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Pennsylvania is about to lose tax reciprocity with New Jersey. Here's what it means

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New Jersey Gov. Chris Christie recently announced that he will end an agreement between New Jersey and Pennsylvania that allows commuters to pay state income tax only to the state where they live, instead of to the state where they work. The announcement, which came as a surprise to many, was denounced by employers and employees in both New Jersey and Pennsylvania.

In an effort to balance the state's budget and account for what he described as a "$250 million state budget hole" created by the State Legislature regarding proposed, yet potentially unattainable, public employee health insurance savings, Christie stated he will unilaterally end New Jersey's participation in the state income tax reciprocity agreement with Pennsylvania, effective Jan. 1.

The agreement between New Jersey and Pennsylvania allows employees to file tax returns and pay income tax in their state of residence only, regardless of their place of employment. New Jersey does not have a tax reciprocity agreement with any other of its neighboring states, including New York.

Ending the agreement (originally implemented in 1977) will impact thousands of employees and employers. It is estimated that nearly 250,000 workers will take on the added burden of filing income tax returns in both states. While Pennsylvania has a low, flat personal income tax rate of 3.07 percent, New Jersey's income tax rates range from 1.40 percent, for taxable incomes under $20,000, to 8.97 percent for taxable incomes over $500,000 -- nearly triple Pennsylvania's rate. Christie's action is designed to raise New Jersey state revenue without raising state tax rates, eliminating property tax relief, reducing state aid to education and hospitals, or reducing the state's scheduled pension payments. Christie expressed a willingness to revise these plans, however, if New Jersey lawmakers take action to reduce health care costs.

Employees and individuals will not be the only parties affected; employers will need to modify their payroll withholding processes. All employers with locations in both states will need to track the work location for each employee so that individual employee tax withholdings are allocated to the proper state. Employers who operate out of one state only may find that their payroll processing time and cost is reduced since they will only have to report to one state.

New Jersey-based companies may have to offer higher salaries to attract and retain qualified Pennsylvania-based employees. Employers will also need to consider New Jersey's new 23 cents-per-gallon gas tax, which will eliminate the commuter cost savings that Pennsylvania residents enjoy by purchasing their gas in New Jersey. The long-term impact of this announcement may be that companies looking to relocate or expand in the region will favor Pennsylvania, whereas in the past the personal income tax was not an issue most companies needed to consider, due to the reciprocal agreement.

Employers may want to consider notifying their employees now of the potential changes to their withholdings, as described below, so that the employees can adequately plan for the upcoming change in their net pay. The change will take effect with the first payroll paid in 2017.

Pennsylvania residents commuting to New Jersey may see a tax rate increase of up to 5.9 percent since their incomes may be subject to taxation at New Jersey's higher marginal rates. New Jersey residents commuting to Pennsylvania may see a tax rate increase if they are being taxed at the lower marginal New Jersey rates, which are less then Pennsylvania's flat tax rate.

New Jersey residents commuting to Philadelphia or any other Pennsylvania municipality that imposes a local earned income tax potentially will be subject to higher taxes, since New Jersey residents will no longer be able to claim a tax credit for taxes paid to a Pennsylvania municipality. Philadelphia resident employees working at New Jersey companies will be hardest hit, and the impact on their net pay check could be significant.

Pennsylvania Gov. Tom Wolf has urged Christie to reverse his decision, citing both states' mutual interest in creating jobs and economic opportunities in the region, and in defense of Pennsylvania commuters who will suffer higher tax burdens as a result of New Jersey's political budget debate. The Pennsylvania Department of Revenue estimates a $5 million revenue loss for the Commonwealth as a result of the change.

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