

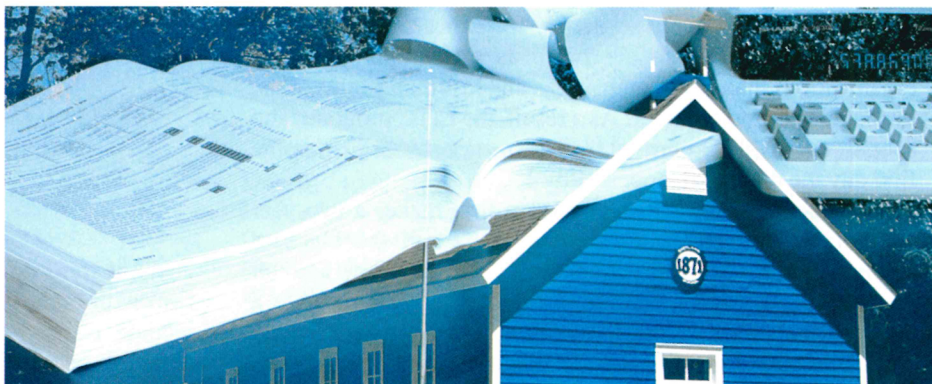
# Redirect Taxes to Invest in Our Community's Future

## *Changes to Pennsylvania Law Allow Taxpayers to Help Low-Income Children Receive a Quality Education*

**S**ay you are a partner in the Philadelphia office of the law firm, ABC LLP, that does business in more than 20 states. You may have heard about programs like the Pennsylvania Education Improvement Tax Credit (EITC) and Opportunity Scholarship Tax Credit (OSTC) that lets you use your Pennsylvania taxes to leverage your charitable interests in helping children from low-income Philadelphia families succeed. But, since not all the partners in your firm either need or want Pennsylvania tax credits, it probably would not work for you. Well, all that has now changed with a major amendment (Act 194 of 2014) to the Pennsylvania educational tax credit programs that went into effect in 2015.

**How does the credit work?** You and some of your fellow partners in the Philadelphia office pay significant Pennsylvania personal income on the revenue passed through to you as a partner at ABC LLC. You may even have Pennsylvania personal taxes to pay from capital gains. You and these other partners can now easily form a subsidiary partnership, a “business firm,” for the sole purpose of using EITC or OSTC credits to offset each of your Pennsylvania personal income tax liabilities. Once you form the entity, you apply for tax credits based on each member’s personal tax liability (and how many credits you want), and then the members pass-through the state tax credits to use against their personal state tax liability.

This eliminates the issue that larger multi-state law practices often had when there were too many out of state members who could not take advantage of the Pennsylvania tax credits, or members who did not wish to contribute money and participate in the programs. Another important change also allows the EITC/OSTC credits to be used to offset joint



income of the partner, member or shareholder’s spouse on a jointly filed tax return. This is a substantial change to the long-standing Commonwealth tax laws that dictate that tax credits are personal to the person who obtained them. Therefore, you can apply the credits to your and your spouse’s jointly filed state tax return.

**How does it work for ABC LLP firm?** Previously, ABC LLP could not participate in these tax credits because the credit would be allocated on a pro rata ownership basis to all the partners in all 20 states, most of whom could not use the credit. But now – for example – you and two other partners (U, V, W) can form a subsidiary organization, UVW LLC, owned by the three of you in proportion to the amount of credits you wish to use. Next, on July 1 (the start of the state’s fiscal year and when the tax credits are available), UVW LLC will apply with the Dept. of Community and Economic Development through a short online application for either EITC or OSTC credits based on the total amount of credits the partners want. If your personal Pennsylvania liability is \$12,000, for example, you make a contribution to UVW LLC of \$13,333, and upon approval by the state, UVW LLC sends a contribution on your behalf for \$13,333 to a qualified scholarship

organization. In turn, you claim \$12,000 on your Pennsylvania return and receive a \$1,333 deduction on your federal return. Your donation of \$13,333 to a qualified scholarship organization has a \$0 net cost to you. As such, the EITC and OSTC programs are some of the most leveraged and strategic investments that anyone can make on behalf of low-income children, their future families and our city.

**What are these programs?** EITC and OSTC are a way for a business firm that pays Pennsylvania business taxes to get a significant (up to 90 percent) state tax credit (i.e., it directly reduces the amount of liability) for donations made to certain state-approved organizations that help improve kindergarten-12th grade education for children in need in the Commonwealth. From a business standpoint, the tax credit and application process of the EITC and OSTC programs operate identically. The main difference between the two programs are the beneficiaries. Under the long-standing EITC program, there are three types of tax credits available: (1) credits for contributions to an eligible “education improvement organization” (EIO), (2) credits for contributions to an eligible “scholarship organization” (SO) and (3) credits to a “pre-school organization” (PKTC). Under OSTC,

however, the credits are only available for contributions to approved scholarship organizations, that in turn must provide scholarships specifically to children who are trapped in what the state considers “failing” schools. Specifically, a contribution by a business under OSTC requires that an approved scholarship organization provide scholarships for students that reside in the catchment zone of the lowest 15 percent of performing public schools in the state. The state maintains a list of those low-performing schools and it maintains a separate list of approved organizations under OSTC and EITC, and unfortunately, nearly half of these failing schools are located in Philadelphia.

A business must apply separately for either OSTC or EITC credits. Note that there are twice as many approved EIO organizations than SO organizations and less than a third of the available tax-credit dollars. As a result, the EITC program, and specifically the EIO portion, is always over-subscribed on the first day the credit bank opens July 1.

**What is the credit?** If the business firm makes a two-year commitment for the same amount each year, the business receives a state tax credit equal to 90 percent of the amount donated. For a one-year commitment, the business receives a 75 percent state tax credit. In addition, you can take a federal charitable gift deduction as you would for any charitable donation, thereby making the out-of-pocket cost about a nickel for a dollar in scholarship support. There is no minimum amount and the maximum is up to \$750,000 in state tax credits per business firm. Here is a sample calculation based on UVW LLC above:

ENTITY TYPE	S/LLC/LP
PENNSYLVANIA TAXABLE INCOME OF ALL 3 DONORS	\$1,000,000
PENNSYLVANIA TAX OF ALL 3 DONORS	\$30,700
AMOUNT DONATED TO OSTC PROGRAM	\$34,111
PENNSYLVANIA OSTC CREDIT ALLOCATED TO DONORS (2-YEAR-90 PERCENT) AMOUNT IS DISTRIBUTED PRO RATA BASED ON OWNERSHIP INTERESTS OF UVW LLC	\$30,700
FEDERAL TAX SAVINGS (NET AMOUNT AT 35 PERCENT)	\$1,351
CASH OUT FROM DONORS	\$34,111
TOTAL TAX SAVINGS TO DONORS	\$32,051
NET COST TO DONOR FOR \$34,111 GIFT	\$2,060

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**What steps do I take?** First, you can easily form a business firm with other partners who will pay Pennsylvania personal income taxes. Second, on July 1, the business firm must complete a simple online application at the Pennsylvania Department of Community and Economic Development website ([www.newpa.com](http://www.newpa.com)) for a particular amount of credits to apply to the following taxes: Personal state liability of a member, partner or shareholder of pass-through organization; Corporate Net Income Tax; Bank and Trust Company Shares Tax; Title Insurance Companies Share Tax; Insurance Premiums Tax; or Mutual Thrift Institutions Tax.

**Businesses new to the program must apply on July 1 when the state’s tax credit bank opens.** The state awards the credits on a first-come, first-served basis. While it has been challenging for new businesses to get into the EITC program, the newer OSTC program (with \$50 million in the tax credit bank) has more flexibility. Businesses are informed by the state of their approval via letter and then have 60 days to make a donation (based on their approved credits as explained below) to an approved organization. Organizations must then provide a proper acknowledgement of the gift, that the business firm sends to the state, and the credits are then applied to the tax account for the business firm. Finally, the business firm makes an election (Form Rev 1123) to pass the credits to each of the owners based on their ownership interest in the business firm.

For Philadelphia area-based lawyers interested in directly impacting the educational futures of low-income children, this charitable commitment is a win-win. For those individuals paying the federal alternative minimum tax, the full federal charitable deduction, coupled with the ability to lower one’s personal state tax liability, can be even more beneficial. Many organizations that utilize this funding can help with all the steps and answer questions, but the time to act is now: with new applications for credits due on July 1, interested persons must take the steps to form their special business firm now. ■

*Nicole G. Tell ([ntell@csfphiladelphia.org](mailto:ntell@csfphiladelphia.org)) is vice president, development at Children’s Scholarship Fund Philadelphia.*