

Unfinished Business: The New Pittsburgh Payroll Tax May Generate Complex Problems for the City and Affected Taxpayers

On December 1, 2004, Governor Ed Rendell signed into law amendments to the Pennsylvania Local Tax Enabling Act (Act 222 of 2004) authorizing the City of Pittsburgh, effective January 1, 2005, to levy and collect a tax of up to 0.55% on payroll amounts generated as a result of an employer conducting business activity within the city and a \$52 annual occupational privilege tax. Upon implementation of the payroll tax, the rate of the city's business privilege tax will be reduced from six mills to two mills in 2005 and 2006; to one mill in 2007 through 2009; and will be eliminated entirely beginning in 2010. In addition, Pittsburgh's parking tax will be capped at 50% and gradually reduced to a maximum rate of 35% by 2010. Act 222 applies the payroll tax to "all persons conducting business activity" within Pittsburgh, including unrelated business activities of charitable organizations and businesses engaged in the manufacturing, processing or transportation of goods, minerals, timber and farm products that currently enjoy a statutory exemption from the business privilege tax.

Pittsburgh's Mayor, Tom Murphy, praised the enactment of Act 222 as "an important and historic accomplishment" that would close so-called "tax loopholes" which allegedly allowed "24 of the 27 largest businesses in Pittsburgh to pay almost no business taxes." According to Mayor Murphy, the legislation provided for the "reform and modernization of [Pittsburgh's] tax structure [that] was essential to position Pittsburgh to compete, to thrive and grow in an increasingly interdependent, global marketplace." In particular, Mayor Murphy described the phase-out of the city's current business privilege tax on gross receipts as essential because the tax "discouraged

small and entrepreneurial start-ups from locating [in Pittsburgh] and discouraged business expansion."

Regardless of whether taxpayers share Mayor Murphy's optimism regarding the desirability of phasing-out Pittsburgh's business privilege tax and reducing its parking tax using revenues provided by a new payroll tax, serious questions exist regarding the scope and coverage of the new payroll tax that will pose challenges with respect to the implementation of the tax. These problems include clarifying the extent to which various types of for-profit and not-for-profit entities are subject to or exempt from the tax; determining what types of payments to include in payroll and net earnings subject to the tax; establishing procedures for the preparation and submission of tax returns; and determining the legal significance of provisions of the law prohibiting the offset of tax payments by compensation reductions. While many of these problems may be effectively addressed by implementing ordinances and regulations adopted by the city, some problems may require an extended period of time to resolve.

FOR-PROFIT ENTITIES SUBJECT TO AND EXEMPT FROM THE PAYROLL TAX

While the objective of Act 222 is to establish a comprehensive payroll tax applicable to all employers doing business in Pittsburgh, because the legislation fails to expressly override numerous judicial and legislative limitations upon the power of the city to impose taxes, the scope of its coverage is uncertain. For example, nothing in the legislation clarifies whether the General Assembly intended to override long-standing judicial decisions exempting banks¹

and beer distributors² from local taxation on the basis of a state preemption. Likewise, because of state preemption it is uncertain whether slot machines licensees authorized to do business within the city by the Pennsylvania Gaming Control Board will be subject to the tax.³ In addition, the legislation fails to clarify whether it is intended to override various existing statutory exemptions from local taxation provided for credit unions,⁴ mutual thrift institutions,⁵ and hospital plan and professional health service corporations (*i.e.*, Blue Cross and Blue Shield).⁶

NOT-FOR-PROFIT ENTITIES SUBJECT TO AND EXEMPT FROM THE PAYROLL TAX

Applying Act 222 to non-profit entities may also pose difficult challenges. Charitable organizations that qualify for tax exemption pursuant to the Institutions of Purely Public Charity Act are required to calculate the tax attributable to the city based upon their total payroll, but are only required to pay tax on that portion of payroll expense attributable to “business activity” for which a tax may be imposed pursuant to § 511 of the Internal Revenue Code, *i.e.*, payroll attributable to unrelated business income as reported on IRS Form 990T. In addition, if the charity operates branches, affiliates, subsidiaries and other business entities that do not independently qualify as institutions of purely public charity, the tax must be paid on the payroll attributable to such branches, affiliates or subsidiaries, regardless of whether the employees are leased or placed under the charity’s umbrella or parent organization. Charities may, however, contract with the city to provide services for the benefit of the city in lieu of taxes due.

In implementing Act 222, the city will need to determine the extent to which non-profit organizations that do not qualify as institutions of purely public charity otherwise constitute “employers” engaged in

business activities. For example, the city will need to determine whether foundations generating funds and distributing grants to charitable organizations are engaged in business activities subject to the tax. Furthermore, to the extent non-profit organizations do not own real property within Pittsburgh and have not been classified as institutions of purely public charity by the city, it will be necessary to determine whether the city will accept or seek to review charitable exemptions granted for sales and use tax purposes by the Pennsylvania Department of Revenue.

CHALLENGES OF CONSTITUTIONAL AND STATUTORY INTERPRETATION

In resolving issues relating to the whether various for-profit and not-for-profit entities are subject to the payroll tax, the city will be forced to confront difficult issues relating to the constitutional uniformity of taxation and the statutory interpretation of enabling legislation.

To the extent the city elects to selectively apply the tax to some but not all businesses, uniformity problems may arise. For example, if the city elects to recognize statutory exemptions from taxation for credit unions (especially those with community charters) but not commercial banks and mutual savings banks, will the legislation irrationally discriminate against similarly situated taxpayers? Likewise, will the tax be subject to attack based upon impermissible discrimination if it is applied to commercial health insurers, but not Blue Cross and Blue Shield Plans

On the other hand, to the extent the city interprets Act 222 as applicable to all “employers,” various legal and practical problems may arise. Legally, the city may be confounded by provisions of Pennsylvania Statutory Construction Act requiring that laws imposing taxes must be strictly construed with any

¹ *City of Pittsburgh v. Allegheny Valley Bank of Pittsburgh*, 412 A.2d 1366 (Pa. 1980).

² *Commonwealth v. Wilsbach Distributors*, 519 A.2d 397 (Pa. 1986).

³ See *e.g.*, *Liberty Racing Association v. Philadelphia Tax Review Board*, 488 A.2d 1063 (Pa. Cmwlth. 1984) (holding that the General Assembly by enacting legislation licensing, comprehensively regulating and imposing special taxes on harness racing intended to preempt all local regulation, including taxation).

⁴ 17 Pa. C.S. § 517 (“A credit union incorporated under or subject to this title ... shall not be subject to taxation except as to real estate owned by it”).

⁵ 72 P.S. § 8502(e) (“Institutions subject to the provisions of this article ... shall be exempt from all local taxation imposed by political subdivisions of this Commonwealth ... except taxes on real estate or transfers thereof”).

⁶ 40 Pa.C.S. §§ 6103(b) & 6307(b) (Every health plan corporation and professional health service corporation “shall be exempt from taxation by the Commonwealth and its political subdivisions”).

uncertainty resolved in favor of the taxpayer.⁷ Likewise, in implementing the payroll tax the City will be forced to cope with provisions of the Statutory Construction Act providing that whenever a general provision in a statute conflicts with a special provision in another statute, the two shall be interpreted to give effect to both with the special provision being construed as an exemption to the general provision, absent a “manifest” contrary intent expressed by the General Assembly.⁸ From a practical perspective, the City may also be faced with the retaliatory tax laws of other states relating to the taxation of insurance companies and may be limited in its ability to impose the tax on state-chartered credit unions because of their ability to convert to national charters exempt from state taxes as a matter of federal law.

PAYROLL SUBJECT TO TAXATION

Act 222 defines “payroll amounts” subject to taxation as “all amounts paid by an employer as salaries, wages, commissions, bonuses, net earnings and incentive payments” and “fees and similar remuneration for services rendered.” The term “employer” is defined to mean “all persons conducting business activity within [Pittsburgh], except for a governmental entity.” An employer is deemed to be conducting business activity within the city if the employer maintains a fixed place of business within the city, owns or leases real property within the city for business purposes, maintains a stock of tangible personal property within the city for sale in the ordinary course of business, conducts “continuous solicitation” within the city related to a business, or utilizes the streets of the city in connection with the operation of a business, except for transportation through the city. Total payroll is apportioned to the city for tax purposes based upon the “portion of payroll expense which the total number of days an employee, partner, member, shareholder or other individual works within the city bears to the total number of days such employee or person works within and outside the city.”

The broad definition of payroll fails to clarify whether or not the tax applies to fringe benefits, including

health, accident and life insurance payments; payments to employee cafeteria plans; moving expense payments; employee achievement awards; reimbursement of employee expenses, including expenses for meals, lodging and travel; workers’ compensation and disability pay; dependent care benefit payments; deferred compensation; tuition or scholarship payments; retirement benefits and other State and federal payroll taxes. Act 222 also fails to clarify the extent to which payments to partners, members and shareholders participating in pass-through entities constitute “remuneration for services rendered” as opposed to earnings on capital invested in an enterprise. It is similarly unclear regarding the extent to which “fees and similar remuneration for services rendered” subject to the tax constitute the gross receipts, rather than payroll, of businesses primarily engaged in the provision of services.

One approach to minimizing these concerns may be for the City of Pittsburgh in implementing Act 222 to interpret the term “payroll” consistent with the policies of the Internal Revenue Service incorporated into the Simplified Tax and Wage Reporting System and as recently codified in the Uniform Wage Withholding and Unemployment Insurance Act.⁹ Other problems, however, especially with respect to the application of the tax to “net earnings,” will require solutions for which no template or precedent is readily available.

THE PREPARATION AND SUBMISSION OF TAX RETURNS

Implementing ordinances and regulations will be critically needed to supplement the scanty provisions of Act 222 relating to the preparation and submission of tax returns. Although the legislation requires that all employers file quarterly returns and make quarterly payments of the correct amount due, and imposes substantial penalties for underpayments of obligations, no quarterly payment schedule is established, no system of annual reconciliation is established, and no safe-harbors are provided for taxpayers not able to accurately estimate earnings on a quarterly basis. At a minimum, these details will be critical to the

⁷ 1 Pa.C.S. § 1928(b)(3).

⁸ 1 Pa.C.S. § 1933.

⁹ The text of the Uniform Act is available at www.nccusl.org.

establishment of a workable tax system that avoids imposing unreasonable administrative burdens on taxpayers.

Implementing ordinances and regulations may also be necessary to address provisions of Act 222 that allow non-profit organizations to provide services to the city in lieu of making tax payments. In particular, standards will be required for the execution of Service in Lieu of Payroll Tax Agreements and to coordinate such agreements with existing Payment in Lieu of Tax Agreements (“PILOTS”).

LIMITATIONS ON PAYROLL AND BENEFIT REDUCTIONS

In an apparent attempt to distinguish the payroll tax from the less politically palatable alternative of increasing wage taxes or adopting a commuter tax, Act 222 requires that “an employer shall not offset the amount of tax paid ... by reducing compensation or benefits to employees.” Unfortunately, this provision has the potential for creating a host of legal and practical problems for taxpayers and the city.

For example, is the anti-offset provision enforceable and, if so, does it create a regulatory taking without compensation? If the law is valid, what are the consequences of violations and what remedies are available? Will all reductions in compensation or benefits be regarded as a reduction for purposes of Act 222 regardless whether there is a legitimate business reason for the reduction? Will the city inject itself into collective bargaining negotiations and other compensation-setting arrangements to ensure that the anti-offset law is not violated? How in the context of the distribution of returns from pass-through entities, such as partnerships, can the requirement be implemented? Does the prohibition against the reduction of benefits and compensation for partners subject to the tax mean that the tax must be exclusively paid by partners not working within the City of Pittsburgh?

In the interest of minimizing problems associated with the anti-offset language, implementing ordinances and regulations should ideally define the applicability and limitations of the requirement and provide a variety of safe-harbors by which taxpayers can avoid inadvertent violations of the law.

CONCLUSION

While the passage of Act 222 may constitute the historic event described by Mayor Murphy, successfully implementing a payroll tax will require extensive work and cooperation between the city and affected taxpayers and the development of detailed and comprehensive implementing ordinances and regulations. Completing this work in time to implement the new tax on a timely basis will clearly constitute a substantial challenge. Kirkpatrick & Lockhart will monitor developments relating to the implementation of Act 222 and will provide further guidance following the development of implementing ordinances and regulations by the City of Pittsburgh.

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