase its local income tax rate or change to relying on the personal income tax rate, provided that the proposed rate does not exceed homestead and farmstead exclusions of 50 percent. As with the proposed increase in 2007, all new such revenues must be used solely for homestead and farmstead exclusions, and the increase or change must be approved by voters through referendum.

Does It Matter If It Is a Local Earned Income or Personal Income Tax?

Under Act 1, school districts have the ability to levy a personal income tax rather than the earned income tax. For many districts this may be attractive because some people consider the personal income tax fairer and because it will greatly expand some districts' tax base. The earned income tax is levied on residents' earned income, such as wages, salaries, or other reimbursements for work. It exempts unearned income, such as interest, dividends, pensions, and Social Security. The earned income tax currently is available to and used by many municipal governments and school districts in Pennsylvania. The personal income tax option under Act 1 is identical to the Pennsylvania state income tax and includes the earned income subject to the earned income tax, as well as interest and dividend income. Both the earned income and personal income tax exempt Social Security and pension income.

Some people believe the personal income tax is fairer than the earned income tax because it doesn't discriminate on the basis of income sources. The earned income tax applies only to earned sources of income and ignores investment income. It can therefore have a bigger impact on working-age people with little investment income than on higher-income residents with broader sources of income. Higher-income residents who make most of their money through investment income can end up paying little or nothing in earned income tax simply because their sources of income are not subject to the tax. Increasing the earned income tax rate to pay for real property tax breaks means that low- and middle-income households could end up paying for tax breaks received by some of their wealthier neighbors. This concern was raised under Act 50 by local officials and residents in several parts of Pennsylvania where large numbers of wealthy retirees have moved from out of state.

Statewide, income subject to the earned income tax (compensation and net profits) accounted for about 90.9 percent of the income subject to the personal income tax

in 2002. This varied among school districts, ranging from a low of 70.8 percent (in the Ligonier Valley School District in Westmoreland County) to a high of 97.8 percent (in the Chester Upland School District in Delaware County).

Shifting from the earned income tax to the personal income tax would bring additional tax savings for the many low- and middle-income taxpayers who have little interest or dividend income. Some people would argue that this makes the local income tax a more complete reflection of a taxpayer's ability to pay. Statewide, the average reduction in the local income tax rate with this change would be 9.1 percent, but the reduction would vary tremendously across school districts—from 29.2 percent in the Ligonier Valley School District to only 2.2 percent in the Chester Upland School District.

What Are the Tax Savings Under Act 1?

Act 1 provides several different tax breaks, including (1) real property tax and rent rebates for low-income senior citizens; (2) targeted real property tax breaks for homeowners and farmers (called "homestead and farmstead exclusions"); and (3) wage tax reductions in Philadelphia for both residents and nonresidents of the city. Each tax break is entirely separate, so taxpayers can be eligible to receive more than one. Low-income seniors, for example, can receive both a real property tax rebate and the homestead exclusion. Homeowners who commute out of their county to work in Philadelphia can receive both the homestead exclusion and the Philadelphia wage tax reductions. Farmers can receive the homestead exclusion on their house and the farmstead exclusion on their farm buildings. These major tax breaks are discussed below.

Senior Citizen Property Tax and Rent Rebates

Act 1 redefines the Senior Citizens Property Tax and Rent Rebate Assistance Act, which was initially passed in 1971 and provides real property tax rebates to low-income seniors. That original act had relied on lottery funds to pay for rebates, and Act 1 supplements this with state gaming dollars.

As with the earlier act, the Senior Citizens Property Tax and Rent Rebate Assistance component of Act 1 provides real property tax rebates for both homeowners and for renters, explicitly recognizing that renters indirectly pay the real property tax through their rent payments; landlords base the rent, in part, on the local property tax and, thus, tend to pass the tax on to their renters. This is consistent with how the program has operated prior to Act 1.

Who Is Eligible for Senior Citizens Property Tax and Rent Rebates?

To be eligible for a property tax or rent rebate in lieu of property taxes, a claimant must be

1. at least 65 years old (or whose spouse was at least 65 years old) during the year when the property taxes or rent were paid ;
or
2. a widow or widower at least 50 years old during the year or part of the year when the property taxes or rent were paid ;
or
3. permanently disabled and at least 18 years old during the calendar year the property taxes or rent were paid.

In addition, claimants must meet the household income requirements. For this purpose, the act defines household income as all income received by the claimant and his/her spouse, including wages, pensions, Social Security, capital gains, interest, and interest from tax-free municipal bonds. People receiving public assistance from the Department of Public Welfare are ineligible to receive the rent rebate during the months they receive such public assistance. Only one claim per household shall be granted; if more than one claim is filed and the household members cannot decide which should be paid, the Department of Revenue shall make the decision.

How Large Are the Real Property Tax Rebates?

The size of the real property tax rebates under Act 1 vary depending on the household income of the claimants. Lower-income households are eligible to receive a larger rebate than somewhat higher-income households (Table 1), but in no case can the rebates exceed the amount of real property taxes a claimant actually paid.

Table 1. Amount of real property taxes allowed as a rebate for low-income seniors.

<i>Household Income (Spouses Together)</i>	<i>Rebate Amount</i>
\$0 to \$8,000	\$650
\$8,001 to \$15,000	\$500
\$15,001 to \$18,000	\$300
\$18,001 to \$35,000	\$250

The size of the supplemental rebate for homeowners similarly depends on household income, but eligibility for it varies depending on where the claimant lives (Table 2). Claimants in Philadelphia, Pittsburgh, and Scranton can receive the supplement if their household income is \$30,000 or less. Claimants in other Pennsylvania communities must meet the same household income requirement, but in addition, their real property taxes must exceed 15 percent of their household income.

Table 2. Supplemental real property tax rebate.*

<i>Residence</i>	<i>Eligibility</i>	<i>Supplemental Amount</i>
Philadelphia, Pittsburgh, Scranton	Household income of \$30,000 or less	Additional 50 percent
Other communities	Household income of \$30,000 or less; plus, real property taxes must exceed 15 percent of household income	Additional 50 percent

**Does not apply to rent rebates.*

How Large Are the Rent Rebates?

The size of the rent rebates similarly vary by income (Table 3). Rent rebates cannot exceed 20 percent of the gross rent paid by a claimant. Act 1 provides no supplemental rebates for renters.

Table 3. Amount of rent rebate in lieu of property taxes for low-income seniors.

<i>Household Income (Spouses Together)</i>	<i>Rebate Amount</i>
\$0 to \$8,000	\$650
\$8,001 to \$15,000	\$500

Targeted Tax Breaks for Homeowners and Farmers

Act 1 uses homestead and farmstead exclusions, authorized under the Pennsylvania Constitution and Act 50 of 1998, to target its real property tax reductions to homeowners and farmers. The targeted aspect of the tax reductions is intentional—the tax reductions under Act 1 will be paid for by residents through higher income taxes and by gamblers through slot machines. If these tax savings were given by simply lowering millage rates, businesses statewide would get about 26 percent of the tax savings since they currently pay about 26 percent of all real property tax dollars in the Commonwealth. Many legislators felt this would be unfair since local businesses would get tax savings paid for by residents and gamblers, and they did not want to be accused of raising residents' taxes to give tax breaks to local businesses.

What Is a Homestead Exclusion?

The homestead exclusion targets tax relief to homeowners whose permanent residence is in the school district by reducing the assessed value of their homestead (home), which thus reduces their property tax. The homestead exclusion provides the same dollar tax reduction for all eligible properties in the taxing jurisdiction, including houses on farms, condominiums, single-family homes, and other places of permanent residence owned by the occupant.

What Is a “Homestead” Property?

A homestead property is a dwelling primarily used by an owner as a permanent home. The owner may be living temporarily at another location, but he or she must have the intention of returning to that home. No one can have more than one permanent home at any one time. Homestead properties do not include rental units, vacation homes, camps, or other homes in which the owner does not live on a permanent basis. In general, it is the address where you have registered to vote and have registered your driver's license.

The homestead property includes the land under the dwelling, as long as it is owned by the same person who owns the dwelling. The formal definition is the same as is used for determining residence status for the earned income tax.

What Is a Farmstead Exclusion?

The farmstead exclusion is a similar method of targeting real property tax relief to farmers. It allows real property tax relief for farmers on the taxes they pay on farm buildings (other than the farmhouse, which receives tax breaks through the homestead exclusion), as long as at least one farm owner lives on that farm. This is in addition to other existing real property tax relief programs aimed at farms, such as “Clean and Green,” that reduce the assessed value of farmland. It is important to note that eligible farmers will receive both a homestead exclusion and a farmstead exclusion on their farm—the homestead on their house and the farmstead on the rest of their farm buildings.

What Is a “Farmstead” Property?

A farmstead property is all buildings and structures on a farm of ten contiguous acres or more in size that are used primarily for agricultural purposes (such as housing animals or storing supplies, production, or machinery). The farmstead must be the permanent residence of at least one owner, as defined under the homestead definition. The farmstead exclusion would be applied to buildings and structures that are not already exempt from real property taxation under other laws. The requirement that an owner live on the farm means that farms owned and operated by absentee owners are not eligible for the farmstead exclusion.

How Do Homestead and Farmstead Exclusions Reduce Real Property Taxes?

The amount of real property tax owed by any taxpayer is the tax rate (measured in mills) multiplied by the assessed value of his or her property (see Example 1). If the assessed value of the property is made smaller, the amount of the tax owed will be smaller. With a homestead exclusion of \$20,000, the taxpayer in Example 1, for instance, would only owe \$600 in taxes (see Example 2).

Example 1. A taxpayer in Sample School District with a property assessed at \$50,000 will owe \$1,000 in property tax if the tax rate is 20 mills (2 percent).

Assessed value x tax rate = tax owed

or

\$50,000 x 20 mills (2 percent) = tax owed

or

\$50,000 x 20 mills (2 percent) = \$1,000

Example 2. The same taxpayer in Sample School District receives a \$20,000 homestead exclusion on his or her property and now owes only \$600 in property tax. The homestead exclusion gives the taxpayer a \$400 tax savings.

(Assessed value – homestead exclusion) x tax rate = tax owed
or
(\$50,000 – \$20,000) x 20 mills (2 percent) = tax owed
or
\$30,000 x 20 mills (2 percent) = \$600

How Large Will Homestead and Farmstead Exclusions Be Under Act 1?

School districts are required under Act 1 to propose a local income tax increase sufficient to provide homestead and farmstead exclusions of at least 25 percent of the median homestead value (which means an average 25 percent tax reduction in real property taxes). These new local revenues will be supplemented by state gaming revenues to provide homestead and farmstead exclusions of up to 50 percent (an average 50 percent tax reduction), which is the maximum allowable exclusion under Pennsylvania's constitution.

The size of the homestead and farmstead exclusions will vary across school districts due to differences in the state allocation, the income tax rate proposed (and approved) in each district's referendum, and differences in the value of homestead and farmstead properties. In school districts where properties in general are worth a lot, the dollar value of their homestead exclusions can be high because the median value of homestead properties will likely also be high. If the median value of homestead properties is \$60,000, for example, the maximum exclusion for all eligible properties will be \$30,000 (one-half the median value of \$60,000); in contrast, if the median value is \$80,000, the homestead exclusion in the jurisdiction will be a maximum of \$40,000 (one-half the median value of \$80,000). A larger median value in the jurisdiction means that larger homestead and farmstead exclusions are possible in that jurisdiction.

How Will I Know that I Received a Homestead or Farmstead Tax Break?

School districts that implement homestead and farmstead exclusions must itemize these on tax bills sent to homestead and farmstead property owners. In addition, they must include a statement that at a minimum takes the following form:

Notice of Property Tax Relief

Your enclosed tax bill includes a tax reduction for your homestead and/or farmstead property. As an eligible homestead and/or farmstead property owner, you have received tax relief through a homestead and/or farmstead exclusion that has been provided under the Pennsylvania Taxpayer Relief Act, a law passed by the Pennsylvania General Assembly designed to reduce your property taxes.

For Homeowners and Farmers Paying Taxes to Philadelphia

The City of Philadelphia must use the state gaming funds it receives to reduce the city's wage tax on residents and nonresidents, not to reduce its real property tax. All money it receives from the fund must be used for such wage tax reductions. Act 1 also mandates an additional wage tax reduction schedule the city must follow for 2005 through 2009. The property tax reduction allocation for Philadelphia will be paid directly to the city, which will then transfer the funds to the school district.

Voter Approval for Future Large School Tax Increases

Act 1 includes a "back-end" referendum to give local voters greater voice in future tax increases and to help prevent real property tax bills from creeping back to their previous levels. Under Act 1, if a school district wants to increase its tax rates by greater than inflation, it must get voter approval through a local tax referendum during the spring primary election. If voters approve the extra-inflationary increase, the tax rates increase as requested. If voters disapprove of the proposed increase, the tax rate increase is not allowed and the school district is allowed to take an increase up to the inflation index.

The inflation increase for the referendum is an index averaging the percentage increase in the statewide average weekly wage (typically called the SAWW and calculated annually by the Pennsylvania Department of Labor and Industry), and the percentage increase in the Employment Cost Index for Elementary and Secondary Schools (calculated annually by the Bureau of Labor Statistics in the U.S. Department of Labor).

The index will be adjusted upward for school districts with a state aid ratio of greater than 0.400; for these districts, the state index will be adjusted by multiplying it by the sum of 0.75 and the district's aid ratio. If the state index is 4 percent, for example, and a school district has an

aid ratio of 0.500, its individualized index will be 5 percent (e.g., $[0.75 + 0.500] \times 4\% = 5\%$). That district would be allowed to increase its real property tax rate to 5 percent that year without triggering the need for a back-end referendum. The Pennsylvania Department of Education will calculate the index for each school district and provide it to them by no later than September 30 of each year. In addition, the department will determine whether each proposed tax rate increase is less than that district's index, or whether it is greater and will thus require voter approval.

It is important to note that the index under Act 1 applies to tax rates rather than to total tax revenues. So, tax revenues can naturally grow as incomes and the tax base can increase without counting against the index.

Do Exceptions Exist that Allow a School District to Avoid a Back-End Referendum?

Act 1 specifies ten exceptions that allow a school district to raise tax rates by more than the index. Three must be approved by the Court of Common Pleas in the judicial district in which the school district's administrative office is located, and seven must be approved by the Department of Education. Districts planning to use one of the exceptions must follow a strict protocol for approval and must provide clear and convincing evidence that it qualifies for each exception sought.

Exceptions Requiring Court Approval

The following specific exceptions must be approved by the court:

1. Costs incurred in responding to or recovering from an emergency or disaster.
2. Costs of implementing a court order or administrative order from a federal or state agency as long as the tax increase is rescinded after fulfillment of the court or administrative order.
3. Costs of responding to conditions posing an immediate threat of serious physical harm or injury to students, staff, or residents, but only until the conditions causing the threat have been fully resolved.

A school district seeking an exception via court action must give public notice in a newspaper (and Web site, if it has one) that it is seeking approval for an exception at least one week before formally filing the petition with the local court. When the school district receives information from the court that a hearing has been scheduled, it needs to publish notice of this in a newspaper (and on a Web site,

if it has one) and include the date, time, and place of the hearing.

The court is supposed to rule on the school district's petition at least 55 days prior to the election, which allows the district to request a referendum vote if its petition is rejected. Any person residing within or paying real property taxes to a school district petitioning the court for an exception has the right to file written objections to that petition with the court.

Exceptions Requiring Pennsylvania Department of Education Approval

The following are exceptions decided by the Department of Education:

1. Costs associated with several debt repayment and construction issues, including paying interest and principal on indebtedness incurred prior to the effective date of the act, on voter-approved debt, and under several conditions on indebtedness for school construction projects (up to 60 percent of the construction cost average on a square-foot basis).
2. Costs incurred in special education programs and services to students with disabilities, if the annual increase in expenditures on special education programs and services was greater than the index. The dollar amount of the exception must only be equal to the amount of the increase that exceeds the index.
3. Costs that were incurred to implement a school improvement plan required under the Elementary and Secondary Education Act of 1965 and that were not offset by a state allocation.
4. Costs necessary to maintain:
 - a. per-student local tax revenue, adjusted by the index, if the percentage growth in average daily membership between the school year and the third school year preceding that year exceeds 7.5 percent; *or*
 - b. actual instruction expense per average daily membership, adjusted by the index, if the increase between the school year and the preceding school year is less than the index.
5. Maintaining revenues from the real property, earned income, personal income, basic education funding allocations, and special education funding allocations, adjusted by the index, when the percentage increase in these revenues has been less than the index.

6. Costs for healthcare-related benefits that are directly attributable to a collective bargaining agreement in effect on January 1, 2006, if the anticipated increase in costs is greater than the index. This exception does not apply to collective bargaining agreements renewed, extended, or created after January 1, 2006.
7. Costs for the school district's share of payments to the Public School Employees' Retirement System, if the dollar increase between the current year and the upcoming year is greater than the index. The dollar amount of the exception must be equal only to the amount of the increase that exceeds the index.

A school district seeking an exception via Department of Education approval must give public notice in a newspaper (and on its Web site, if it has one) that it is seeking approval for an exception at least one week before formally submitting its request to the department. If the department schedules a hearing on the request, the district must immediately publish notice of this in a newspaper (and on its Web site, if it has one), and include the date, time, and place of the hearing.

When making its decision, the department must use data collected under the public school code, which may not necessarily be the prior year (since it takes time to collect and collate this information) and must inform school districts of the years it will use in this determination. The department must make a decision on the exception request at least 55 days prior to the election, and if the request is denied, the district is allowed to request a referendum vote.

Can School Districts Campaign for or Lobby About a Referendum?

Act 1 clearly states that no public funds can be used to urge electors to vote for or against a referendum, so school districts cannot actively lobby for or against a referendum. However, the act also states that school districts may use public funds to disseminate factual information relating to a referendum.

What Else Requires Voter Approval Via Referendum?

Through Act 1, school districts must get voter approval if they want to start levying a tax they were not using in the 2005–2006 fiscal year. If a district was not levying a per capita tax in 2005–2006, for example, they can only start using that tax in a future year with the explicit approval of voters via referendum.

How Will Act 1 Affect Taxpayers and School Districts?

Taxpayers

The overall impact of Act 1 on local taxpayers is difficult to predict since it depends so much on the local income tax a specific school district uses (earned income versus personal income) and its tax rate, the amount of money available at the state level for distribution through the property tax relief fund, and the state formula used for distributing these funds. It also depends on the income sources of individual taxpayers and whether they live on a homestead or farmstead property.

All taxpayers should benefit from the back-end referendum since it gives them a formal voice in approving future tax rate increases that exceed inflation (as defined by the state index). How Pennsylvania voters will respond to this new, great responsibility is unclear since they previously never had this opportunity. Will many automatically vote “no” on increases, or will they carefully weigh each referendum request carefully and thoughtfully before making their decision? Will they vote “no” on unreasonable requests and “yes” when the school district and students truly need a large tax rate increase?

Low-Income Seniors

Low-income seniors will be the immediate beneficiaries of Act 1 through the supplements to the Senior Citizens Property Tax and Rent Rebate since this program receives precedent for state funds. Eligible home-owning seniors will receive larger rebates paid from gaming revenues.

The impact of the voter-approved higher income taxes on seniors is less clear. Seniors will be subject to the higher earned or personal income tax rate, so they may end up paying more depending on their sources of income. The earned income tax is levied against salaries, wages, and other sources of earned income, which tend to be a very small part of the typical senior's income. If the new local tax is a personal income tax, higher-income seniors with investment and interest income will begin having to pay local income tax on these. Neither local tax is levied on Social Security income. Seniors who own their own home will generally be eligible to receive the homestead exclusion, so they should see their real property taxes decrease.

Homeowners and Farmers

Homeowners and farmers in the Philadelphia suburbs will be immediate beneficiaries of Act 1 since their school districts will receive credits for the income tax lost by the districts due to the Sterling Act. The school districts must use such credits solely for real property tax reductions through homestead and farmstead exclusions, funding tax breaks for these homeowners and farmers. These credits receive precedent for state funds.

Act 1 should also benefit permanent residents who own their homes or farms in other school districts across Pennsylvania. All owners of homesteads and farmsteads in a school district will receive the same dollar tax savings, but this will make a bigger difference for owners of lower-valued properties than for owners of higher-valued properties. The percentage reduction in your real property tax bill will be influenced by how the value of your own property compares to the median value of homesteads (Table 4). If your property is worth less than the median value of homestead properties in your community, you may experience a larger percentage reduction in property taxes. Conversely, if your property is worth more than the median homestead, you may experience a smaller percentage decrease in your real property taxes.

In the example shown in Table 4, notice that all properties receive a \$15,000 reduction in assessed value because of the homestead exclusion. The properties with the lowest

values receive the largest percentage reductions in their taxes, while the higher-valued properties receive smaller percentage reductions. Everyone's taxes are reduced by \$300, but this makes a bigger relative impact on properties with smaller values than on properties with larger values. An owner of a property with an initial assessed value of \$30,000 in this sample community would enjoy a 50 percent reduction in property taxes, while this same \$300 would represent only a 15 percent reduction in real property taxes to the owner of a property valued at \$100,000.

These homestead and farmstead exclusions will be paid from state gaming funds and higher local income taxes in the school districts where such an increase was approved by voters in the May 2007 primary. Whether the homestead and farmstead exclusion is more or less than the higher local income taxes paid by a taxpayer depends on the taxpayer's sources and amount of income, how high the new income tax rate is increased, and whether the voters approve an earned income or personal income tax.

In some school districts with significant personal income, which isn't subject to the earned income tax, switching to the personal income tax may actually mean a lower local income tax since the change must be revenue neutral, benefiting taxpayers whose income comes primarily from wages and salaries. Taxpayers with significant dividend and interest income will likely pay more in local income taxes because they will be paying tax on that formerly exempt

Table 4. Impact of homestead exclusion on properties in one example school district (actual numbers will vary across school districts).

- Median assessed value of homesteads is \$60,000.
- Homestead exclusion is one-quarter of median value, so it is \$15,000.
- Tax rate is 20 mills.

<i>Without the Homestead Exclusion</i>		<i>With the Homestead Exclusion of \$15,000</i>		<i>Percent Decrease in Real Property Taxes for that Property</i>
<i>Assessed Value of a Property</i>	<i>Tax Owed on that Property</i>	<i>Assessed Value of a Property with the Exclusion</i>	<i>Tax Owed on that Property</i>	
\$30,000	\$600	\$15,000	\$300	50%
\$40,000	\$800	\$25,000	\$500	37.5%
\$50,000	\$1,000	\$35,000	\$700	30%
\$60,000	\$1,200	\$45,000	\$900	25%
\$70,000	\$1,400	\$55,000	\$1,100	21%
\$80,000	\$1,600	\$65,000	\$1,300	18.8%
\$90,000	\$1,800	\$75,000	\$1,500	16.6%
\$100,000	\$2,000	\$85,000	\$1,700	15%

income. Since the change to the personal income tax is primarily a tax shift, some taxpayers—those with significant interest and dividend income—will be paying somewhat more, while others—those who have primarily wage or salary income—will be paying somewhat less.

Renters

Renters (other than low-income seniors) in school districts where voters increase the local income tax will generally lose as a result of Act 1. Rental properties are not homestead properties, so renters will receive no tax break on the portion of their rent that goes to pay the real property tax. Yet renters in these districts will be paying more in local income tax rates so homeowners and farmers can have larger real property tax breaks.

Renters will not be negatively affected in school districts where the local income tax is left unchanged by voters. Homestead and farmstead exclusions in those districts will still be provided to eligible property owners, but the exclusions will be somewhat smaller since they will be funded solely with state gaming funds. Renters in these districts will not be paying higher local taxes to give such breaks to others.

A common misconception is that renters pay no real property tax; it is true that they do not formally receive a property tax bill, but landlords typically consider property taxes when setting rent. When property taxes go up, rents generally go up as well. Act 1 treats renters inconsistently; its Senior Citizens Property Tax and Rent Rebate Assistance provisions provide low-income seniors who rent a rebate on their rent payment, consistent with the earlier Pennsylvania's Senior Citizens Rebate and Assistance Act (which Act 1 supersedes). Yet its homestead and farmstead provisions, which provide property tax reductions to other taxpayers, do not apply to other renters.

Wage Tax Payers in Philadelphia

People paying wage taxes to the City of Philadelphia will benefit from Act 1. The act mandates a schedule for reducing the wage tax for both resident and nonresident taxpayers. In addition, the gaming revenue received by Philadelphia must be used for additional reductions in the wage tax.

Taxpayers living in school districts who lose a significant amount of income tax revenue due to residents who work in Philadelphia (which means those taxpayers currently pay little or nothing in income tax to the school district) will benefit from Act 1 because their district will receive credits for this lost revenue. All such reimburse-

ments to the school district must be used for homestead and farmstead exclusions.

Local Businesses and Nonresident Property Owners

Act 1 should have little short-run effect on local businesses, nonresident property owners, such as owners of vacation homes, second homes, and camps, and owners of other properties ineligible for homestead and farmstead exclusions. Local businesses and nonresidents do not pay earned income tax to school districts (nor would they pay a personal income tax, if one were levied), so their tax bills will not increase because of the higher local income tax. Since the real property tax reductions will only be given to homestead and farmstead properties, the owners similarly will not receive any of the real property tax reductions, though business owners who live in the community can receive a homestead exclusion on their house if it is their homestead. In the long run, these property owners might experience lower real property tax increases because of the back-end referendum.

School Districts

Several of the most significant impacts of Act 1 for school districts include a changed relationship with the public, changes in districts' budgeting cycle, and the effect of the back-end referendum on their future flexibility to respond to changing situations.

Act 1 fundamentally changes school districts' relationship with the public because of the back-end referendum. School districts will need to focus much more on nurturing their relationship with taxpayers and voters, as well as do a better job of explaining and justifying budget decisions. This relationship between school boards and the public will be very different from the relationship between the public and other elected officials, such as township supervisors, county commissioners, or even state legislators, since school board members will be the only elected officials needing direct voter approval for future large tax increases.

The back-end referendum, even with the ten exceptions under Act 1, will reduce school districts' flexibility to respond to future needs and conditions in the district. It will give local voters the ability to restrict future large tax rate increases, yet it gives neither voters nor school boards greater ability to respond to future unfunded mandates from the state or federal governments, such as "No Child Left Behind," prevailing wages, charter schools, or collective bargaining. If the district has little or no control over

the amount that it must spend in response to mandates, simply restricting tax revenues can create very difficult local choices that may adversely affect the quality of education.

Act 1 similarly changes when school districts budget for the succeeding year. School districts typically follow a fiscal year calendar of July 1 through June 30. Because back-end referenda will occur during the spring primary, school districts must have their preliminary budget finished in time to determine if they will likely exceed the allowable tax rate increase. If so, they must either petition their local court or the Department of Education for a tax rate increase exception or put the proposed increase on the spring primary ballot.

This timing accelerates their traditional budgeting cycle, requiring them to adopt their preliminary budget for their upcoming fiscal year at least 90 days prior to the spring election, which means sometime in February (almost five months before the new fiscal year begins), around the time of the governor's proposed state budget announcement, which means that districts will have to approve their preliminary budget when they may not even know the proposed increase in state aid they might receive (much less the actual amount).

The need for early budget preparation under Act 1 will pose a challenge for many school districts since they will need to make major budget decisions before the current school fiscal year is even halfway completed. School districts will have to forecast their expenses and revenues much farther into the future, increasing the possibilities of error.

School districts near Philadelphia will be compensated for the local income tax revenue they lose on suburban commuters due to the Sterling Act, which "credits" taxpayers for the income tax they pay in the city. Yet all such reimbursement funds can only be used for taxpayer real property tax reductions, so the funds will not directly benefit the school districts themselves.

School districts' ability to change from the earned income tax to the personal income tax gives them an additional opportunity to improve the fairness of their local taxes since this change more accurately reflects taxpayers' ability to pay. But the change will be revenue neutral for school districts since it will be dollar for dollar.

What Are Citizens' Roles and Responsibilities Under Act 1?

Citizen Participation and Elections

By giving voters a greater formal voice in school district decision making, Act 1 places great responsibility on citizens to become knowledgeable about school district issues such as educational quality, local taxation and fairness, changing state and federal mandates, and the ability of the school district to attract and retain good teachers and staff. The various referenda under Act 1, such as the initial vote on increasing local income tax rates to pay for real property tax reductions, potential follow-up referenda changing this tax rate, and the back-end referendum about proposed large tax rate increases, all assume that voters will be informed and make decisions for the common good.

It is important that citizens learn about and understand the issues rather than just vote based on impressions or anecdotes.

Receiving the Tax Breaks

Senior Citizens Real Property Tax and Rent Rebate

To claim a property tax or rent rebate, eligible seniors must file a claim with the Pennsylvania Department of Revenue on or before June 30 of the following year (e.g., to receive a rebate on your 2006 taxes, you must file on or before June 30, 2007). Claims received after the June 30 deadline but before December 31 shall be accepted as long as funds are available to pay the claims.

Homestead/Farmstead Exclusions

To receive a homestead or farmstead exclusion on your property you must submit an application form with your county assessor. Unless the assessor specifically denies the application, a property is deemed eligible. Once enrolled, property owners cannot be required to resubmit an application more than once every three years. The deadline for applying is March 1 of every year, and applicants cannot be required to pay a fee for filing or review of the application.

If your application for a homestead or farmstead exclusion is denied, the assessor must give you written notice by first-class mail no later than 30 days after the application was received.

If My Application Is Denied, How Can I Appeal?

If your application is denied, you can appeal the assessor's decision to your county's board of assessment appeals (the exact name of this board varies depending on the county's

class). This board is the same one to which assessment appeals are made. Appeals generally are limited to whether the parcel under question meets the definition of “farmstead property” or “homestead property.”

What Are My Responsibilities Under the Homestead and Farmstead Exclusions?

If your property receives the homestead or farmstead exclusion, you must notify the county assessor if your use of the property changes to a nonqualifying use (e.g., if you move out of your home and rent it to others, or convert the farm buildings for nonfarm use). You have 45 days after such a property change to notify the assessor. If you fail to notify the assessor within the time deadline, you can be required to pay any taxes (plus interest) that you should have paid but did not because of the exclusions and a penalty of 10 percent of these unpaid taxes; you could also be found guilty of a third-degree misdemeanor and be sentenced to pay a fine not exceeding \$2,500.

What Else Does Act 1 Do?

Act 1 includes several other important provisions that may affect taxpayers and school districts. These include the ability for school districts to offer installment payment plans for taxpayers, sunsetting nuisance taxes, and the relationship of Act 1 with some prior local tax reform options.

Installment Payments

Act 1 requires school districts (other than Philadelphia) to give taxpayers with homestead or farmstead property the option of paying real property taxes on such properties in installments rather than as one single payment. Each school district can determine how many installment payments they want to allow, but the act specifies that districts must allow at least three payments (and no more than monthly). School boards must approve an installment payment plan before June 30, 2007. Districts are required to include information about their installment payment plan on the tax notices they annually send to homestead and farmstead property owners.

Nuisance Taxes

School districts are currently authorized under the Local Tax Enabling Act (commonly referred to as “Act 511”) to choose from a variety of different local tax options, including the per capita, occupation, occupational privilege, realty transfer, mechanical devices, amusement, business gross receipts, and earned income taxes. They also receive some tax authorization through the Public School Code. Act

1 changes this list of authorized taxes by allowing school districts (with voter approval) the option of levying the personal income tax. It also changes the list by taking away options from school districts not using certain taxes.

Act 1 says that after December 31, 2011, school districts can only use the taxes authorized under Act 511 that they are using at that time; if they aren’t using one of Act 511’s taxes as of December 31, 2011, they forever lose the ability to use that tax. These specifically include the per capita tax (though this will continue to be authorized under the school code), occupation (flat rate), occupation (millage), occupational privilege, realty transfer, mechanical devices, amusement, business gross receipts, and earned income tax. School districts already lost the ability to newly impose the amusement tax under Act 50 of 1998, and the business gross receipts tax under the Local Tax Reform Act of 1989.

What Doesn’t Act 1 Address?

Act 1 does not address some of the issues underlying arguments for tax reform. It does little to address inequities across school districts, particularly with regard to the dissimilar amount of local revenue that districts are able to generate through local taxes and the amount that they spend per student. The act provides real property tax reductions (and wage tax reductions in Philadelphia), but does nothing to increase or change state aid to school districts. It does little to rectify the long-term decrease in state share of local school expenses, which many school district officials argue is one of the main underlying reasons for rising local tax rates. Wealthy districts under Act 1 will continue to spend more per student than do less-wealthy districts.

The act also does not give school districts any greater ability to control spending, particularly expenditures required by unfunded or underfunded state and federal mandates. The back-end referendum focuses solely on reducing future large tax increases, not in helping school districts avoid the need for such future increases.

Act 1 may inadvertently exacerbate some tax fairness issues at the local level due to how it treats renters compared to other taxpayers. In districts where local voters choose to increase the local income tax to provide larger homestead and farmstead exclusions, renters will be paying higher local income taxes to pay for tax breaks for homeowners and farmers. Yet homeowners in Pennsylvania tend to have about twice as much income as do renters: \$47,611 in average annual income to home-owning households compared to \$24,601 in average annual income to renting

households (*Source: 2000 U.S. Census*). This means that low-income residents would pay for tax breaks received by their wealthier neighbors. Statewide, about 25 percent of all households rent (and the percentages are much higher in some school districts), so this affects a significant number of Pennsylvanians.

In addition, Act 1 treats senior and nonsenior renters differently. Low-income seniors who rent will receive partial rebates of their rent payments, while working-age renters, even if they have the same low level of income, will receive no rebate. If the school district increases the earned income tax rate to pay for real property tax breaks, low-income, working-age renters will actually be worse off than prior to Act 1 since their local tax bills will have increased.

Act 1 also does not address the local tax reform needs of other local jurisdictions, such as county governments, which are almost exclusively dependent on the real property tax by state law.

Where to Get More Information About How Act 1 Is Being Implemented

Act 1 requires that school districts, the Department of Education, and the Department of Revenue develop and publicly release several different reports, including the following, on a regular basis.

Senior Citizens Property Tax and Rent Rebate Assistance

Reported: Number of claims and rebates paid in that fiscal year by school district, by county, and for each household income level

Report deadline: September 30 of each year

To whom: Senate Appropriations Committee (to the chair and minority chairman) and House Appropriations Committee (to the chair and minority chairman)

Index for Maximum Tax Rate Increases Not Subject to Referendum

Reported: The Index used to determine each school district's maximum tax rate increase not subject to a voter referendum

Report deadline: September 1 of each year (it must be calculated by August 15)

To whom: The Pennsylvania Bulletin

School Districts Requesting Exemption from the Back-End Referenda

Reported: All school districts requesting an exemption from the back-end referenda, including the name of the

school districts, the specific exemptions and dollar amounts requested by each district, the Department of Education's rulings on each request, the dollar amount and the tax rate increase approved for specific districts, and a statistical summary of this information.

Report deadline: At least 15 days before that year's primary election

To whom: President pro tempore of the Senate, Minority Leader of the Senate, Speaker of the House of Representatives, and the Minority Leader of the House of Representatives and published on the Pennsylvania Department of Education's publicly accessible Internet site

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- Note:* This publication is intended strictly to help you know and understand more about the school tax changes possible under Act 1 of Special Session 2005–2006. The material is general and educational in nature. It is not intended to be legal advice, nor to replace the need for legal advice. If legal advice is what you need, please seek the aid of a competent professional in your area.

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