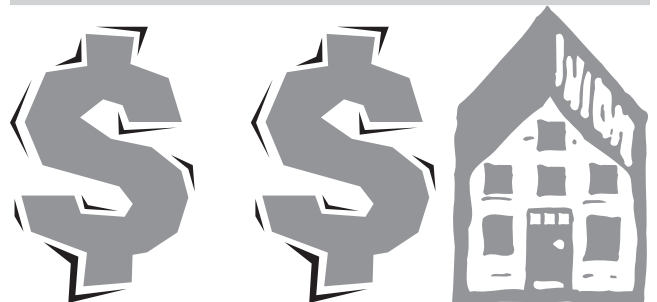




# UNDERSTANDING THE HOMEOWNER TAX RELIEF ACT

*Act 72 of 2004*





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## Contents

<b>What Is the Homeowner Tax Relief Act (Act 72 of 2004)?</b> .....	<b>3</b>
<b>What Are Homestead and Farmstead Exclusions?</b> .....	<b>4</b>
<b>What Is the Back-End Referendum?</b> .....	<b>6</b>
<b>How Can Act 72 Be Implemented in My School District?</b> .....	<b>8</b>
<b>How Will This Affect Taxpayers and School Districts?</b> .....	<b>9</b>
<b>What Doesn't Act 72 Address?</b> .....	<b>11</b>
<b>Summary</b> .....	<b>11</b>
<b>References</b> .....	<b>12</b>

For more than 20 years, Pennsylvanians have been trying to make local taxes fairer, with particular attention on the real property tax (sometimes called the property tax, or real estate tax). Recent local reform efforts have included the Homestead Exclusion constitutional amendment of 1997, which authorized a method for targeting tax breaks to homeowners and farmers; Act 50 of 1998, which gave school districts the option of shifting to a higher earned income tax in exchange for eliminating several nuisance taxes and lowering real property taxes; and Act 24 of 2001, which allowed school districts to increase their earned income tax enough to eliminate the occupation tax. For a variety of reasons, none of these have been wholly successful in addressing peoples' concerns about local tax fairness.

During the summer of 2004, the Pennsylvania general assembly and governor passed and signed a new local tax reform alternative, Act 72 of 2004, titled the "Homeowner Tax Relief Act." Unlike the earlier local tax reform efforts, which relied solely on local revenues to reduce real property tax bills, Act 72 relies instead on a mix of new local tax money and state gaming revenues.

As in the earlier tax reform efforts, school districts have the option of participating in Act 72. In addition, the act gives local voters a greater voice in local tax decision-making through referenda.

This publication is written to help local taxpayers and residents understand the provisions of the Homeowner Tax 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.

Note: This publication is intended strictly to help you know and understand more about the school tax changes possible under Act 72 of 2004. 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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## What Is the Homeowner Tax Relief Act (Act 72 of 2004)?

The Homeowner Tax Relief Act is intended to reduce homeowners' and farmers' real property tax bill, through a combination of new money from state gaming revenues and higher local income taxes. The real property tax reductions will be targeted to homeowners and farmers through homestead and farmstead exclusions, rather than being given to

all property owners (such as local businesses, landlords, and non-residents). The act also gives voters in participating school districts the right to approve or disapprove future property tax increases that are greater than inflation (through a local vote called the "back-end referendum.")

School districts are not required to participate in Act 72, but they must choose by May 30, 2005, whether to accept its provisions. To participate and receive state gaming funds (which will be allocated to districts through the state's property tax relief fund), they must make a "qualifying contribution" by raising their local income tax (or levying it, if they currently do not) by 0.1 percent. This can be done through a simple resolution by the district, or through a voter referendum (called the "front-end referendum").

Act 72 is a tax and revenue *shift* rather than an overall tax and revenue *cut* for school districts, at least in the short run, so districts should have the same amount of revenue for operation. The new gaming-funded state property tax relief fund monies and new local income tax revenues are devoted solely to real property tax relief.

The act also gives school districts a new option of levying the personal income tax rather than the earned income tax. This is significant because many people argue that the personal income tax, which is identical to the state income tax, is a fairer representation of taxpayers' ability to pay than the earned income tax, since it includes interest and dividend income.

School districts participating in Act 72 will need to adjust their budget cycle to accommodate the back-end referendum; since back-end votes will occur during the spring primary election, participating districts will now need to complete their proposed budgets much earlier in the year. Most Pennsylvania school districts operate on a July 1 to June 30 budget year, so they will need to adopt their preliminary budget around January (before the state budget is announced, so they will not yet know how much state aid they will receive).

### Where will the money for real property tax reductions come from?

Most of the money to be used for the tax reductions will come from 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 \$900 million; \$500 million of this will then be given to participating school districts, and the remaining \$400 million will be held in reserve (the state eventually expects

\$1 billion to be distributed annually).

The distributions possibly could begin during the 2005-06 school year but will more likely occur during the 2006-07 or 2007-08 school years. School districts that opt into Act 72 are required to conform to its requirements, including the new budget year and back-end referendum, even before they receive their first property tax relief fund monies from the Commonwealth.

The amount of state money for property tax relief will vary across school districts, depending on a state formula for distribution. The formula is based on a mix of factors, including a district's 2003-04 average daily attendance, personal income per student, market value/personal income ratio, equalized millage, and the ratio of local tax revenues to personal income.

All the property tax relief fund money that school districts receive must be used solely for real property tax reductions, given through homestead and farmstead exclusions. If the amount of state money varies from year to year, districts are allowed to adjust the size of the exclusions to compensate.

Districts receiving this state money are required to make a "qualifying contribution" through a higher income tax. The required initial increase is nominal, being only 0.1 percent (or \$30 a year for a taxpayer with \$30,000 in earned income), but the increase could be higher if the district opts to give higher real property tax reductions. As with the new state fund money, revenues from higher local income tax rates can only be used for real property tax reductions.

### **How will I know that I received a 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, which has been provided under the Homeowner Tax Relief Act, a law passed by the Pennsylvania General Assembly designed to reduce your property taxes.

## **What Are Homestead and Farmstead Exclusions?**

Act 72 uses homestead and farmstead exclusions, authorized under the Pennsylvania Constitution and Act 50 of 1998, to target the real property tax reductions to homeowners and farmers. The targeted aspect of the tax reductions is intentional; the tax reductions under Act 72 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 the 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 (such as \$300) 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 the 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 farm house, which receives tax breaks

through the homestead exclusion), so 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,” which 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).

$$\begin{aligned} \text{Assessed value X tax rate} &= \text{tax owed} \\ \text{or} \\ \$50,000 \text{ X } 20 \text{ mills (2 percent)} &= \text{tax owed} \\ \text{or} \\ \$50,000 \text{ X } 20 \text{ mills (2 percent)} &= \$1,000 \end{aligned}$$

**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.

$$\begin{aligned} (\text{Assessed value} - \text{homestead exclusion}) \text{ X tax rate} &= \text{tax owed} \\ \text{or} \\ (\$50,000 - \$20,000) \text{ X } 20 \text{ mills (2 percent)} &= \text{tax owed} \\ \text{or} \\ \$30,000 \text{ X } 20 \text{ mills (2 percent)} &= \$600 \end{aligned}$$

The homestead exclusion will be based on and will change assessed values, not market values. Market values are the price at which a property would sell with both a willing buyer and a seller. Assessed values are the values used in calculating real property taxes and are always calculated as a percentage of market value. The percentage used on all properties in a county to calculate assessed values, set by the County Board of Assessment Appeals during reassessment, is called the assessment ratio. Unless the property itself is changed in some way, either through physical improvements or demolition that affect its market value, this assessed value will not be changed or recalculated until the next reassessment occurs.

The overall value of homestead property in the community affects the maximum size of the homestead exclusion; if properties in general are worth a lot, the *dollar* value of the homestead exclusion can be high because the median value of homestead properties likely will be high. If the median value of homestead properties is \$50,000, the maximum exclusion for all eligible properties will be \$25,000 (one-half the median value of \$50,000); in contrast, if the median value is \$70,000, the homestead exclusion in the jurisdiction will be a maximum of \$35,000 (one-half the median value of \$70,000). A larger median value in the jurisdiction means that larger homestead and farmstead exclusions are possible in that jurisdiction.

**How do I apply for a homestead exclusion or a farmstead exclusion?**

To receive a homestead or farmstead exclusion on your property, you file 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 one time 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 not 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 class of county). 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 non-qualifying use (such as 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 you should have paid but did not because of the exclusions (plus interest) and to pay a penalty of 10 percent of these unpaid taxes; you could also be found guilty of a misdemeanor of the third degree and be sentenced to pay a fine not exceeding \$2,500.

## **What Is the Back-End Referendum?**

The back-end referendum is intended to give local voters greater voice in future tax increases and to help prevent real property tax rates from creeping back to their previous levels. Under Act 72, if a school district wants to increase its tax rates 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 increase, the proposed tax rate increase is not allowed.

Note that the back-end referendum under Act 72 is fundamentally different from that authorized under Act 50 of 1998. If a referendum failed under Act 50, the school district was not allowed to take any tax increase at all. Districts thus had to decide whether to take the allowable tax increase or to ask voters for a larger increase but with the risk that if the referendum failed they would get no increase at all. In contrast, if a referendum fails under Act 72, the school district is still allowed to take an increase of up to the inflation index. In other words, it is not penalized for asking voters to decide. In addition, the index under Act 72 applies to tax *rates* rather than to total tax *revenues* (as under Act 50). So tax revenues can naturally grow as incomes and the

tax base increase, without counting against the index.

The allowable 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 upwards for school districts with a state aid ratio of greater than .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 .500, its individualized index will be 5 percent (e.g.,  $[0.75 + .500] \times 4\% = 5\%$ ). That district would be allowed to increase its real property tax rate up 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 by August 15 of each year and will publish the index by September 1. Back-end referenda go into effect in participating school districts with the 2006-07 school year.

## **Are there exceptions allowing a school district to avoid a back-end referendum?**

Act 72 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 specific exceptions that must be approved by the court include:

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;
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 primary election, which thus 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 with the court written objections to that petition.

### ***Exceptions requiring Pennsylvania Department of Education approval***

Exceptions decided by the Department of Education include:

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 10 percent. The dollar amount of the exception must only be equal to the amount of the increase that exceeds the 10 percent.
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. Costs necessary to maintain 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 health-care-related benefits that are directly attributable to a collective bargaining agreement in effect at the time of the effective date of Act 72, 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 Act 72 goes into effect.
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 7.5 percent. The dollar amount of the exception must be equal only to the amount of the increase that exceeds the 7.5 percent.

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?**

No. Act 72 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. They may, however, use public funds to disseminate factual information relating to a referendum.

## How Can Act 72 Be Implemented in My School District?

School districts must voluntarily choose to participate in Act 72 and thus be eligible to receive property tax relief funds from the state. To participate, a school district must make a “qualifying contribution” by increasing its Earned Income and Net Profits tax (EIT) (or levying the tax if not currently using it) by at least 0.1 percent. For a taxpayer earning \$30,000 a year, this would be a tax increase of \$30.

School districts become eligible for state money by passing a resolution by May 30, 2005, that either:

1. *Raises the earned income tax by 0.1 percent.* The district also has the option of placing a referendum on the November 2005 ballot asking voters to approve a higher EIT tax rate to provide larger real property tax cuts, and/or to convert its earned income tax to the personal income tax.

If the new income tax revenues aren't sufficient to provide a homestead and farmstead exclusion of at least one-half the maximum, in November 2007 the school district must have a front-end referendum to increase the tax rate to this level. Since the maximum is one-half the median value of eligible homesteads, this means that a November 2007 referendum is needed if the homestead and farmstead exclusion is not at least one-quarter of the median value.

2. *Simply gives voters in a November 2005 front-end referendum the choice of whether to raise the earned income tax by 0.1 percent.* If that referendum passes, the higher EIT goes into effect. If that referendum instead fails, the school board still is required to impose the 0.1 percent increase.

As with the first option, if the new income tax revenues are not sufficient to provide a homestead and farmstead exclusion of at least one-half the maximum, in November 2007 the school district must have a referendum to increase the tax rate to this level.

School districts that currently do not levy the earned income tax also have a third option: that of allowing voters to decide in a November 2007 front-end referendum without the district itself making the decision about levying the earned income tax. That referendum must propose to levy the income tax (either an earned income or personal income tax, depending on the choice of the school district) at a high enough tax rate to fund at least one-half the maximum homestead and farmstead exclusion.

A school district that chooses to participate under Act 72 and that follows one of the above methods is still subject to the act's obligations (such as the back-end referendum and new budget time line) even before it receives any state property tax relief funds. Participating districts can opt to put a referendum to change their earned income to a personal income tax in any municipal election, not just in 2005 or 2007.

### What must the referendum say?

The front-end referendum must be written in clear language, be understandable to a lay person, and be framed in one of the following forms:

Do you favor imposing an additional X% (insert name of tax)? The revenue generated from the increased tax rate will be used to reduce taxes on qualified residential property by an estimated amount of \$Y. The current (insert name of tax) for the school district is Z%.

Or

Do you favor converting the school district's current earned income and net profits tax into a personal income tax at X%? The revenue generated from the personal income tax will be used to reduce taxes on qualified residential property by an estimated amount of \$Y and to replace the revenue from the current school district's earned income and net profits tax, which is now levied at Z%.

### Can school districts opt in at any point?

No. If by May 30, 2005, the school district chooses not to adopt the higher earned income tax rate or to use a 2005 referendum (or a 2007 referendum for districts not using the earned income tax at present), it does not qualify to receive property tax relief funds from the state. Act 72 gives the school district no later option for changing its decision.

### Can voters put this on the ballot?

No. Unlike Act 50 of 1998, there is no provision for taxpayers or residents to put an Act 72 referendum on the local school district ballot. The local school board alone has the ability to decide whether or not the district should participate. If the school board chooses not to implement Act 72, taxpayers and residents have no ability to override this decision.

### What is the difference between the earned income and the personal income tax?

Under Act 72, school districts for the first time 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 dramatically 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 72 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 or personal income tax exempt Social Security and pension income.

Fairness concerns about the earned income tax arise because it predominantly affects working-age people who have little investment 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 for some of their wealthier neighbors. Under Act 50, this concern was raised by local officials and residents in several parts of Pennsylvania where large numbers of wealthy retirees have moved in 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 between 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.

### How Will This Affect Taxpayers and School Districts?

#### How will Act 72 affect taxpayers?

The overall impact of Act 72 on local taxpayers is difficult to predict since it depends so much on the amount of money available at the state level for distribution through the property tax relief fund, and on the state formula used for distributing these funds. It also depends on the tax rates levied in individual school districts as well as on the income sources of individual taxpayers and whether they live in a homestead or farmstead property.

In general, however, Act 72 should benefit permanent residents in the school district who own their own home or farm. 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 (see table). If your property is worth less than the median value of homestead properties in your community (and your jurisdiction uses

<b>Impact of Homestead Exclusion on Properties in One Sample Jurisdiction.</b>				
Median value of homesteads is \$80,000. Homestead exclusion is one-half of median value, so it is \$40,000. <i>Tax rate is 30 mills.</i>				
Without the homestead exclusion		With the homestead exclusion of \$40,000		Percent decrease in real property taxes for that property
Value of a property	Tax owed on that property	Value of a property with the exclusion	Tax owed on that property	
\$40,000	\$1,200	\$0	\$0	100%
\$60,000	\$1,800	\$20,000	\$600	66%
\$80,000	\$2,400	\$40,000	\$1,200	50%
\$100,000	\$3,000	\$60,000	\$1,800	40%
\$120,000	\$3,600	\$80,000	\$2,400	33%
\$140,000	\$4,200	\$100,000	\$3,000	29%
\$160,000	\$4,800	\$120,000	\$3,600	25%

Note that even though the dollar savings to all homesteads was identical (\$1,200), the actual percentage savings varied based upon how much they were paying.

the maximum homestead exclusion of one-half the median value), you may experience a more than 50 percent reduction in property taxes. Conversely, if your property is worth more than the median homestead, you may experience a decrease of less than 50 percent in your real property taxes.

In the example shown in the table, notice that all properties receive a \$40,000 reduction in 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 \$1,200, but this makes a bigger relative impact on properties with smaller values than with larger values. An owner of a property with an initial value of \$40,000 in this sample community would enjoy a 100 percent reduction in property taxes, while this same \$1,200 would represent only a 40 percent reduction in real property taxes to the owner of a property valued at \$100,000.

Homestead and farmstead tax savings will be paid for, in part, through the local higher income tax necessary to qualify to receive money from the state property tax relief fund. Taxpayers with earned income will be paying slightly more in earned income tax, but the increase should be relatively negligible (only 0.1 percent or \$30 a year for a taxpayer with annual wages of \$30,000).

If the district opts through referendum to switch to the personal income tax, the impact on taxpayers will be somewhat different. Depending on the school district, taxpayers whose income primarily is wages and salaries should see their local income tax decrease. But taxpayers who have significant dividend and interest income (which is exempt from local taxation under the earned income tax) will likely pay more in local income taxes because they will be paying tax on that formerly exempt income. Since the change to the personal income tax is primarily a tax shift, it means that some taxpayers (those with significant interest and dividend income) will be paying somewhat more, while others (those who have wage or salary income primarily) will be paying somewhat less.

Renters generally will lose under Act 72's tax changes. Rental properties are not considered homestead properties; they will be ineligible for the homestead exclusion, so renters will receive no tax break on the portion of their rent that goes to pay the real property tax. And yet renters will be paying the higher local income tax necessary to qualify for the state funds. 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 do consider property tax bills when setting rent. When property taxes go up, generally rents go up as well.

That renters indirectly pay the property tax is recognized in state law. Pennsylvania's Senior Citizens Rebate and Assistance Act provides eligible seniors an annual rebate of up to \$500 on property taxes paid by seniors who own their home, and by seniors who rent a home on which the landlord paid property taxes.

All taxpayers will 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 have never had this opportunity previously. 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?

### **How will Act 72 affect school districts?**

Several of the most significant impacts of Act 72 include changes in districts' budgeting cycle, a changed relationship with the public, and the effect of the back-end referendum on their future flexibility to respond to changing situations.

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 likely will 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 publicly display the preliminary budget for their upcoming fiscal year at least 110 days prior to the spring election, which means sometime in January (almost six months before the new fiscal year begins).

At least 90 days before that election, in February, they will need to adopt the preliminary budget. This timing generally occurs before the governor's proposed state budget announcement, which means districts will not yet know the proposed increase in state aid they will receive. In about March, the Department of Education must notify school districts whether their proposed tax rate increases exceed the inflation index, and if so, districts will then need to either file for a petition for an exception or file to place a referendum on the ballot.

The need for early budget preparation under Act 72 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 further into the future, increasing the possibilities of error.

Act 72 fundamentally will change 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, and do a better job of explaining and justifying budget decisions. This relationship between school boards and the public will be very different from that between other elected officials (such as township supervisors, county commissioners, or even state legislators) and the public, since these will be the only elected officials who need direct voter approval for future large tax increases.

The back-end referendum, even with the ten exceptions under Act 72, 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.

Some school districts near Philadelphia will receive additional benefits from Act 72 since the act compensates districts for the earned income tax revenue they lose on suburban commuters through the Sterling Act. Districts that lose money because of the Sterling Act will receive funds directly from the state, but they must use this money for real property tax reductions.

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.

### **How will Act 72 affect local businesses and non-resident property owners?**

Act 72 should have little short-run effect on local businesses, non-resident 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 non-residents 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.

### **What Doesn't Act 72 Address?**

Act 72 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 only provides real property tax reductions, and it does nothing to increase or change state aid to school districts. It does nothing to rectify the long-term decreasing 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 72 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 state and federal mandates. Since the act focuses solely on school districts, it does little to resolve the local tax reform needs of local governments, particularly of county governments.

### **Summary**

Act 72 of 2004 is the latest and most ambitious attempt at local tax reform in Pennsylvania, with a clear focus on reducing the real property tax burden on homeowners and farmers. The combination of state gaming money and new local income tax revenues creates the possibility of significant reductions in property tax payments. The Homeowner Tax Relief Act also will give local voters a voice in local tax decision-making through front-end and back-end referenda. Yet this act does not address some of the major issues underlying tax reform arguments, and it creates new obligations on school districts that may affect them negatively. Residents need to understand Act 72 and local school finance so they can make informed decisions about them.

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## *Prepared by Timothy W. Kelsey, professor of agricultural economics*

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