

**STATUS REPORT:**

**DISTRIBUTION OF NON-RESIDENT  
EARNED INCOME TAX FUNDS**

**April 2003**

In January 2002, pursuant to its authority and responsibility as set forth in the Fiscal Code, 72 P.S. § 403, the Department of the Auditor General (the Department) issued a Notice to School Districts. The purpose was to inform school districts of questionable practices in the distribution of non-resident Earned Income Tax (EIT) funds and delinquent taxes by private tax collectors as disclosed in reports prepared by the Department's Office of Special Investigations (OSI) and to alert school districts to the need for effective financial management and oversight of their local tax collection activities.

Since the issuance of the Notice, the Department has:

1. Received additional complaints concerning questionable practices and abuses in the handling and distribution of non-resident EIT funds extending far beyond those described in OSI's reports and involving other local governments and tax collectors.
2. Provided information and made recommendations to the Department of Community and Economic Development (DCED) in connection with an analysis of the EIT system conducted by DCED's Governor's Center for Local Government Services.
3. Monitored ongoing efforts of tax collectors to resolve disputed EIT claims in one of the cases referred to in the Notice.

The details of our information to date in each of the three above areas of concern show that the system for distribution of non-resident EIT funds is seriously flawed and that requirements of the governing statute are not being followed:

#### Questionable EIT Practices and Abuses

The EIT is imposed by municipalities and school districts pursuant to the Local Tax Enabling Act, 53 P.S. § 6901, et seq. (referred to as Act 511). Act 511 requires employers to withhold EIT funds from employees' salaries and wages and to remit the withheld funds to the jurisdiction (or to the jurisdiction's tax officer/collector) in which the employer's facility is located. The jurisdiction and its tax officer are responsible for distribution of the collected EIT funds of non-residents to other jurisdictions entitled to all or a portion of them based on the taxpayer's residence. However, actual practices among some jurisdictions and public, as well as private, tax collectors are quite different, as has been brought to our attention during the past year. The questionable activities include:

- *Requiring submission of tax claims as the basis for distribution of non-resident EIT funds.*

Act 511 specifically states that political subdivisions, i.e., local governments, are not required to request the distribution of non-resident EIT funds to which they are entitled. However, the practice of some collectors is to hold non-resident EIT funds they have collected until after a tax claim has been submitted by the jurisdiction seeking the funds. This results in delays, retention of EIT funds by collectors without disclosure of earned interest and, in some cases, the almost complete breakdown of the system. An example of this is Erie County, where, according to information from local government officials and media reports during 2002, the City of Erie, Erie School District and Millcreek Township are involved in a dispute over claims to approximately \$11.8 million of undistributed non-resident EIT funds.

In some cases, it may be necessary for local governments to submit claims because the resident municipality and school district of the taxpayer cannot readily be identified by tax collectors and employers. However, this should be the exception rather than the rule. Requiring school districts and other local governments to submit claims for undistributed EIT funds to which they are entitled shifts responsibility for proper and timely distribution away from the tax collector that receives the funds from employers, adds additional costs to the process and increases the likelihood of protracted disputes or litigation. All of this results in taxpayer funds not being used for the intended purposes.

- *Charging of interest and “collection fees.”*

The Department received complaints that some private and public tax collectors and local jurisdictions regularly charge other jurisdictions interest and fees in connection with the distribution of non-resident EIT funds to the school district or local government entitled to the funds. The amounts of interest or fees vary considerably among jurisdictions. In some cases, the interest or fee has been as high as seven percent. There is no provision in Act 511 that authorizes charging interest or fees for the distribution of non-resident EIT funds.

- *Imposition of a statute of limitations on claims for non-resident EIT funds.*

Tax collectors impose varying and often arbitrary periods beyond which they refuse to honor claims. Some tax collectors refuse to honor claims after as few as three years. Some limitation period may be appropriate. However, given the time it often takes local governments to identify taxes that were due and collected, the imposition of an unreasonably short statute of limitations results in some EIT funds never being

distributed to the appropriate local government. Act 511 does not authorize use of a statute of limitations in connection with the distribution of collected EIT funds.

#### DCED's Analysis of the EIT Collection Process

DCED has primary responsibility for providing assistance and guidance to local governments in regard to financial management, including local tax matters. During 2002, DCED's Governor's Center for Local Government Services conducted a survey of the collection of the local EIT in the Commonwealth. In connection with the survey, DCED sought assistance from the Department, including information gathered in the cases reported by OSI and other information obtained by the Department after the Notice was issued. The preliminary results of the survey appear to confirm that the EIT process, particularly the handling and distribution of non-resident EIT funds, is not functioning in accordance with Act 511.

The Department supports strongly the efforts of the Governor's Center for Local Government Services to develop an accurate picture of the EIT collection and distribution process and to recommend legislation, as well as steps to be taken by local governments, tax collectors and employers to correct problems. The Department has made recommendations to the Center and endorsed recommendations submitted by others, including the following:

- Time limits should be established for distribution of non-resident tax moneys by tax collectors.
- Statutes of limitations and fees for tax claims should be prohibited or made reasonable, consistent and uniform.
- Penalties should be established for violations of Act 511 by tax collectors.
- A mechanism should be established to resolve disputes over undistributed non-resident EIT funds and to enforce the Act 511 requirements applicable to tax collectors.
- Audit requirements for EIT collectors should be strengthened, especially those requiring disclosure of sources and disposition of all collected EIT funds. The Department specifically recommended that such audits be conducted in accordance with generally accepted government auditing standards.
- Local taxing jurisdictions should be required to enter into written contracts with tax collectors and tax collectors' bonding requirements should be increased.

- Additional education and training should be provided for taxing jurisdictions and tax collectors.

### Disputed EIT claims

The Department's January 2002 Notice to School Districts stated that an OSI inquiry found that there had been a failure to make timely distribution of EIT funds and that, as recently as September 2001, three school districts (Forest Hills, Ligonier Valley and Westmont Hilltop) informed the Department that they were owed over \$276,000 in collected, but undistributed, EIT funds.

A summary report of the OSI inquiry was released in January 2002. The inquiry was limited, based on the information available to OSI at that time, and was not an audit or a full investigation. After the release of the Notice and the summary report, the private tax collector to whom the EIT funds were reportedly paid contacted the Department and offered to cooperate. Since that time and while the Department has received complaints of problems in the EIT system involving other tax collectors, that tax collector and the private tax collector demanding the funds on behalf of the three school districts have made efforts to resolve the issue. Tax claims on behalf of the three school districts totaling \$257,000 were submitted in March and April 2002. According to the most recent information, claims in the amount of approximately \$43,481 (about 16 percent of the total) have been paid. The remaining claims, totaling about \$213,000, are still in dispute. The tax collector to whom the claims were submitted has informed the Department that it has no record of receiving payments on accounts of individuals whose social security numbers were listed in the claims submitted on behalf of the three school districts.

While both tax collectors appear to be acting in good faith, there are still substantial unresolved claims on behalf of the three school districts. The issues between the two collectors represent only a small part of the problems in the EIT system. However, the duration of these issues, after a year of efforts to resolve the claims, demonstrates vividly some of the glaring deficiencies in the EIT process, particularly the long delays in distribution of funds and the lack of a fair mechanism for timely resolution of disputes among tax collectors.

### Conclusions

We continue to urge school districts and other local government bodies to institute internal controls to ensure proper and timely distribution of local tax funds, including requiring detailed reports from tax collectors showing sources of tax funds, funds to be distributed to other taxing authorities, actual distributions of such funds, collected tax funds for which the taxing authority (i.e., the local government entitled to the funds) has not been identified, overpayments, refunds and explanations of partial and incomplete distributions.

We also urge DCED to complete and issue the results of the analysis of the EIT system conducted by the Governor's Center for Local Government Services, and, in particular, to address the abusive and questionable practices related to tax claims, interest, fees and the use of statutes of limitations in the distribution of non-resident EIT funds.