K&LNG Alert

OCTOBER 2005

Pennsylvania Real Estate

New Developments in Pennsylvania's Local Transfer Taxes

New Pennsylvania Law Requires Local Ordinances to Fully Conform to State Transfer Tax Requirements; Allows the Pennsylvania Department of Revenue to Enforce Local Real Property Transfer Taxes; Exposes Taxpayers to Increased Liabilities for Alleged Underpayments of Local Transfer Taxes; and Clarifies that Most, But Not All, Local Transfer Taxes Are Subject to a One Percent Rate Limitation

On July 7, 2005, Pennsylvania's Governor, Ed Rendell, signed Act 40 into law, amending provisions of the Tax Reform Code of 1971 which governs the imposition, enforcement and collection of local real estate transfer taxes in Pennsylvania. Act 40 is intended to make the enforcement and collection of local transfer taxes more effective by allowing local taxing authorities to delegate collection responsibilities to the Department of Revenue; increasing the statute of limitations with regard to the collection of local taxes; synchronizing the requirements of local ordinances and state transfer tax laws; and clarifying the application of a 1% aggregate rate limitation to local transfer taxes, which are not assessed in home rule municipalities. The transfer tax provisions of Act 40 will take effect and apply to any document executed or presented for recording on or after October 5, 2005.

BACKGROUND

In addition to a 1% real estate transfer tax imposed by the Commonwealth of Pennsylvania, Pennsylvania law also allows cities, boroughs, towns, townships and school districts to impose local transfer taxes. Typically, all transfer taxes levied by local taxing authorities may not exceed an additional 1% aggregate levy. However, certain home rule municipalities are permitted to levy higher transfer taxes, including Philadelphia (3%), Pittsburgh (3%), and Scranton (2.7%). Transfer taxes are imposed in Pennsylvania upon the recording of deeds transferring title to property; the execution of certain long-term leases; and the transfer of ownership interests in certain real estate companies and family farm corporations. Both state and local transfer taxes are collected by County Recorders of Deeds, who remit payments to the Commonwealth or the appropriate local taxing authorities.

Since 1986, the power of local taxing authorities to levy transfer taxes generally has been limited to transactions subject to tax by the Commonwealth. To the extent local transfer taxes were imposed upon "additional classes or types of transactions" prior to 1986, local governments have been permitted to continue collecting taxes on transactions not subject to state tax.

Historically, the split of local collection and enforcement responsibilities between Recorders of Deeds and local taxing authorities, the creation of overlapping enforcement jurisdictions between municipalities and school districts, and uncertainty regarding differences between state and local taxing practices typically have resulted in weak and poorly coordinated efforts to recover underpayments of local transfer taxes. Although the Department of Revenue has been reasonably aggressive in identifying and pursuing claims for the nonpayment or alleged underpayment of transfer taxes, the Department has been reluctant to become involved in local collection efforts because of potential differences in state and local taxing practices and concerns regarding the

legality of sharing tax information with local governments. As a result, the recovery of tax underpayments by the Commonwealth has not been accompanied by comparable recoveries by local governments.

Act 40 is intended to authorize (but not mandate) the Department of Revenue to coordinate a unified transfer tax collection program to remedy these problems. When a local taxing authority delegates collection responsibilities to the Department, the Department may retain 10% of all amounts collected as compensation for its collection efforts. Other informal methods of state and local cooperation are also authorized by the legislation in the form of the sharing of information regarding tax collection activities. To facilitate state and local cooperation, the legislation provides a significant benefit to taxpayers by eliminating nonuniform local transfer tax collection practices by all local taxing authorities, except for the City of Philadelphia.

ENHANCED ENFORCEMENT POWERS

In an attempt to enhance the enforcement and collection of local transfer taxes, the legislation has increased the statute of limitations afforded to local taxing authorities in several situations. Prior to the enactment of Act 40, local taxing authorities were authorized to make a determination of additional tax and interest due by any person failing to pay a local transfer tax only within three years after the document conveying the applicable interest in real property was recorded. Furthermore, only in limited situations involving fraud were local taxing authorities afforded an unlimited statute of limitations for the collection of delinquent taxes. However, pursuant to the enhanced enforcement procedures enacted under Act 40, in addition to cases of fraud, local taxing authorities are afforded an unlimited statute of limitations with respect to any case involving an "undisclosed, intentional disregard of rules and regulations." Therefore, under the new law, local taxing authorities are afforded an unlimited statute of limitations in a much broader array of situations. Act 40 also allows for a six-year statute of limitations in cases where taxpayers underpay local transfer taxes by 25% or more.

In addition to exposing taxpayers to more vigorous enforcement powers, by allowing for the coordination of state and local enforcement activities, Act 40 also may expose taxpayers to more frequent demands to pay taxes based on "computed values" (*i.e.,* the assessed value divided by the common level ratio) when significant differences exist between stated consideration and computed values. This may be true especially where real property is transferred with other business assets and the consideration reported is a result of allocations of the purchase price, which may not be set forth in a separate sales agreement.

CONFORMITY BETWEEN STATE AND LOCAL REGULATIONS

The "grandfather clause" allowing local taxing authorities to continue pre-1986 practices with respect to the taxation of "additional classes or types of transactions" not subject to tax under state law has created uncertainty regarding the extent to which transactions are subject to local transfer taxes. For example, although the Department of Revenue promulgated regulations in 1988 codifying a previously recognized "turnkey exception" from transfer tax, some local taxing jurisdictions have questioned whether they are required to recognize the exception. Pursuant to this regulation, no state transfer tax is assessed on either end of a transaction in which a property owner transfers real estate to a contractor or developer who is contractually required to reconvey the property to the original owner after developing or constructing improvements upon the property. While it is questionable whether any local taxing authorities expressly provided for the taxation of turnkey transactions prior to 1986, disputes about the scope of transactions taxed under pre-1986 ordinances have allowed local taxing authorities to argue that they have the authority to tax transactions like the turnkey transaction even though the state does not tax such transactions.

Act 40 addresses the problem of the lack of uniformity between state and local taxing powers by repealing the grandfather clause allowing for the taxation of additional "classes or types of transactions" by local governments. While it is possible that some local taxing authorities may attempt to continue to argue

that they possess greater taxing authority under the "tax anything" powers granted by the Local Tax Enabling Act, the validity of such claims certainly will be subject to challenge. To minimize surprises, however, prudent property owners and their counsel should continue to consult both state and local transfer tax laws when analyzing whether a specific transaction is exempt from both state and local transfer taxes. In the event local taxing authorities attempt to continue taxing transactions exempt under state law and regulations, the discrepancy should be disclosed in statements of value or other written communications to avoid potential allegations concerning any alleged "undisclosed, intentional disregard of rules and regulations" that may trigger an extended statute of limitations and increased penalties.

IMPACT OF ACT 40 ON HOME RULE TRANSFER TAX RATES

The inclusion of a previously omitted cross-reference from state law by Act 40 and the history of the legislation have generated some uncertainty and controversy regarding the applicability of the 1% aggregate local transfer tax limit to home rule municipalities.

Generally, the Local Tax Enabling Act imposes a 1% limit on the aggregate amount of local transfer taxes imposed by local taxing authorities. Home Rule Charter legislation, however, generally exempts home rule municipalities from tax rate limitations imposed by the Local Tax Enabling Act, except with respect to the taxation of the income of nonresidents. However, in 1986, when the General Assembly generally required local transfer taxes to be collected pursuant to state law, it created confusion by referencing certain limitations on the total amount of revenue collected by local taxing authorities, but by failing to expressly cross-reference the law imposing the 1% rate limitation. Because Act 40 corrects this oversight, some commentators have suggested the intent is to subject all local transfer taxes, including those in home rule municipalities, to the 1% aggregate rate limit.

The confusion regarding the impact of supplying the previously omitted cross-reference to the 1% rate limit was exacerbated by the legislative history of Act 40. When the original version of the legislation was introduced, it contained a provision excepting "a city of the second class which is a home rule municipality" from the combined maximum tax rate requirement. Pittsburgh is the only such municipality within the state. When other home rule municipalities requested the inclusion of similar language in the legislation, these provisions were removed purportedly as unnecessary because of the express provisions of Home Rule Charter Laws allowing higher tax rates. The legislative history in this regard, unfortunately, is less than clear.

However, due to the fact that the legislation did not expressly modify or repeal provisions of other laws exempting home rule municipalities from tax rate limitations and given the prior judicial precedent upholding such exemptions for home rule governments, claims that the legislation limits all local transfer taxes, including those of home rule municipalities, to a 1% aggregate rate limit may face substantial legal challenges.

Blaine A. Lamperski
412.355.8309
blamperski@klng.com

Raymond P. Pepe
717.231.5988
rpepe@klng.com

Lisa R. Geisel
412.355.6339
lgeisel@klng.com

Steven J. Adelkoff
412.355.6325
sadelkoff@klng.com

FOR MORE INFORMATION on this Alert or other Pennsylvania real estate tax issues, please feel free to contact one of the Kirkpatrick & Lockhart Nicholson Graham LLP lawyers listed below:

Pittsburgh

Steven J. Adelkoff	412.355.6325	sadelkoff@klng.com
David H. Ehrenwerth	412.355.6532	dehrenwerth@klng.com
Blaine A. Lamperski	412.355.8309	blamperski@klng.com
David J. Lehman	412.355.6738	dlehman@klng.com
Raymond P. Pepe	717.231.5988	rpepe@klng.com
Pierce Richardson	412.355.6786	prichardson@klng.com

www.klng.com

BOSTON ▪ DALLAS ▪ HARRISBURG ▪ LONDON ▪ LOS ANGELES ▪ MIAMI ▪ NEWARK ▪ NEW YORK ▪ PALO ALTO ▪ PITTSBURGH ▪ SAN FRANCISCO ▪ WASHINGTON