pennsylvania DEPARTMENT OF REVENUE

TAX UPDATE SPECIAL EDITION

Edward G. Rendell, Governor **C. Daniel Hassell**, Acting Secretary of Revenue

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GOVERNOR RENDELL PROPOSES BUDGET WITH NO TAX INCREASE, MORE MONEY FOR PUBLIC SCHOOLS, STRATEGY FOR JOBS, PLAN TO ADDRESS FUTURE DEFICITS

With Pennsylvania finances still suffering the effects of the most stubbornly challenging national economy since the Great Depression, Governor Edward G. Rendell proposed a fiscal year 2010-11 General Fund budget on Feb. 9 that spends $26.3 billion in state money, augmented by more than $2.7 billion in federal stimulus funds.

Requiring no tax increases to balance, the plan holds the line on spending in most areas where cost increases are not mandated by law. It keeps the state on pace to meet its adequate school funding targets, and it continues Pennsylvania's commitment to meet the health care needs of seniors, those with disabilities, and children.

At $29 billion, the size of the General Fund in 2010-11 would increase by $1.15 billion, or 4.1 percent, over the current year. Spending of state dollars, however, would still be $2 billion less than in the 2008-09 fiscal year.

"The proposed budget is one that works. It keeps the cost of state government down while still investing in our future," Governor Rendell said. "It balances the needs of our citizens with the financial pressures that the national economic downturn has imposed. It readies our young people and businesses for the opportunities a reviving economy will bring."

Overall, Governor Rendell's new budget reduces spending by an average of one percent in all areas other than Education, Aging and Long Term Living, Public Welfare, Corrections, Probation and Parole, and debt service.

2010-2011 PA EXECUTIVE BUDGET

Click here for more details on the Governor's 2010-11 proposed budget.

FAST FACT:

The Governor's fiscal year 2010-11 budget contains administrative spending that is 4 percent lower than it was the year before he took office in 2002-03.

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"Initial indications are that states will face shortfalls as big as or bigger than they faced this year in the upcoming fiscal year. States will continue to struggle to find the revenue needed to support critical public services for a number of years." – *Center on Budget and Policy Priorities*

GOVERNOR RENDELL PROPOSES PLAN TO ADDRESS END OF $2.3 BILLION IN STIMULUS FUNDS BY CALLING FOR LOWER SALES TAX RATE, BUSINESS TAX REFORMS

To address future budget gaps due to the end of the federal stimulus program, Governor Edward G. Rendell recently proposed for Pennsylvania to join the ranks of states that tax natural gas extraction and tobacco products, and also to lower the state's sales tax rate from 6 percent to 4 percent starting in September.

In communities with a local sales tax on top of the state's tax, the total sales tax rate will be cut by one third as well. He also continued his call for a package of business tax reforms that would lower the state's corporate net income tax rate to 8.99 percent.

The Governor said all the revenues would be put into a special Stimulus Transition Reserve Fund that could not be touched until July 2011 – after Governor Rendell's term of office has ended – to help cover the estimated $2.3 billion budget gap that will result from the loss in federal stimulus dollars. By acting now, legislators can avoid huge tax increases that would be inevitable in the coming years.

Fairer, Simpler Sales Tax

When Pennsylvania's sales tax was adopted in 1953, the levy applied to nearly all tangible goods. Since that time, 74 categories of goods and services – goods and services that many other states already tax – have been exempted through frequent amendments pushed through the General Assembly by special interests.

"For the average Pennsylvania family, the elimination of sales tax loopholes does not impact them one way or the other. But for retail and related businesses, a lower sales tax rate will give them a stronger competitive edge," Governor Rendell said. "And businesses that have gotten a pass on sales taxes will now have to pay their fair share."

Reducing the sales tax will mean Pennsylvania's sales tax rate will be the same as New York's, and lower than the rates of Ohio, Maryland, West Virginia, and New Jersey.

In addition to exempting food, clothing, and prescription medications, the Governor's proposal would leave in place the original exemptions for manufacturing, processing and agriculture that cover machinery and equipment.

The revised sales tax would also apply broadly to services, a growing sector of the economy that is now mostly exempt. The Governor's plan would add nearly all services to the tax base, except for health care services and educational tuition. See Page 3 for the proposal of currently exempt goods and services.

Business Tax Reform Package

The Governor also asked the General Assembly to direct the proceeds of other tax changes toward a Stimulus Transition Reserve Fund. He called for lowering the corporate net income (CNI) tax rate from 9.99 percent to 8.99 percent while closing the so-called "Delaware loophole." The Governor's business tax reform package will also adopt a single sales factor plan that will help manufacturers expand and remove the cap on net operating losses which will encourage more start up and technology firms to locate their businesses in Pennsylvania.

He also called for a new tax on the extraction of natural gas, and enacting a tobacco tax on cigars and smokeless tobacco.

"For the millions of our citizens who don't have political action committees and lobbyists, this approach will lower their taxes and buffer against hefty tax increases in the future. It is fair, it is relatively pain-free, and it allows us to prepare responsibly for the challenges to come," Governor Rendell said.

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The proposal would make taxable the following 74 goods and services that are currently exempt:

Accounting, auditing and bookkeeping services
Administrative services
Advertising, public relations and related services
Air transportation
Airline catering
All other professional and technical services
Amusement and recreation industries
Architectural, engineering and related services
Bad debts
Basic television
Call center credit
Candy and gum
Caskets and burial vaults
Catalogs and direct mail advertising
Charges for returnable containers
Coal
Coin-operated food and beverage vending machines
Commercial vessels (construction and repair)
Commercial vessels (equipment, maintenance)
Common carriers
Construction of memorials
Consulting (scientific, environmental and technical)
Custom programming, design and data processing
Dry-cleaning and laundry services
Electric - Residential
Electrical, plumbing, heating and AC service fees
Financial institutions fees
Firewood
Fish feed
Flags
Fuel oil/gas - residential
Funeral parlors, crematories and death care services
Gratuities
Helicopters
Horses sold to out-of-state purchasers
Hotel-permanent resident
Information services
Investment metal bullion and investment coins
Legal services
Liquor or malt beverage purchased from retail dispenser
Magazines
Manufacturing exemption (public utility)
Motor vehicles (out-of-state purchases)
Museums, historical sites, zoos and parks (for-profit)
Newspapers
Non-prescription drugs
Other transportation
Other: personal services
Parking lots and garages
Personal care services
Personal hygiene products
Rail transportation equipment
Recreational parks, camps and campgrounds
Rental of films for commercial exhibition
School buses
Scientific research and development services
Services to buildings and dwellings
Specialized design
Spectator sports admissions (excludes schools)
Stair lift devices
Telephone - residential
Temporary usage
Textbooks
Theater, dance, music and performing arts admissions (for-profit)
Tourist promotion agencies
Transit and ground transportation
Trout
Truck transportation
Uniform commercial code filing fees
Veterinary fees
Warehouse storage
Waste management and remediation services
Water and sewage services
Wrapping and packing supplies

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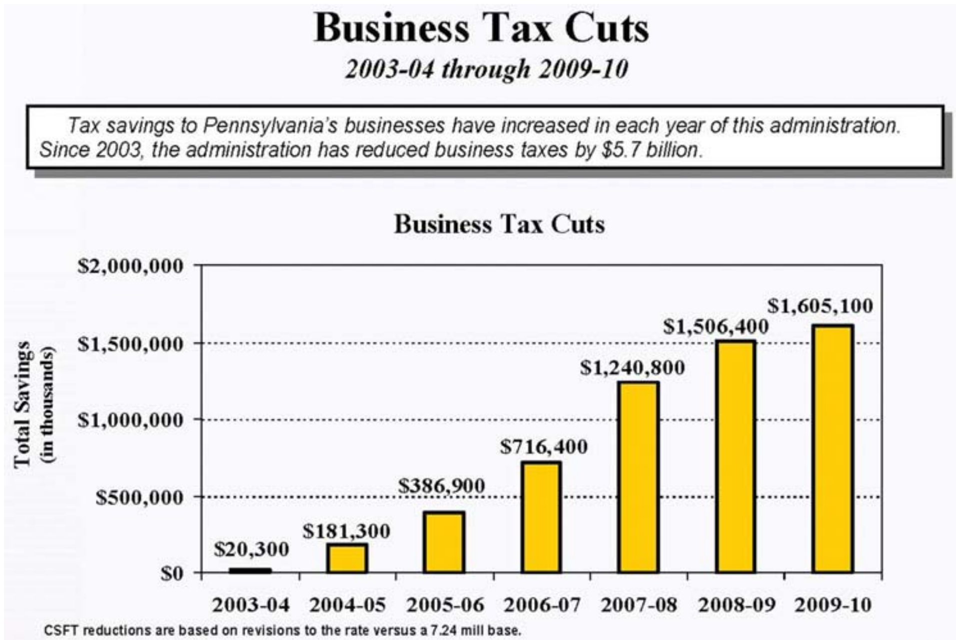
Lower Corporate Tax Rate Will Improve Competitiveness

Pennsylvania business tax rates are higher than they need to be because too many firms do not pay their fair share. Seventy-one percent of Pennsylvania companies subject to the tax currently do not pay corporate net income taxes in Pennsylvania. This is partly because the "Delaware loophole" allows businesses to shift income and profits to no- or low-tax states and avoid paying Pennsylvania taxes. For example, a company might set up a headquarters office in locations like Delaware or Nevada and shift income to that affiliate, even though most of its day-to-day operations are located in Pennsylvania.



The Governor's plan will put an end to tax avoidance strategies and will make Pennsylvania the 24th state to adopt a process called combined reporting.

"I propose that we extend the same principle of fairness to our corporate tax system by closing the loopholes that allow companies located outside the state, yet have a substantial Pennsylvania presence, a significant tax advantage over those that have all of their operations within our borders. The goal, again, is for all companies to pay their fair share," Governor Rendell said.

States That Have Adopted Combined Reporting Since 2005

State	Year Adopted
Texas	2006
West Virginia	2007
New York	2007
Michigan	2007
Massachusetts	2008
Wisconsin	2009

Combined reporting will allow Pennsylvania to lower its corporate net income tax rate from 9.99 percent to 8.99 percent.

Under the single sales factor system, Pennsylvania will calculate taxes based on the share of a company's sales that take place in Pennsylvania. The tax change is good for employers including manufacturers that already have a significant presence in Pennsylvania, but sell most of their goods and services in other markets. It also creates new incentives for employers to add jobs or build a new plant in the commonwealth. Ten other states already use the single sales factor model.

By lifting the cap on net operating loss deductions, Pennsylvania will become a more attractive place for entrepreneurs to start new business and create new jobs. Many young companies, including technology and biotech firms, do not record profits for the first few years of operation. The Governor's plan will help create more jobs in these industries as well as support new job growth by alternative energy, clean transportation, and environmental cleanup companies. Pennsylvania will join 44 other states that do not have a dollar limit on net operating loss carry forwards.

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Updating Other Taxes

In asking the General Assembly to approve taxes on natural gas extraction, cigars and smokeless tobacco, and to eliminate the on-time payment discount for vendors, Governor Rendell renewed requests that he made to the legislature last year.

- **Natural gas** — Pennsylvania has immense natural gas reserves in a geologic formation known as the Marcellus Shale, yet it is one of just six states that do not tax natural gas. The industry is growing rapidly and in a recent Marcellus Shale land lease sale, the commonwealth received more than twice the revenue it expected. These results show that the industry can bear a modest tax — 5 percent of value, plus 4.7 cents per 1,000 cubic feet of gas produced — without hurting growth. Ten percent of the revenues will be distributed to local governments where drilling is taking place.
- **Cigars and smokeless tobacco** — Pennsylvania remains the only state in the nation that does not tax smokeless tobacco and one of only two states that do not tax cigars. Under the Governor's plan, these products would be taxed at 30 percent of their wholesale value.
- **Vendor Discount** — A one-percent discount currently offered to vendors that pay sales taxes on time is a relic of the pre-computer era, when many companies had to manually calculate the sales taxes owed to the state. The incentive is no longer needed because 90 percent of filers submit sales tax records electronically. More than half of all companies receive a discount of less than $9 per year and two-thirds receive less than $100 annually.

Act Now or Face Unacceptably Large Tax Hikes

Pennsylvania must begin preparing now for the end of federal stimulus funding in 2011. By enacting the measures Governor Rendell called for, Pennsylvania would accumulate $2.3 billion for the 2011-12 fiscal year to prepare itself for the loss of federal stimulus money, and to help the next governor and General Assembly deal with the fiscal challenges that will remain in the slowly recovering national economy.

"If we don't act now, the next administration will be backed into a corner that will result in unacceptably large tax hikes for Pennsylvania businesses and families," Governor Rendell said.

Over the past seven years, the Rendell administration has enacted tax cut policies that have saved individual citizens and businesses billion of dollars. Since 2006, property tax relief has provided $1.7 billion in savings for Pennsylvania homeowners, mostly notably seniors, many of whom have had their school property taxes completely eliminated. State homeowners will receive a projected $700 million in additional real estate tax savings next year.

Since 2003, Pennsylvania businesses have saved $5.7 billion in state taxes through reductions in the capital stock/foreign franchise tax, targeted tax credits, and an expansion of the net operating loss deduction.

Stimulus Transition Reserve Fund – Proposed Revenue Sources

Type of Revenue	Additional Revenue September 2010 to June 2011	Resulting Revenue Used for 2010-11 Budget	Transfer to Stimulus Transition Reserve Fund
Sales and Use Tax Reform (cut sales tax rate to 4% and eliminate 74 tax exemptions)	$531.5 million	$0	$531.5 million
Eliminate the Vendor Sales Tax Discount	$73.6 million	$0	$73.6 million
Extend Tobacco Products Tax to Cigars and Smokeless Tobacco	$41.6 million	$0	$41.6 million
Natural Gas Severance Tax	$160.7 million	$0	$160.7 million
Business Tax Package (combined reporting, single sales factor, uncap the Net Operating Loss deduction)	$66.6 million	$0	$66.6 million
Total	**$874.0 million**	**$0**	**$874.0 million**

THE 2010-11 BUDGET PROVIDES NEARLY $770 MILLION IN CONTINUED PROPERTY TAX RELIEF

The 2010-11 budget provides nearly $770 million in property tax relief, including $613.7 million in broad-based property tax relief and $129.1 million in property tax and rent rebates for older Pennsylvanians. When fully in place, this tax reform will cut property taxes by more than $1 billion each year. This will ensure that Pennsylvania communities will be able to compete even more effectively for new and existing businesses and remain attractive for families.

Continuing Property Tax Relief for Pennsylvania Homeowners

The 2010-11 budget marks the fourth year of historic property tax relief for Pennsylvania homeowners. The Taxpayer Relief Act – signed into law in 2006 – has already eliminated school property taxes for more than 123,000 older Pennsylvanians. In the coming year, Pennsylvania homeowners, on average, will continue to receive nearly $200 in state-funded property tax relief – with even more savings for older adults who have the most urgent need.

- In 2010-11, the $613.7 million in broad-based property tax cuts will translate to an average of nearly $200 for every Pennsylvania household. Instead of reducing property taxes, Philadelphia's share of funding for broad-based tax relief will be used to reduce the city's wage tax, which is a greater barrier to economic growth in Philadelphia. The Taxpayer Relief Act also allows Scranton to use a portion of its tax relief funds to cut that school district's wage tax, the highest of all Pennsylvania school districts.
- The Property Tax/Rent Rebate program will provide $129.1 million in property tax and rent rebates for nearly 600,000 older Pennsylvanians earning less than $35,000 a year. This program funds tax relief for nearly 405,000 homeowners and 195,000 renters. These older Pennsylvanians will receive additional property tax relief through the broad-based property tax relief eligible to all homeowners.
- Older Pennsylvanians who pay a significant portion of their income in property taxes or who live in high property-tax areas will receive additional targeted property tax relief totaling $26.9 million in 2010-11.

Pennsylvania's favorable business and tax climate, along with property tax reductions that are the direct result of the successful implementation of expanded legalized gaming, strongly position the commonwealth to attract and retain jobs.

Estimated Property Tax Relief
Funded by Expanded Gaming in Pennsylvania

Type of Tax Relief	Amount of Tax Relief in 2010-11
Property tax relief for all homeowners from gaming revenue (wage tax relief in Philadelphia)	$613.7 million
Enhanced property tax rebates of up to $650 for older Pennsylvanians earning up to $35,000 a year	$129.1 million
Higher rebates for older Pennsylvanians with a high tax burden or those living in cities with a high tax burden	$26.9 million
TOTAL	**$769.7 million**

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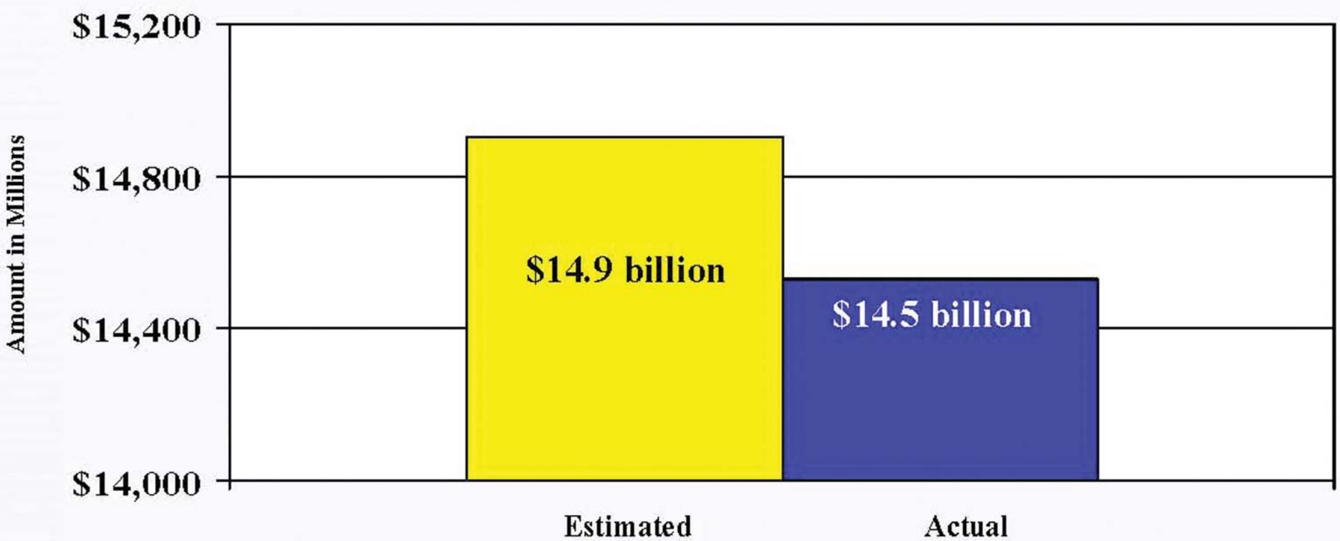
2009-10 General Fund Revenues

Estimated versus Actual Revenue Collections, July 2009 – January 2010

Despite a conservative, zero-growth projection, General Fund revenue collections in the first seven months of 2009-10 were $374 million lower than estimated. The administration now projects a year-end revenue shortfall of $525 million.



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