PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 1: CUSTOMER SERVICE AND TAXPAYER ASSISTANCE

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CHAPTER 1: CUSTOMER SERVICE AND TAXPAYER ASSISTANCE

I. ONLINE SERVICES

A. Revenue e-Services Center at www.revenue.state.pa.us

This is the location for all the department's electronic filing services. Through this Web site you can –

1. file returns using pa.direct.file
2. request an extension of time to file
3. make payments, including estimated payments
4. check the status of your return and refund
5. update your address
6. calculate penalty and interest
7. pay tax due by electronic funds withdrawal for Pennsylvania personal income taxes (PA PIT) and
8. find a link to pay by credit/debit card.

Taxpayers who filed a Pennsylvania tax return last year but did not receive a booklet can receive an access number to file using either PA TeleFile or pa.direct.file by logging onto the Department's Online Customer Service Center at www.revenue.state.pa.us or going to the nearest District Office and presenting picture identification.

B. Online Customer Service Center at www.revenue.state.pa.us

If you have Internet access, you can find answers to commonly asked questions by using the department's Online Customer Service Center. Use the *Find an Answer* feature to search the database of commonly asked questions. If you do not find your answer, submit your question to a customer service representative.

II. TAXPAYER ASSISTANCE

A. Taxpayer Service and Information Center

Call (717) 787-8201 for Pennsylvania personal income tax help during normal business hours, 7:30 a.m. to 5 p.m., Eastern Standard Time. For business taxes call (717) 787-1064.

B. 1-888-PATAXES (728-2937)

Touch-tone service is required for this automated 24-hour toll-free line. Call to order forms or check the status of a personal income tax account, corporation tax account or property tax/rent rebate.

Harrisburg area residents may call (717) 772-9739.

C. Services for Taxpayers with Special Hearing and/or Speaking Needs

Services for Taxpayers with Special Hearing and/or Speaking Needs: Call 1-800-447-3020 (TTY only).

D. Language Services

Non-English-speaking taxpayers can receive assistance from the Department through an interpretation service. Assistance is available in 140 languages.

Español
El Departamento de Impuestos puede ayudar los contribuyentes que no hablan inglés por medio de un servicio de traducción durante el periodo de pago de impuestos.

III. TAX PREPARATION SERVICE ASSISTANCE

A. Free Income Tax Preparation Service

Taxpayers can receive free assistance in preparing uncomplicated, non-business Federal, state, and local income tax returns through the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. Contact the District Office nearest you for information or call the Internal Revenue Service's toll-free number (1-800-829-1040) for the location of assistance sites. Taxpayers with moderate incomes and senior citizens are urged to take advantage of this service.

B. Federal Tax Assistance

Assistance in filing your federal income tax return is available –

1. Federal tax account or technical information and problem solving are available by calling 1-800-829-1040.
2. Recorded Tele-Tax Service on federal tax topics or current year tax refund information is available by calling 1-800-829-4477.
3. Federal tax forms and publications are available by calling 1-800-829-FORM (3676).
4. Federal tax forms and publications are available at www.irs.gov.

IV. TAXPAYERS' RIGHTS ADVOCATE

The Pennsylvania Department of Revenue has a Taxpayers' Rights Advocate who assists taxpayers with problems and concerns that have not been resolved through normal administrative procedures. It is the Advocate's responsibility to ensure that the Department provides equitable treatment with dignity and respect. If you would like more information concerning taxpayer's rights, taxpayers may contact the Taxpayers' Rights Advocate –

1. Send e-mail to: pataxadvocate@state.pa.us

2. Call (717) 772-9347

3. Fax: (717) 787-8264

4. Write to:

   PA DEPARTMENT OF REVENUE
   TAXPAYERS' RIGHTS ADVOCATE
   LOBBY, STRAWBERRY SQUARE
   PO Box 280101
   HARRISBURG PA 17128-0101

Please include PA form REV-556, Taxpayer Request for Assistance with all written correspondence. PA form REV-556 is available on the department's Web site or by contacting the Taxpayers' Rights Advocate office.

V. VOLUNTARY DISCLOSURE PROGRAM

The Voluntary Disclosure Program provides an opportunity for businesses and individuals who have recently become aware of their Pennsylvania tax obligations to voluntarily come forward. In return for coming forward voluntarily, filing their tax returns, and clearing their tax debts, taxpayers are only responsible for the payment of tax and interest. All of the penalties for all taxes administered by the Pennsylvania Department of Revenue will be waived when the requirements of the Voluntary Disclosure Agreement have been completed.

The program is only available to those taxpayers who are not registered with the department, and for which no investigations or collection actions have begun.

VI. FORMS ORDERING SERVICES

To obtain any Pennsylvania forms, instructions booklets, schedules, or brochures, use one of these services –

1. **Internet:** www.revenue.state.pa.us
   Pennsylvania income tax forms, schedules, brochures, electronic filing options, and other information are available on the department's Web site. If you do not have Internet access, visit your local public library.

2. **E-mail Requests for Forms:** ra-forms@state.pa.us

3. **1-888-PATAXES (728-2937)**
   Touch-tone service is required for this automated 24-hour toll-free line. Call to order forms or check the status of a personal income tax account, corporation tax account or property tax/rent rebate.

   Harrisburg area residents may call (717) 772-9739

   Note: The department does not have all forms available by fax.

4. **Automated 24-hour Forms Ordering Message Service:**
   Call 1-800-362-2050. This telephone line serves taxpayers without touch-tone telephone service.

5. **Written Requests:**

   PA DEPARTMENT OF REVENUE
   TAX FORMS SERVICE UNIT
   711 GIBSON BLVD
   HARRISBURG PA 17104-3200

VII. PENNSYLVANIA DEPARTMENT OF REVENUE DISTRICT OFFICES

A district office's location may change. Please call to verify the address before visiting a district office or visit the department's Web site at **www.revenue.state.pa.us** for information. Office hours are 9:00 a.m. to 12 p.m. and from 1 to 4 p.m., Eastern Standard Time.

ALTOONA
STE 204
CRICKET FIELD PLZ
615 HOWARD AVE
ALTOONA PA 16601-4867
(814) 946-7310

BETHLEHEM
44 E BROAD ST
BETHLEHEM PA 18018-5998
(610) 861-2000

CHESTER
6TH FL STE 602
419 AVENUE OF THE STATES
CHESTER PA 19013-4451
(610) 619-8018

ERIE
448 W 11TH ST
ERIE PA 16501-1501
(814) 871-4491

GREENSBURG
SECOND FL
15 W THIRD ST
GREENSBURG PA 15601-3003
(724) 832-5386

HARRISBURG
LOBBY
STRAWBERRY SQ
HARRISBURG PA 17128-0101
(717) 783-1405

JOHNSTOWN
425 MAIN ST
JOHNSTOWN PA 15901-1808
(814) 533-2495

NEW CASTLE
103 S MERCER ST
NEW CASTLE PA 16101-3849
(724) 656-3203

NORRISTOWN
SECOND FL
STONY CREEK OFFICE CENTER
151 W MARSHALL ST
NORRISTOWN PA 19401-4739
(610) 270-1780

PHILADELPHIA
STE 204A
110 N 8TH ST
PHILADELPHIA PA 19107-2412
(215) 560-2056

PHILADELPHIA
ACDMY PLZ SHPG CTR
3240 RED LION RD
PHILADELPHIA PA 19114-1109
(215) 821-1860

PITTSBURGH
CHMBR COMMRCE BLDG
411 7TH AVE – ROOM 420
PITTSBURGH PA 15219-1919
(412) 565-7540

READING
STE 239
625 CHERRY ST
READING PA 19602-1186
(610) 378-4401

SCRANTON
RM 200
SAMTERS BLDG
101 PENN AVE
SCRANTON PA 18503-1970
(570) 963-4585

SUNBURY
535 CHESTNUT ST
SUNBURY PA 17801-2834
(570) 988-5520

III. FILING OPTIONS.

A. Paperless Filing. Millions of taxpayers are choosing one of these fast file options. Select the one that is right for you and go paperless!

PAPERLESS FILING IS:

Safe: Taxpayer information is protected by the latest security, plus taxpayers receive confirmation that they filed, whatever option they choose

Easy: The systems perform all of the math calculations; and

Fast: The Pennsylvania Department of Revenue approves paperless refunds within three to four weeks instead of six to eight weeks for paper returns.

When a taxpayer uses one of the three paperless filing options outlined below, they do not have to send a paper copy of their return to the Department. For their records, taxpayers should keep a copy of the return or worksheet. With pa.direct.file and TeleFile, taxpayers receive a confirmation number as proof that they filed their Pennsylvania Income Tax return.

Election Access Number - EAN
To file over the Internet using pa.direct.file or by telephone using TeleFile, taxpayers need an Election Access Number(s). If the taxpayer filed a 2001 Pennsylvania tax return:

- They can look up the PIN on the Department's home page, or
- Go to a Department district office, present their picture identification, and obtain a PIN. If the taxpayer qualifies for a paperless filing option, they can also obtain a Pennsylvania Fast File booklet at the district office.

If the taxpayer is filing electronically for the first-time:

- Taxpayers can complete Form REV-749- Electronic Signature Form and receive a PIN, or
- Taxpayers can download Form REV-749 from the Department's home page, or
- Taxpayers can order from one of the Forms Ordering Services .

1. Do-It-Yourself Free Electronic Filing. *pa.direct.file* - This Internet filing option is fast, easy, safe, and *free*. Select the link for pa.direct.file and use the Department-assigned PIN.

Certain taxpayers may file their Pennsylvania tax returns from a personal computer, live over the Internet, directly to the Department of Revenue. There is no charge for this service. In order to use Pennsylvania Direct File, an individual must have the insert with the preprinted label or the PA-V payment posting voucher letter indicating the correct Social Security Number(s) and personal identification number(s) (PINs). This information is needed to access the Pennsylvania Direct File system via the Department's Internet home page of www.revenue.state.pa.us.

Field Code Changed

Pennsylvania Direct File may be used to file a return comprised of one or more of the following:

- Pennsylvania taxable compensation from Federal Forms W-2 and 1099 MISC
- Allowable unreimbursed employee business expenses (PA Schedule UE)
- Pennsylvania taxable interest income (PA Schedule A)
- Pennsylvania taxable dividend income (PA Schedule B)
- Pennsylvania taxable income if similar to that being reported on Federal Schedule C-EZ
- Certain sales of property (PA Schedule D)
- Pennsylvania taxable rents, royalties, patents, and copyright income (PA Schedule E)
- Pennsylvania taxable income from estates and trusts (PA Schedule J)
- Pennsylvania taxable income from gambling and lottery
- Pennsylvania tax withholding from Federal Form W-2
- Pennsylvania estimated tax payments
- Pennsylvania tax forgiveness credit

If any other schedules, types of income, or credits are applicable, a PA-40 return must be filed.

Complete instructions for Pennsylvania Direct File are located on the Department's home page listed above.

If a taxpayer has not received a PIN (Personal Identification Number) because he or she did not file a 2001 Pennsylvania income tax return, they can obtain one through one of the the Department's district offices or from the central office.

A taxpayer can complete an Electronic Signature Form available from a district office, through forms ordering, or off the Department's WEB site. This may be presented to the district office where a PIN will be provided for use at another site immediately or may be mailed or faxed to the address on the form. Then the PIN will be sent to the applicant via e-mail or regular mail.

If the taxpayer wishes to file the return at the district office, he or she may fill out a short form, provide picture identification, and a PIN will be assigned immediately.

2. <u>Telefile</u>. This is often the easiest way to file simple Pennsylvania Personal Income Tax return. A taxpayer can find out if he or she can use *TeleFile* by visiting the Department's Internet home page or by ordering a Pennsylvania Fast File booklet.

3. <u>Through a Tax Preparer or Purchased Software</u>. *PA/IRS e-file* - If a taxpayer pays a professional to complete his or her Federal and PA-40 tax returns, the taxpayer should ask his or her preparer to e-file the return. E-file is a joint initiative with the IRS that allows for the simultaneous filing of your Pennsylvania and Federal tax returns.

   If a taxpayer prepares his or her own tax returns, they can buy software that allows them to file their Pennsylvania and Federal returns together. Although not free, e-file allows direct refund deposit and electronic funds withdrawal for payment.

B. Paper Filing. PA-40EZ – Taxpayers may not file the PA-40EZ in the following circumstances: (1) final return for a decedent, (2) amended return, (3) if they were a nonresident, and (4) if they were a part-year resident. Taxpayers who desire to file a paper return and cannot use the PA-EZ should file a PA-40.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 2: PERSONAL INCOME TAX INFORMATION SECURITY

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CHAPTER 2: PERSONAL INCOME TAX INFORMATION SECURITY

I. INTRODUCTION

The self-assessment feature is an essential component of Pennsylvania's personal income tax. The Department of Revenue is acutely aware that, to foster this feature, the public must maintain the highest degree of confidence that any personal and financial information furnished to the Department is protected against unauthorized use, inspection or disclosure. Accordingly, there are significant statutory constraints on the Department's use of tax information.

II. GENERAL RULE FOR PENNSYLVANIA TAX INFORMATION

Generally, it is unlawful for any officer, employee or agent of the Commonwealth to –

- Divulge or to make known in any manner whatever to any person (including other officers, agents or employees of the Commonwealth), the amount or source of income, profits, losses, expenditures or any particular thereof set forth or disclosed in any return made pursuant to or under color of Article III of the Tax Reform Code ("TRC"), or

- Permit any return made pursuant to or under color of Article III of the TRC or copy thereof or any book containing any abstract or particulars thereof, to be seen or examined by any person (including other officers, agents or employees).

It is also unlawful for any person (including an officer, agent or employe of the Commonwealth) to print or publish in any manner whatsoever, any return made pursuant to or under color of Article III of the TRC or any part thereof or source of income, profits, losses or expenditures appearing in any such return.[1]

Moreover, it is unlawful to divulge or make known—

- Any information gained by any administrative department, board, or commission, as a result of any returns, investigations, hearings or verifications required or authorized under the statutes of the Commonwealth imposing taxes for State purposes, or providing for the collection of the same.[2]

- Any Federal tax information obtained from the Federal Government.[3]

[1] 72 P.S. §7353(f)
[2] 72 P.S. §731
[3] IRC §6103

III. "OFFICIAL PURPOSES" EXCEPTION

Nothing prohibits the divulging or making known of information gained by any administrative department, board, or commission, as a result of any returns, investigations, hearings or verifications required or authorized under the statutes of the Commonwealth imposing taxes for State purposes, or providing for the collection of the same, for official tax administration or tax collection purposes of the Commonwealth.

"Official purposes," however is limited to official tax administration or tax collection purposes. Such information cannot lawfully be used for other purposes (including even a purpose within the statutory powers of a state agency or an investigation of criminal activity by the Attorney General, a district attorney, the Crime Commission or the General Assembly). [4]

IV. OTHER EXCEPTIONS TO GENERAL RULE

There currently are only thirteen other exceptions to the general rule set forth in Part III.

A. Liens Filed Of Record

Information regarding unpaid taxes shown in liens filed of record in a prothonotary's office because of unpaid tax is not confidential. [5]

B. Delivery To Taxpayer

The delivery to a taxpayer or his duly authorized representative of a certified copy of any return filed in connection with his tax is permitted. [6]

C. Delivery With Consent Of Taxpayer

The delivery of a certified copy of any return filed in connection with a taxpayer's tax to a third party is permitted when the Department has in its possession a statement signed by the taxpayer authorizing the Department to deliver the same thereto. [7]

D. Inspection By Legal Representatives Of The Commonwealth

The inspection by the Attorney General or other legal representatives of the Commonwealth of the return of any taxpayer who shall bring action to review the tax based thereon or against whom an action or proceeding has been instituted for the collection or recovery of any tax imposed by Article III of the TRC is permitted. [8]

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[4] 42 Pa. C.S.A. §8721 et seq.
[5] Note: As the law is unclear respecting information regarding unpaid taxes shown in liens filed of record *in the Department*, it is the policy of the Department not to make them known except for tax collection purposes.
[6] 72 P.S. §7353(g)
[7] 1990 Op.Atty.Gen. No. 90-1.
[8] 72 P.S. §7353(g)

E. Where The Department Of Revenue Is A Party In An Action Or Proceeding In Court Under The Provisions Of Article III Of The TRC

It is lawful for any officer or employe of the Commonwealth having custody of returns to produce them or evidence of anything contained in them in any action or proceeding in any court on behalf of the Department of Revenue under the provisions of Article III of the TRC to which it is a party, or on behalf of any party to any action or proceeding under the provisions of article III of the TRC, when the returns or facts shown thereby are directly involved in such action or proceeding. In either of which events, the court may require the production of and may admit in evidence so much of said returns or the facts shown thereby as are pertinent to the action or proceeding and no more. [9]

F. Other Actions, Proceedings Or Matters

Except as provided in Part IV. (E), it is unlawful for any officer or employe of the Commonwealth having custody of returns to produce them or evidence of anything contained in them in actions or proceedings without the consent of the taxpayer or unless pursuant to a court order. [10]

The Department may release personal income tax information pursuant to a court order only if the taxpayer whose information is sought is provided an opportunity to show cause why the information ought not be released. A subpoena for personal income tax information is legally insufficient.

G. Cooperation With Other Governmental Agencies

1. Officers and employees of the Department of Revenue may permit the Commissioner of Internal Revenue of the United States, or the proper officer of any political subdivision of this Commonwealth or of any other state imposing tax based upon the incomes of individuals, or the authorized representative of such officer, to inspect the tax returns of any taxpayer, or may furnish to such officer or his authorized representative an abstract of the return of income of any taxpayer, or supply him with information concerning any item of income contained in any return of any taxpayer.

   Except as provided in the following paragraph, such permission shall be granted or such information furnished to such officer or his representative only if the statutes of the United States or of such other state, as the case may be, grant substantially similar privileges to the proper officer of this Commonwealth charged with the administration of the personal income tax law thereof. [11]

[9] *Ibid*.
[10] 1990 Op.Atty.Gen. No. 90-1
[11] 72 P.S. §7356

2. Where the department has entered into an agreement with the taxing authorities of any state that imposes a tax on or measured by income to provide that compensation paid in such state to residents of this Commonwealth shall be exempt from such tax, the department, in such agreements, may provide for an exchange of information.

H. Information Regarding Refunds Or Credits And The Names Of The Persons Or Corporations Entitled Thereto

Information regarding refunds or credits in excess of $200 and the names of the persons entitled thereto, is not confidential. Accordingly, the contents of the refund docket of the Board of Appeals and Board of Finance and Revenue are not confidential information respecting such information. The contents of their review and refund dockets, however, are otherwise confidential. [12]

I. Statistical Publications

The publication of statistics so classified as to prevent the identification of particular returns and the items thereof is permitted.

J. PHEAA

The delivery to the Pennsylvania Higher Education Assistance Agency of a certified copy or extract of any State income tax return requested by the agency for use in determining the eligibility of applicants for State grants is permitted when the Executive Director of the agency certifies that the agency has in its possession a statement signed by the applicant and his parent, parents, guardian or guardians, as the case may be, authorizing the agency to obtain a certified copy or extract of any State income tax return from the Department of Revenue. [13]

K. School Districts Imposing A Personal Income Tax

The Department of Revenue is expressly authorized to permit the proper officer or an authorized agent of a school district imposing a personal income tax to inspect the tax returns of any taxpayer of the school district or may furnish to the officer or an authorized agent an abstract of the return of income of any current or former resident of the school district, or supply information concerning any item of income contained in any tax return. The officer or authorized agent of the school district imposing the personal income tax shall be furnished the requested information upon payment to the Department of Revenue of the actual cost of providing the requested information.

Note: this exception is applicable only if the taxpayer has designated the school district as having been his place of legal residence on the taxpayer's tax return, either for the returnable year or for a prior returnable year.

[12] 1988 Op.Atty.Gen. No. 88-3.
[13] 72 P.S. §7353(g).

L. Total Personal Income Of School Districts

The Department is authorized and required to release to the Secretary of Education the total amount of personal income of each school district.[14] This information is used by the Department of Education to determine the amount of State subsidies to individual school districts.

The Department is also authorized to supply to each school district a listing of the names and addresses of each person who has filed a State income tax return with the Department of Revenue for the tax year preceding the immediate prior year and designated thereon the code number indicating that the taxpayer was a resident of the school district at the close of the tax year for which the return was filed.[15]

M. Absent Parents

Information collected as a result of the use of tax records of an absent parent may be released to the Secretary of Public Welfare or his designees in writing as provided by Federal law relating to the disclosure of Federal tax information.[16]

V. FEDERAL INCOME TAX RETURNS AND RETURN INFORMATION SECURITY

The self-assessment feature is also an essential component of the Federal income tax. Accordingly, there are also significant constraints on the Department's use of Federal Tax Information ("FTI"). They are set forth in IRC §6103 and explained in Federal Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies and Entities*. Federal requirements are outlined below.

A. Definitions

1. "Return"

IRC §6103 uses the term "return" to denote all of the following:

i. Any tax or information return;

ii. Any declaration of estimated tax;

iii. Any claim for refund; and

iv. Any amendment or supplement to items i, ii, or iii, including supporting schedules, attachments, or lists which are supplemental thereto or part thereof.

[14] 24 P.S. §25-2514.1
[15] *Ibid.* That section also authorizes, but does not require, the school district to disclose that return information to the school district it claims should properly have received the information.
[16] 23 Pa. C.S.A. §4373

2. "Return Information"

The term "return information" is broadly defined in IRC §6103 to mean--

i. A taxpayer's identity;

ii. The nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, over-assessments, or tax payments;

iii. Whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing;

iv. Any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary of the Treasury with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense;

v. Any part of any written determination or any background file document relating to such written determination (as such terms are defined in IRC §6110(b)) which is not open to public inspection under IRC §6110; or

vi. Any closing agreement under IRC §7121, and any similar agreement, and any background information related to such an agreement or request for such an agreement.

The term takes in not only the information that appears on a tax or information return, declaration of estimated tax or claim for refund (*i.e.*, "the information on a return") but also—

- Any information gained in verifying the accuracy of a tax or information return, declaration of estimated tax or refund claim or other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to the same, as well as

- Data received by, recorded by, prepared by, furnished to, or collected by the Secretary of the Treasury *wholly without respect to a "return"* for the purpose of determining the existence, or possible existence, of liability (or the amount thereof) of any person for any Federal income tax, penalty, interest, fine, forfeiture, or other imposition. [17]

[17] The only information not covered by the definition is information that is gained at a hearing required or authorized under the IRC.

B. General Rule For State Officers And Employees

FTI may be obtained by State tax agencies only to the extent the information is needed for, and is reasonably expected to be used for, State tax administration and/or the administration of State and local child support enforcement programs. Accordingly, although Pennsylvania law permits access to State tax information by PHEAA, the Department of Education, and school districts, they are not permitted access to FTI. State tax agencies also are not permitted to furnish FTI to political subdivisions, such as cities or counties, for any purpose, including tax administration (but see Part V.C). [18]

Even among officers and employees of the Department, access to FTI must be strictly on a need-to-know basis. Therefore, as a condition of receiving FTI, a State must show, to the satisfaction of the IRS, the ability to secure and protect the confidentiality of that information. Safeguards must be designed to prevent unauthorized access and use. A State must ensure its safeguards will be ready for immediate implementation upon receipt of FTI.

C. Disclosure To Contractors And Other Agents

IRC §6103(b)(5)(B)(iii) permits Federal return or return information to be disclosed to a contractor or other agent of a State only if such entity, to the satisfaction of the Secretary of the Treasury —

i. Has requirements in effect which require each such contractor or other agent which would have access to returns or return information to provide safeguards to protect the confidentiality of such returns or return information,

ii. Agrees to conduct an on-site review every 3 years (or a mid-point review in the case of contracts or agreements of less than 3 years in duration) of each contractor or other agent to determine compliance with such requirements,

iii. Submits the findings of the most recent review conducted under subclause (ii) to the Secretary of the Treasury, and

iv. Certifies to the Secretary for the most recent annual period that such contractor or other agent is in compliance with all such requirements.

The certification required by subclause (IV) must include the name and address of each contractor and other agent, a description of the contract or agreement with such contractor or other agent, and the duration of such contract or agreement.

[18] Pp. 17-18, Publication 1075.

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CHAPTER 4: FILING REQUIREMENTS FOR PENNSYLVANIA PERSONAL INCOME TAX RETURNS

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pennsylvania
DEPARTMENT OF REVENUE

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 4: FILING REQUIREMENTS FOR PENNSYLVANIA PERSONAL INCOME TAX RETURNS

I. WHO MUST FILE

The following taxpayers must file a Pennsylvania personal income tax return-

A. Every resident, part-year resident or nonresident individual earning, receiving and realizing more than $33 in gross Pennsylvania-taxable income for their taxable year beginning on or after Jan. 1, 2004 ($35 for taxable years beginning on or after Jan. 1, 1993 and ending Dec. 31, 2003), even if no tax is due (*e.g.*, when an employee receives compensation where tax is withheld). Refer to Pennsylvania Personal Income Tax (PA PIT) Guide, Chapter 7, Gross Compensation.

Note: Pennsylvania income tax law cannot be amended to provide a standard deduction or personal exemption and eliminate the return-filing requirement for taxpayers with small incomes. The Uniformity Clause of the Pennsylvania Constitution and cases decided under it preclude such an amendment. *Kelly v. Kalodner,* 320 Pa. 180, 181 A. 598 (1935). Likewise, a taxpayer is required to file a return, even if he or she ultimately qualifies for special tax forgiveness (SP). A filed, signed tax return encourages compliance with the statute and enables the Department to verify whether a claimant meets SP eligibility standards. Refer to PA-40 Schedule SP and PA PIT Guide, Chapter 20 Tax Forgiveness.

B. Every resident, part-year resident or nonresident individual earning, receiving and realizing a gain, profit, income (loss) in any of the following classes of Pennsylvania-taxable income during the taxable year: business, profession or farm; sale, exchange or disposition of property; or rents, royalties, copyrights or patents.

Refer to PA PIT Guide, Chapter 11, Net Income (Loss) from the Operation of a Business, Profession or Farm; Chapter 12, Net Gains (Losses) from the Sale, Exchange or Disposition of Property; and Chapter 13, Net Income (Loss) from Rents, Royalties, Copyrights and Patents.

C. Every resident partner, shareholder, and beneficiary earning and realizing income (loss) from a partnership, PA S corporation, and estate or trust.

Refer to PA PIT, Guide Chapter 14, Estates, Trusts and Decedents and Chapter 16, Pass Through Entities.

D. Every nonresident partner, shareholder and beneficiary earning and realizing Pennsylvania-taxable source income (loss) from a partnership, PA S corporation, and estate or trust.

Refer to PA PIT Guide, Chapter 14, Estates, Trusts and Decedents and Chapter 16, Pass Through Entities.

E. Every part-year resident shareholder earning and realizing income (loss) from a partnership and PA S corporation for that part of the taxable year the member is a resident and from Pennsylvania-taxable source income (loss) for that part of the taxable year the member is a nonresident.

Refer to PA PIT Guide, Chapter 16 Pass Through Entities.

Note: Partnerships and PA S corporations may file consolidated or "group returns" on behalf of their nonresident individual partners and nonresident individual shareholders by using the PA-40 Nonresident Consolidated (NRC) Income Tax return as long as all requirements for filing the consolidated return are met.

F. A person who is charged with the care of the property of a decedent who died during the tax year, of a minor child, or a disabled or incompetent individual who cannot prepare his or her own return, must file a return on behalf of that individual if that individual meets the above requirements.

G. Every resident, part-year resident or nonresident professional athlete or entertainer earning, receiving and realizing Pennsylvania-taxable income during the taxable year.

Refer to PA PIT Guide Chapter 7, Gross Compensation and Chapter 11, Net Income (Loss) from the Operation of a Business, Profession or Farm.

H. Every resident, part-year resident or nonresident earning or receiving fees from Pennsylvania-taxable source income as an executor or fiduciary.

Refer to PA PIT Guide, Chapter 7, Gross Compensation.

I. Every nonresident receiving deferred compensation distributions, which are related to Pennsylvania-taxable source income earned while a Pennsylvania resident.

Refer to PA PIT Guide, Chapter 7, Gross Compensation and Chapter 30, PA Department of Revenue Personal Income Tax Policy Guidance and Related Personal Income Tax Bulletins.

J. Every nonresident earning, receiving and realizing other miscellaneous compensation from Pennsylvania sources (*e.g.*, covenant not to compete), which constitutes Pennsylvania-taxable income during the taxable year.

Refer to PA PIT Guide, Chapter 7, Gross Compensation.

II. RESIDENCY STATUS

A. Resident and Nonresident Defined

One's domicile and permanent abode must be identified to determine residency for Pennsylvania personal income tax purposes. An individual may have to pay income tax as a Pennsylvania resident even if he or she is not considered a Pennsylvania resident for other purposes. For income tax purposes, one must consider both where he or she is domiciled and where he or she maintained a permanent place of abode during the taxable year.

With the different lifestyles that have developed, the questions: "Where do I live?" may not be as simple as it used to be. Individuals who have their domicile or statutory residence in Pennsylvania are subject to the Pennsylvania personal income on their entire incomes. They may qualify for credits against tax paid to other states or countries on income earned outside of Pennsylvania.

Individuals who do not have either their domicile or statutory residence in Pennsylvania are taxed only on the income from sources within Pennsylvania and cannot qualify for credits against the taxes paid to other states or countries.

This chapter will help you understand what domicile and statutory residence mean and help you decide whether you are a resident or nonresident of Pennsylvania for income tax purposes. It also addresses the most common circumstances that may make it difficult to determine residence.

1. Domicile

For most individuals, the word domicile refers simply to the locality where a taxpayer maintains his or her permanent abode, and is the place where he or she intends to return whenever absent, even though he or she may live elsewhere. A person may only have one place of domicile at a time.

However, for individuals that have more than one locality where they maintain permanent abodes, two factors determine their domicile-

- Which place is the one where the individual has had the greatest connections for the taxable year; and

- Which place does the individual intend to be his or her domicile?

Some factors to consider in determining an individual's place of domicile are:

- Where does the taxpayer spend the greatest amount of time during the taxable year;

- Where does the taxpayer maintain a permanent abode for the longest amount of time during the taxable year;

- Where does the taxpayer support his or her spouse and children;
- Where does the taxpayer purchase the necessities of life;
- Where does the taxpayer have doctors, lawyers, and accountants;
- Where does the taxpayer house his or her pets;
- Where does the taxpayer have active banking accounts;
- Where does the taxpayer worship regularly;
- Where does the taxpayer participate in social, fraternal, or athletic organizations, lodges, or country clubs;
- Where does the taxpayer have works of art, expensive furniture, family portraits, or heirlooms;
- Where does the taxpayer fulfill local tax obligations;
- Where is the taxpayer employed;
- Where does the taxpayer own real estate fit for year-round living;
- Where does the taxpayer maintain a driver's license and vehicle registration;
- Where does the taxpayer maintain professional licenses;
- Where does the taxpayer maintain union membership;
- Where does the taxpayer declare residency for fishing or hunting licenses, income tax returns, or school tuition;
- Where does the taxpayer conduct his business;
- Where does the taxpayer receive mail;
- Where does the taxpayer receive unemployment income;
- Where does the taxpayer record his or her address for insurance policies, deeds, mortgages, leases, passport, federal and local tax returns, etc;
- Where was the taxpayer domiciled at birth;
- Where does the taxpayer maintain safe deposit boxes;

- Where does the taxpayer own a cemetery plot;
- Where is the taxpayer listed in the telephone directory;
- Where has the taxpayer obtained a homestead exemption;
- Where does the taxpayer gather for family and social events; and/or
- Where is the taxpayer registered to vote.

A person's state of domicile does not change until he or she moves to another state or country with the sincere intention of making his or her permanent home there and abandoning his or her previous domicile. If a person moves to another state or foreign country but intends to stay there only for a fixed or limited time (no matter how long), his or her domicile does not change.

2. Statutory Residency

For many individuals, the phrase statutory residence refers simply to the state where an individual spends the most time during the taxable year. More specialized definitions, however, apply when there are either frequent or prolonged absences from, or no permanent place of abode in Pennsylvania. A person is a statutory resident of Pennsylvania unless meeting these conditions-

- A person who spends a total of more than 183 days (midnight to midnight) of the taxable year outside of Pennsylvania is not a statutory resident of Pennsylvania.
- An individual who has no permanent abode within Pennsylvania for any part of the taxable year is not a statutory resident of Pennsylvania.

3. Permanent Abode

A permanent abode is a house, apartment, dwelling place, or other residence that is maintained as a household for an indefinite period, whether it is owned by the occupants or not. An abode is not permanent if it is occupied only during a fixed or limited period of time for a particular purpose. Barracks, bachelor officer's quarters, quarters on ships, and other living accommodations provided by an employer for a definite period do not qualify as a permanent abode. College dormitories, fraternity houses, sorority houses, and off-campus rentals by students enrolled in college or universities do not qualify as a permanent abode.

B. Three Conditions Are Required To Establish a New Domicile

You can have only one domicile at any given time. Your domicile does not change until you move to another state or country with the sincere intention of making your "new" permanent home there and abandoning your previous domicile.

If an individual moved to another state or country, but intended to stay there only for a fixed or limited time (no matter how long), the domicile does not change. Once established in a locality or state, your domicile continues there until you establish a new a new domicile. It is not dependent upon continuous physical presence. It is not abandoned by absence or even by presence in a former domicile, no matter how long continued, if, in leaving and during the absence, there is no firm, sincere, unconditional intention of remaining in the other jurisdiction for an indefinite and uncertain period.

For example, temporary absence from a new domicile with presence in a former domicile for the purpose of transacting business or for the sake of health, pleasure, or education, with a definite intention of returning to the new domicile does not affect a person's domiciliary status.

In order to establish a new domicile, the following three conditions must be met-

1. There must be evidence of a firm and definite present intention to discontinue making the former domicile your primary base of operations;

2. There must be evidence of a firm and definite present intention to make the new domicile your primary base of operations; and

3. There must be evidence of actual physical presence and actual abode (transient, temporary, or permanent) in the new location.

If a person left their domicile to seek new employment intending to remain in the other location only if they find employment, there is no change in domicile.

If all three requirements are met, the date of the change is the first day of actual physical presence in the new location.

A retired couple with a permanent summer home inside Pennsylvania and a permanent winter home outside of Pennsylvania can only have one state of domicile at any given time. For Pennsylvania personal income tax purposes, a taxpayer can only have one domicile. Therefore, Pennsylvania personal income tax does not recognize the domiciliary status, which is established by operation of another state’s laws. The state of domicile does not change until there is a move to another state or country with the sincere intention of making a "new" permanent home there and abandoning the previous domicile.

Their determination as to the state of domicile should be made based on the factors provided in the definition of domicile above. The location of your domicile is where you have the greatest connection.

After you determine the location with the greatest connection, you should determine if you have taken the necessary steps to establish a new domicile outside of Pennsylvania. Have you moved your church membership, vehicle registration and driver's license, voter registration, bank accounts, etc.? No one item on the checklist determines your domicile. Instead, it is the weight of all your answers that determines in which state you are domiciled.

C. Pennsylvania Resident

Residency in Pennsylvania, for tax purposes, may be established in two ways-

1. Domicile in Pennsylvania

If an individual is domiciled in Pennsylvania, he or she is considered a resident unless he or she meets all three of the following conditions-

a. He or she did not maintain a permanent abode in Pennsylvania for himself or herself or his or her family; and

b. He or she did maintain a permanent abode outside Pennsylvania throughout the entire taxable year; and

c. He or she did not spend in the aggregate more than 30 days of the taxable year in Pennsylvania.

2. Day Test

If taxpayer maintains a permanent abode in Pennsylvania and spends a total of 183 or more days of the taxable year in Pennsylvania, even though he or she is not domiciled in the Commonwealth, he or she is considered a resident.

D. Pennsylvania Nonresident

An individual is a nonresident for Pennsylvania tax purposes if he or she is not a resident as defined above.

E. Persons in the Military or Foreign Service

Unless there is an intention to change his or her domicile, a person generally does not acquire a new domicile by entering the armed forces, or lose the domicile that the person had upon entering. A person on military duty is not precluded, however, from acquiring a new domicile where his or her family is stationed. A person in the military and Foreign Service, or a person living in a foreign country for other than a temporary or transitory purpose while a lawful permanent resident or citizen of the country, is treated as a domiciliary of that country if the person-

1. Is not an employee of the U.S. government, its agencies or instrumentalities (including members of the armed forces and career appointees in the U.S. Foreign Service); and

2. Does not hold an appointive office in the executive branch of the government of the U. S.

However, special rules may apply if the employee or officer maintains a permanent place or abode there. An individual who has a domicile in Pennsylvania is considered a nonresident if meeting all three of the requirements listed under Pennsylvania Resident above.

F. College Student

Generally, a child has the same domicile as his or her parents or legal custodian. Becoming a legal adult does not by itself separate a child from the parent or legal custodian's domicile. The child merely acquires the power to establish a separate or new domicile.

College dormitories, fraternity houses, sorority houses, and off-campus rentals by students enrolled in college or universities do not qualify as a permanent abode.

G. Minor Child

The domicile of a minor child is the same as the domicile of the child's parents. If the parents are separated, then the child's domicile is the domicile of the parent with whom the child lives or with that of the child's legal custodian.

H. Dual Residency

There are special rules for Pennsylvania residents working in Indiana, Maryland, New Jersey, Ohio, Virginia, or West Virginia-

If a taxpayer is a Pennsylvania resident and a tax resident for income tax purposes of a reciprocal compensation state, he or she may claim the Pennsylvania resident credit. The reciprocal compensation agreements with these states are not applicable, and a Pennsylvania resident must file in both Pennsylvania and the other state. The Pennsylvania resident must file a *PA-40 Schedule G-L, Credit for Taxes Paid by PA Resident Individuals, Estates or Trusts to other States or Countries* and submit a copy of the resident tax return filed with the other state to explain that the other state taxed them as a resident in that state and did not allow credit for Pennsylvania taxes owed. Example: Dan is a domiciliary of Pennsylvania for the entire taxable year. He leased an apartment in Maryland and worked 230 days in Maryland. Maryland considers Dan to be a Maryland resident for income tax purposes. He earned $10,000 in compensation for working in Maryland. Dan must report his compensation as Pennsylvania-taxable income. Because he is a Pennsylvania domiciliary, Dan may claim the Pennsylvania resident credit on PA-40 Schedule G-L for the Maryland tax he paid so long as he does not claim credit on a Maryland return for Pennsylvania taxes. Refer to PA PIT Guide Chapter 17, Credits.

I. North Eastern States Tax Officials Association (NESTOA) Agreement – Reserved

J. Who is a Part-Year Resident

A part-year resident is an individual who moved to or from Pennsylvania with the *bona fide* intention of permanently changing residence. A person moving into Pennsylvania with the intent of residing here permanently becomes taxable as a resident on the first day he or she lives here regardless of reason or housing arrangement, such as employer-provided housing, living with relatives, etc.

III. TAXATION

A. How Residents are Taxed

A resident is taxed on all of his or her taxable income whether it is received from sources inside or outside Pennsylvania.

A taxpayer is allowed a resident credit for any tax imposed by and paid to other states or countries based upon income that is subject to Pennsylvania personal income tax. Such taxpayers should complete *PA-40 Schedule G-L, Credit for Taxes Paid by PA Resident Individuals, Estates or Trusts to other States or Countries*. PA-40 Schedule G-L must include a copy of the tax return filed with the other state or foreign country.

Refer to PA PIT Guide, Chapter 17, Credits.

B. How Nonresidents are Taxed

1. Types of Income

Nonresidents are taxed on the following types of income derived from sources within Pennsylvania-

a. Compensation

Pennsylvania taxes nonresidents on compensation for services performed in Pennsylvania unless the taxpayer is a resident of one of the reciprocal agreement states.

Refer to PA PIT Guide, Chapter 7, Gross Compensation and Chapter 30, PA Department of Revenue Personal Income Tax Policy Guidance, for related personal income tax bulletins.

b. Net Income (Loss) from the Operation of a Business, Profession, or Farm

Pennsylvania taxes nonresident owners on all allocated or apportioned income from the operation of a business entity in Pennsylvania. If an individual derives income from sources both inside and outside Pennsylvania, separate accounts and records that clearly reflect the Pennsylvania-business activity should be maintained. Otherwise, that individual must file a *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals* to apportion the income.

c. Net Gains (Losses) from the Sale, Exchange or Disposition of Property

Pennsylvania taxes nonresidents on the gain from the sale of any real or tangible personal property located in Pennsylvania. Pennsylvania does not tax nonresidents on the gain from the disposition of intangible property nor allow the use of any loss from such a disposition to reduce other Pennsylvania-taxable gains. If a taxpayer that moves into Pennsylvania sells property in his or her former state before moving, no gain or loss on that sale is reportable to Pennsylvania. However, if the taxpayer moved from Pennsylvania to another state and then sold real property or any other tangible property located in Pennsylvania, then the gain must be reported.

Refer to PA PIT Guide Chapter 11, Net Income (Loss) From Business, Profession or Farm; Chapter 30, PA Department of Revenue Personal Income Tax Policy Guidance, for related Pennsylvania income tax bulletins; and Chapter 12, Net Gains (Losses) From the Sale, Exchange or Disposition of Property, for additional information regarding the reporting of property used in the operation of a business, profession or farm.

d. Net Income (Loss) from Rents, Royalties, Copyrights, and Patents

Pennsylvania taxes nonresidents on the net income from the use of property located in Pennsylvania or used in Pennsylvania.

Refer to PA PIT Guide, Chapter 13, Net Income or Loss From Rents, Royalties, Copyrights, and Patents.

e. Interest on Installment Sale

Pennsylvania taxes nonresidents on interest from installment sales as *PA Schedule D-I* income.

f. Interest on Business Accounts

Pennsylvania taxes nonresidents on interest on business accounts such as accounts receivable or a business checking account that is included in business income.

g. Mortgage or Security Interests

Pennsylvania taxes nonresidents on mortgage or security interests on installment sales that are being reported as such utilizing *PA Schedule D-I (REV-1689), Computation of Installment Sale Income*. If PA Schedule D-I is not used and the entire gain is reported in the year sold, interest on an installment sale is not subject to tax.

h. Intangible Personal Property

Pennsylvania taxes nonresidents on intangible personal property employed in a trade, profession, occupation, or business carried on in Pennsylvania. The nonresident taxpayer does not report such a sale on a PA-40 Schedule D, Sale, Exchange or Disposition of Property, but includes the gain (loss) in determining net income or loss from the operation of a business, profession or farm.

Refer to PA PIT Guide, Chapter 11 and Chapter 30 for Personal Income Tax Bulletin 2005-02 Gain or Loss Derived from the Disposition of a Going Concern.

i. Estate or Trust Income

Pennsylvania taxes nonresident beneficiaries on income from an estate or trust only to the extent the Pennsylvania-source income to the beneficiaries is taxable to nonresidents.

Refer to PA PIT Guide, Chapter 14, Estates, Trusts and Decedents.

j. Gambling or Lottery Winnings

Pennsylvania taxes nonresidents on gambling and lottery winnings by reason of a wager placed in this Commonwealth, the conduct of a game of chance or other gambling activity located in this Commonwealth or the redemption of a lottery prize from a lottery conducted in this Commonwealth, other than prizes of the Pennsylvania State Lottery.

Nonresidents are not subject to Pennsylvania tax on gambling or lottery winnings, by reason of a wager placed outside this Commonwealth, the conduct of a game of chance or other gambling activity is located outside this Commonwealth or the redemption of a lottery prize from a lottery conducted outside this Commonwealth.

Nonresidents are not subject to Pennsylvania tax on ordinary interest and dividends from investments, or gains realized on the sale, exchange, or disposition of intangible property derived from sources within Pennsylvania. Losses on the sale of intangible property may not be used to offset any taxable gains.

Refer to PA PIT Guide, Chapters 8, 9, 12, and Chapter 30 or PIT Bulletin 2005-02 Gain or Loss Derived From the Disposition Of A Going Concern.

Nonresidents do include interest and dividends from investments, gains realized on the sale, exchange, or disposition of intangible property, or gambling or lottery winnings derived from sources within Pennsylvania when employed in the operation of a business, profession, or farm.

Refer to PA PIT Guide, Chapter 11, Net Income or Loss from the Operation of a Business, Profession or Farm and Chapter 15, Gambling & Lottery Winnings.

2. Apportioning Pennsylvania Taxable Income

A nonresident employee who performs services both inside and outside Pennsylvania is subject to Pennsylvania personal income tax on the net compensation for services performed within Pennsylvania. Usually the employer will allocate and separately report on federal Form W-2, Wage and Tax Statement, the Pennsylvania nonresident-employee's gross Pennsylvania compensation.

If the employer did not report your Pennsylvania gross compensation on the federal Form W-2; or reported an incorrect amount as Pennsylvania gross compensation on the federal Form W-2; or the taxpayer incurred unreimbursed employee business expenses in earning or receiving Pennsylvania gross compensation, the *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals* must be completed.

A separate schedule must be completed for each employer for whom services both within and outside Pennsylvania were performed.

If a nonresident taxpayer has income from a business, profession, or farm derived from sources both within and outside Pennsylvania and has records and accounts that accurately reflect the income from Pennsylvania, he or she should report as Pennsylvania-taxable income those amounts based on these accounts and records. If the accounts and records do not clearly reflect the Pennsylvania-source income, *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals* must be completed.

3. Apportionment Exception–Reciprocal Compensation Agreements

Residents of Indiana, Maryland, New Jersey, Ohio*, Virginia, or West Virginia are not subject to tax on compensation for services performed inside Pennsylvania on which federal withholding is required, such as for wages and salaries. The agreement does not apply to income reported as compensation, such as executor fees on which there is no federal withholding requirement, nor does it apply to any other class of income.

Residents of these states must file a form *REV-420, Authorization to Withhold Other State's Income Tax* with his or her Pennsylvania employer in order that Pennsylvania income tax is not withheld. In this situation, the Pennsylvania employer should withhold and remit income tax to the state of residency.

If you are a resident of a reciprocal agreement state working or performing services in Pennsylvania and your employer withheld Pennsylvania income tax, you may request a refund of the Pennsylvania tax. You report zero taxable compensation on Line 1a and the Pennsylvania tax withheld on Line 13.

Submit your Form W-2 or a photocopy and a copy of the resident income tax return that you filed/will file with your resident state and form *REV-420, Authorization to Withhold Other State's Income Tax*. Also, submit a statement explaining that you are a resident of a reciprocal agreement state.

***Ohio Reciprocal Compensation Agreement:** Commencing Jan. 1, 2004, remuneration paid to an Ohio resident shareholder-employee of a PA S corporation for performing services in Pennsylvania is not covered by the Pennsylvania/Ohio Reciprocal Compensation Agreement and will be subject to Pennsylvania personal income tax. This tax treatment applies to Ohio resident shareholder-employees with a 20 percent or greater interest in a PA S corporation who worked or performed services for the S corporation in Pennsylvania. In addition, a *PA-40 Schedule G-L, Credit for Taxes Paid by PA Resident Individuals, Estates or Trusts to other States or Countries* may be allowable only if the S corporation is both a PA S corporation and an Ohio S corporation.

Refer to PA PIT Guide, Chapter 7, Gross Compensation.

C. How Part-Year Residents are Taxed

A part-year resident is subject to the Pennsylvania personal income tax as a resident for the portion of the year the individual resided in Pennsylvania. The same taxpayer is subject to the Pennsylvania personal income tax as a nonresident for the remaining portion of the year if he or she continues to work in Pennsylvania unless he or she becomes a resident of a reciprocal state. If he or she receives income from sources within the Commonwealth, this income is taxed as shown under How Nonresidents are Taxed.

Part-year residents are not subject to Pennsylvania tax on ordinary interest, dividends, gains from intangible property or gambling and lottery winnings from Pennsylvania sources while a nonresident.

D. How Members of Partnerships and Pennsylvania S Corporations Report Income

A member of a partnership or a shareholder in a PA S corporation must report his or her share of the income whether it was distributed or not. The income (loss) from the partnership or PA S corporation must be reported in the same class from which the partnership or PA S corporation received the income. A line is provided on PA-40 Schedule D, Sale, Exchange or Disposition of Property and PA-40 Schedule J, Income for Estates and Trusts specifically for partnership or PA S corporation income. Ordinary business income, farm income, dividends, interest, and rental income should be added to any similar class of income and included on the appropriate line of the PA-40 Individual Income Tax return. Composite returns can be filed on behalf of the nonresident shareholders/partners.

Sometimes an individual partner or shareholder pays an expense of a partnership or PA S corporation, such as interest expense. In this case, the individual may deduct the expense from his or her income only if the partnership agreement or articles of incorporation require that the member or shareholder pay the business or rental expenses out of his or her personal assets. These expenses must be noted on a separate attachment and do not relate to any existing schedule.

Do not add health care benefits to the Pennsylvania wages of shareholder-employees of PA S corporations as long as the plan is non-discriminatory, even though such benefits must be added to their federal wages.

Each partner in a business, profession or farm must attach to the PA-40 Individual Income Tax return a copy of the PA-20S/PA-65 Schedule RK-1 for residents and/or PA-20S/PA-65 Schedule NRK-1 for nonresidents. A separate PA-20S/PA-65 Schedule RK-1 and/or NRK-1 must be submitted for each partnership in which the taxpayer is a partner. If a partnership fails to provide PA-20S/PA-65 Schedule RK-1 and/or NRK-1, the taxpayer must attach a copy of federal Schedule K-1 and classify the income (loss) according to Pennsylvania instructions for that class. A Pennsylvania return must be filed even if the PA-20S/PA-65 RK-1 or PA-20S/PA-65 NRK-1 shows a loss.

Each shareholder in a PA S corporation must attach to the PA-40 Individual Income Tax return a copy of the PA-20S/PA-65 Schedule RK-1 for residents and/or PA-20S/PA-65 Schedule NRK-1 for nonresidents. A separate PA-20S/PA-65 RK-1 and/or NRK-1 must be submitted for each PA S corporation in which the taxpayer is a shareholder. If a S corporation fails to provide PA-20S/PA-65 Schedule RK-1 and/or NRK-1, the taxpayer must attach a copy of federal Schedule K-1 and classify the income (loss) according to PA instructions for that class. A Pennsylvania return must be filed even if the PA-20S/PA-65 RK-1 or PA-20S/PA-65 NRK-1 shows a loss.

Refer to PA PIT Guide, Chapter 16, Pass Through Entities.

E. Resident Members of the U.S. Armed Forces

Military pay, including housing allowances, earned or received by a Pennsylvania resident member of the U.S. Armed Forces (Army, Air Force, Navy, Marine Corps, and Coast Guard) while not on federal active duty or not on federal active duty training, is fully taxable regardless of where the military service is performed.

Also, military pay, including housing allowances, earned or received by a Pennsylvania resident for military service on federal active duty in Pennsylvania is subject to the Pennsylvania personal income tax, 72 P.S. § 7303(a)(1).

Full-time federal active duty military pay and federal active duty for training pay, including housing allowances, earned or received by a Pennsylvania resident member of the U.S. Armed Forces while serving outside the state is not taxable for Pennsylvania personal income tax purposes. However, a taxpayer must include such compensation when determining eligibility for tax forgiveness on *PA-40 Schedule SP.*

While on federal active duty or federal active duty for training, any other income that the Pennsylvania resident earns, receives, or realizes remains taxable for Pennsylvania personal income tax purposes.

The taxpayer has the burden of establishing that income received for military service outside the Commonwealth was earned while on federal active duty. The Department of Revenue requires a copy of the military orders directing the taxpayer to federal active duty outside the Commonwealth. Residents must file a Pennsylvania personal income tax return and include their Form(s) W–2 and copies of their military orders as evidence of active duty military pay earned outside Pennsylvania.

Pennsylvania residents in the U.S. Foreign Service are not on active duty for Pennsylvania personal income tax purposes, and his or her compensation is subject to tax.

F. Nonresident Members of the U.S. Armed Forces

Nonresident military personnel who are serving in Pennsylvania are exempt from Pennsylvania personal income tax on their federal active duty military pay and housing allowances. They and their families are, however, subject to tax on any other income normally taxable to nonresidents. This includes duty pay that is not active duty pay, such as weekend drills. See J. Military Spouses Residency Relief Act (MSRRA) below.

G. Resident Members of the U. S. Armed Forces Reserves or National Guard

Pennsylvania resident Reservists and National Guardsmen ordered to active duty for training at a two-week summer encampment pursuant to Title 10 or Title 73 of the U.S. Code are presumed to be on federal active duty. For example, all income received for inactive duty while attending weekend drills is taxable.

Military pay, including housing allowances (this includes a reserve unit's two-week summer training) received for service performed while on federal active duty is excludable from taxable compensation provided the active duty training is performed outside the Commonwealth. In addition, scholarships or remuneration received by cadets and midshipmen at U.S. military academies are not taxable because none of these academies is within Pennsylvania and such individuals are on federal active duty.

Beginning with tax years after Dec. 31, 2006, compensation earned by National Guard members on active duty and responding to an emergency shall not be considered taxable income. Act 182 of 2006 amended the Tax Reform Code to expand the definition of active duty military income to include income from the U. S. government or the Commonwealth of Pennsylvania for active state duty for emergencies within or outside the Commonwealth. This addition includes duty ordered pursuant to 35 PA.C.S. Ch. 76 (relating to the Emergency Management Assistance Compact).

When a civilian employer voluntarily either makes up the difference in a National Guardsman's or U.S. Reservist's regular wages or continues at full pay for the

Guardsman or Reservist during the term of their active duty, the differential or full pay continuation will be considered state taxable compensation subject to Pennsylvania personal income tax withholding. The term differential pay includes military continuation pay, active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty. Unless otherwise excluded by a preceding section, military differential pay may be taxable non-employee compensation, whether it is subject to withholding or not. Employers should report military differential pay on *federal Form 1099–MISC*, Box 3 - Other Income.

A full-time Pennsylvania National Guardsman is taxed on all of the following components of military compensation -

1. Inactive State duty pay received for services both within and outside the Commonwealth

2. Inactive federal duty pay received for services as a member of the U. S. Armed Forces both within and outside the Commonwealth

3. Active federal duty pay received for services within the Commonwealth

4. Active State duty pay received for services both within and outside the Commonwealth.

H. Members of the Merchant Marine and Employees of U.S. Public Health Service

Pennsylvania residents serving in the Merchant Marines, U.S. Public Health Service, the National Oceanic and Atmospheric Administration, or the U.S. Foreign Service are subject to tax on compensation whether earned within or outside Pennsylvania. However, compensation earned by Pennsylvania residents serving in the Merchant Marines or U.S. Public Health Service called to active duty in a Combat Zone or hazardous duty zone is not subject to tax in Pennsylvania. Copies of executive orders that make the active duty military active duty are required to be included with the Pennsylvania personal income tax return.

I. Combat Zone and Hazardous Duty Service

1. Military Personnel

Combat zone pay and hazardous duty zone pay received by a member in the U.S. States Armed Forces is not taxable for Pennsylvania personal income tax purposes (Refer to Title 72 P.S. §7301(d)(vii)). Combat zone and hazardous duty zone pay received by a member of the U.S. Armed forces is not considered "*poverty income*" for purposes of tax forgiveness (Refer to Title 72 P.S. §7301(o.2)(vii)).

Combat zone for Pennsylvania personal income tax purposes means any area designated by the President of the U.S. by Executive Order as a combat zone for any time period designated by the President by Executive Order as the period of combatant activities. Hazardous duty zone is also designated by Executive Order.

United States reservists and Pennsylvania National Guardsmen are members of the U.S. Armed Forces while they are serving in a combat zone for purposes of this exclusion. The $500 "combat zone" pay exclusion limit for military officers contained in the Internal Revenue Code is not in the state taxing statute.

2. Civilians Working in Combat Zones

The Internal Revenue Service has concluded that no civilian contractor, or other civilian employee, working in a combat zone is eligible for the combat zone exclusion provided by U.S. Code Section 112. Likewise, there exists no comparable exclusion or exemption provided by the Pennsylvania personal income tax statutes or regulations.

3. Filing Deadlines for Combat Zones

Pennsylvanians serving in combat zones or qualified hazardous duty areas designated by the President of the U.S. are given the same additional time to file and pay their Pennsylvania income tax returns and make payments as allowed for federal income tax purposes. The deadline is automatically extended to 180 days from the last day of service or the last day of continuous hospitalization for injury incurred in one of these areas. Print "*COMBAT ZONE*" at the top of your return. Mail your return and military orders to -

Regarding - COMBAT ZONE
PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280600
HARRISBURG PA 17128-0600

4. Electronic Filing for Combat Zones

If you are filing your return electronically, you must still fax or mail copies of your orders. Print "COMBAT ZONE" at the top of your orders. Fax your orders to (717) 772-4193 or mail your orders to -

Regarding - COMBAT ZONE
PA DEPARTMENT OF REVENUE
ELECTRONIC FILING SECTION
PO BOX 280507
HARRISBURG PA 17128-0507

J. Military Spouses Residency Relief Act

The Military Spouses Residency Relief Act (MSRRA) affects the treatment of residency and income for spouses of military personnel for state tax purposes for tax years 2009 and after. If a Pennsylvania resident service member is serving outside Pennsylvania and their nonmilitary spouse earns income in that other state – and the spouse claims relief under the MSRRA – the spouse's income is only taxable to Pennsylvania. If a Pennsylvania nonresident service member is serving in Pennsylvania and their nonmilitary spouse earns income in Pennsylvania, the spouse's income is not taxable to Pennsylvania under MSRRA, when the service member and spouse are both residents or domiciliaries of the same other state, and if the spouse is in Pennsylvania solely to be with the service member. Pennsylvania source income, from a business, profession, farm, rental or royalty property, related to a business or property located in Pennsylvania remains taxable to Pennsylvania nonresident military personnel and their spouses and is not covered by the MSRRA. For detailed information on how MSRRA impacts state taxation of income earned by a service member's nonmilitary spouse, please review Personal Income Tax Bulletin 2010-01 Military Spouses Residency Relief Act on the department's website, www.revenue.state.pa.us.

IV. TYPE FILER/FILING STATUS

A. Single - Filing Status "S"

A taxpayer must file as "single" if unmarried on the last day of the tax year. This includes those who have been widowed or divorced during the tax year or earlier.

B. Married, Filing Joint Return - Filing Status "J"

A taxpayer and spouse, even though living apart, whether or not under a separate maintenance agreement, may file a joint return for convenience. A spouse is not required to file either a joint or separate return if he or she did not receive total Pennsylvania-taxable income in excess of $33 and/or did not incur a loss during the taxable year. When filing a joint return, both spouses are fully liable for its accuracy and each is fully responsible for any liabilities.

To file jointly, taxpayers must meet all of the following conditions-

1. Both spouses' taxable years end on the same date; and

2. Both spouses elect to have the same residency period (earliest starting date if you moved into Pennsylvania and latest ending date if you moved out of Pennsylvania) if you are part-year residents; and

3. Neither spouse is individually claiming one or more of the credits on *PA-40 Schedule OC, Other Credits* or the PA KOZ/KOEZ Credit; and

4. Both spouses are still living; and

5. Neither spouse is individually liable for the payment under a court order for support and maintenance of a child or of a child and the parent with whom the child is living if the same support order includes support for the child and the parent.

If you and your spouse made your estimated payments jointly, you should file a joint tax return. However, if you and your spouse made estimated payments jointly and because of Pennsylvania guidelines you must file separate tax returns, you must allocate the payments by completing form *REV-459B, Consent to Transfer, Adjust or Correct PA Estimated Personal Income Tax Account*. The form must be completed in its entirety, showing the total number of payments made for the year and the amount of the payments to be transferred to the spouse. Both individuals must sign the form. This form can be sent to the address shown on the form prior to filing the return or a copy of the form can be submitted with both returns when filing. This avoids processing delays and correspondence from the department.

If you and your spouse jointly own income-producing property, you must each report your share of the income (loss). Income-producing property includes savings accounts, businesses, securities, and real estate. Spouses usually equally divide income from jointly owned property. The income and losses of a taxpayer and spouse must be determined separately. You may not off-set the income of the taxpayer with a loss from the spouse and vice versa.

C. Married, Filing Separate Returns - Filing Status "M”

A taxpayer and his or her spouse who is also a taxpayer may each file a separate return instead of a joint return.

Income derived from jointly owned assets must be split between the spouses. Where a definite ownership of the property is known, apply the income to the spouse who owns it. Where ownership is questionable, presume joint ownership unless the taxpayer states otherwise. Some interest and dividend statements show only one name on the account even if jointly owned.

Married taxpayers must file separate returns if-

- One spouse is a resident and the other a nonresident, unless both spouses elect to be taxed as resident taxpayers; or
- The taxpayer's spouse died on or before the last day of the tax year (surviving spouse files as "single" unless he or she remarries before the end of the taxable year). A return must be filed for the deceased as “Deceased"; or
- If one spouse’s taxable year begins or ends on a different date; or
- If either spouse is liable for the payment of spousal and dependent support; or
- The taxpayer or spouse claims any restricted credit listed on PA Schedule OC, Other Credits, such as the: Employment Incentive Payments Tax Credit; Jobs Creation Tax Credit; Research and Development Tax Credit; Film Production

Tax Credit; Resource Enhancement and Protection (REAP) Tax Credit; Keystone Innovation Zone (KIZ) Tax Credit; Organ and Bone Marrow Donor Tax Credit; Neighborhood Assistance Program (NAP) Tax Credit; Educational Improvement Tax Credit; Strategic Development Area Job Creation Tax Credit: or Volunteer Responder Retention & Recruitment Tax Credit. Refer to PA Schedule OC, Other Credits; or

- The taxpayer or spouse claims a Keystone Opportunity Zone (KOZ) or Keystone Opportunity Expansion Zone (KOEZ) Credit must also file separate returns. Refer to PA Schedule P-S KOZ.

D. Deceased - Filing Status "D"

The executor, administrator, or other person charged with caring for the decedent's property must file the tax return for an individual who died during the tax year. The responsible person files the return as "Deceased," and reports all income the decedent received from the beginning of the tax year to the date of death.

If the deceased was married at the time of death, the surviving spouse must file a separate PA-40 Individual Income Tax return as "single" unless he or she remarries before the end of the taxable year. Jointly owned income, such as interest, must be apportioned between the decedent and the survivor from the beginning of the tax year to date of death. After the date of death, all taxable income derived from jointly held property is attributable to the surviving owner.

Any return filed for a deceased individual must show the date of death on the appropriate line.

E. Final Return - Filing Status "F"

A person who lived in Pennsylvania during the tax year but permanently moved from Pennsylvania files a final return unless the individual will receive income from sources within Pennsylvania in succeeding years.

V. RESIDENT RETURNS/NONRESIDENT RETURNS FOR SHORT PERIODS

A. Decedent

Where a final return is required to be filed for a deceased taxpayer, the filing due date is generally the same as the filing date would have been had the person lived until the end of his or her tax year. A calendar year taxpayer is required to file a tax return for the taxable year no later than the following April 15th, unless that date falls on a Saturday or Sunday. In such cases, the tax return must be filed by the next business day after April 15th. For example, if a calendar year taxpayer dies on August 15, 2009, then his or her final return is for the period Jan. 1, 2009, through August 15, 2009, and is required to be filed no later than April 15, 2010. Further, his or her final return may be extended by the fiduciary of his or her estate; however, an extension to file the final return does not extend the due date for payment of any balance due on the final return. All taxes due must be paid no later than April 15, 2010.

B. Change in Residency

When a resident of Pennsylvania establishes a new domicile and/or residency outside of Pennsylvania during the tax year or, conversely, when a nonresident establishes a new domicile and/or residency within Pennsylvania during the tax year, the taxpayer files a PA-40 Individual Income Tax return using the part-year resident filing status.

A taxpayer who changes his or her state of residence/domicile during the tax year is subject to tax-

1. On all income from the enumerated sources received during the time the taxpayer was a Pennsylvania resident, and

2. Only on income from Pennsylvania sources during the portion of the tax year, he or she was a nonresident.

pennsylvania
DEPARTMENT OF REVENUE

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 5: WHEN TO FILE

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CHAPTER 5: WHEN TO FILE

I. DEADLINE

You must report all taxable income received or accrued during the calendar year (from Jan. 1 through Dec. 31) tax period. The Pennsylvania Department of Revenue follows the Internal Revenue Service (IRS) due date for filing returns. You must file before midnight, April 15 or the next business day if April 15 falls on a Saturday, Sunday or IRS recognized holiday. The U. S. Postal Service postmark date on your envelope is proof of timely filing for paper returns. For TeleFile and padirectfile returns, the confirmation number that the department issued at the time of filing is proof of timely filing. For PA/IRS e-File returns, the date the return was acknowledged as accepted by the IRS is proof of timely filing. A late filing can result in the imposition of penalty and interest.

II. EXTENSION OF TIME TO FILE THE PA–40 INDIVIDUAL INCOME TAX RETURN

The department will grant a reasonable extension of time for filing a *PA-40, Individual Income Tax return*. Unless a taxpayer is outside the U.S. the department will not grant an extension for more than six months. People who are outside the country are granted an automatic two-month extension to file until June 15.

Effective for taxable years beginning after Dec. 31, 2001, Act 46 of 2003, amends Pennsylvania's Tax Reform Code of 1971 Section 330(b) 1 to conform with Section 7508 of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. § 7508), as amended. Members of the U.S. Armed Forces serving in qualified Hazardous Duty Areas that are deemed Combat Zones will have the same additional time to file and pay Pennsylvania personal income tax (PA PIT) and take other actions concerning the tax that they have for federal purposes. This section now mirrors federal law. The deadline is automatically extended for 180 days from the last day of combat or hazardous duty service or the last day of any continuous hospitalization for injury incurred in one of the zones or areas.

A. An extension of time for filing will not extend the time for the payment of tax

Any tax, which could reasonably be expected to be due, must be paid with *REV–276, Application for Extension of Time to File*, before the original return due date. No underpayment of tax penalty will be charged if at least 90 percent of the total tax liability was paid by the original due date and all additional tax is paid with the extension on or before the extended due date. However, interest will be imposed on the amount that was not paid by the original due date of the return.

B. Procedures When Applying For An Extension Of Time To File

If a taxpayer has an approved extension to file the federal income tax return and does not owe Pennsylvania personal income tax on the PA-40, Individual Income Tax return, the department will grant the taxpayer an equivalent period to file the PA-40, Individual Income Tax return. In such an instance, the taxpayer does not have to submit *REV–276, Application for Extension of Time to File* or federal Form 4868 before the due date.

If a taxpayer owes income tax on the PA-40, Individual Income Tax return the payment must be submitted with a timely filed *REV–276, Application for Extension of Time to File*. If the taxpayer pays by credit/debit card on or before the original due date of the return, an automatic six-month extension will be granted without having to mail the *REV–276, Application for Extension of Time to File*, to the department. Select one of these options to pay using your credit/debit card:

1. Internet: Go to Official Payments Corporation at www.officialpayments.com; or

2. Telephone: Call 1-800-2PayTAX (1-800-272-9829)

If the taxpayer does not have an extension to file the federal income tax return, the *REV–276, Application for Extension of Time to File,* must be submitted before the original return due date.

The mailing address for *REV–276, Application for Extension of Time to File,* and any applicable payment is:

PENNSYLVANIA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280504
HARRISBURG PA 17128-0504

C. Procedures for Filing a PA–40 Individual Income Tax Return with an Extension of Time to File

- Fill in the extension request oval at the top of the PA–40, Individual Income Tax return.

- If the taxpayer did not file a *REV–276, Application for Extension of Time to File*, a copy of the federal extension Form 4868 must be submitted with the PA-40, Individual Income Tax return.

- If the taxpayer electronically filed the federal extension, submit a statement explaining that an electronic extension was filed with the IRS and include the federal confirmation number.

- If the taxpayer filed *REV–276, Application for Extension of Time to File* or automatically extended the PA-40, Individual Income Tax return with a credit/debit card payment, **do not submit** *REV–276, Application for Extension of Time to File,* with the return.

III. AMENDED RETURN

A. How To File An Amended Return

To file an amended Pennsylvania personal income tax return use the appropriate return for the tax year you are correcting and clearly print *"AMENDED RETURN"* at the top. For the year 1997 and later, be sure to fill-in the amended oval at the top of the front side of the *PA-40, Individual Income Tax return* or *PA-40 EZ, Individual Income Tax return*.

For all tax years, amended returns can be filed using a paper *PA-40, Individual Income Tax return*, regardless of the method used for filing the original return. However, for current tax years, amended returns can also be filed using padirectfile or state only e-file through the date of the October filing deadline regardless of the method of filing the original return. After the October filing deadline, all amended returns must be filed using a paper *PA-40, Individual Income Tax return*, regardless of the method of filing the original return until the next tax year's returns are able to be received by the department.

Beginning with tax year 2011, *Schedule PA-40X,* must be submitted with an amended PA-40, Individual Income Tax return. Schedule PA-40X provides the taxpayer and the department with information about the amended return including the specific line changes, amounts of the changes and reason for the changes. Schedule PA-40X is not a return and cannot be filed without the amended PA-40, Individual Income Tax return.

As a result of the new schedule, the instructions for filing an amended return are different than those for earlier tax years. The instructions to file an amended return for tax years beginning in 2011 are as follows -

1. Fill in the Amended Return oval, and write *"AMENDED RETURN"* at the top of the Pennsylvania tax return.

2. Complete the Schedule PA-40X. Enter the amended amounts from Schedule PA-40X per the PA-40X instructions.

3. Calculate Line 11 amended total Pennsylvania-taxable income.

4. Calculate Line 12 amended Pennsylvania tax liability.

5. Enter Line 24 amended total payments and credits.

6. Complete Line 27 to report any adjusted penalty and interest to be included on the return.

7. DO NOT complete Lines 28 and 29. The department will properly calculate your amended total payment due or overpayment.

8. Complete Lines 30 through 36 to notify the department how to disperse your overpayment.

The department will take your original refund or payment into account when reviewing the amended PA-40, Individual Income Tax return. Be sure to sign your amended return and mail it with all explanations and attachments. Include only those schedules or statements that were amended. Do not include the original return or original schedules.

The instructions to file an amended return for tax years 2010 and prior are as follows -

1. Enter the amounts from the original return that you are not amending.

2. Enter the amended amounts. Explain the reason an amended return is being filed and include only the amended forms or schedules supporting the amended amounts.

3. Calculate the amended total Pennsylvania-taxable income.

4. Calculate the Pennsylvania tax liability. If a refund was received on the original return, add that amount to the Pennsylvania tax liability.

5. Calculate the total credits and payments. If tax was paid with the original return, add that payment to the total credits and payments.

6. Calculate the amended tax due or overpayment. If an overpayment, be sure to complete the lines designating the application of said overpayment.

The department will take the original refund or payment into account when reviewing the amended return. The amended return must be signed.

Refer to PA PIT Guide Chapter 21, Amended Returns.

Amended returns should be mailed to one of the following addresses depending upon the type of return it is -

If you owe tax:
PA DEPT OF REVENUE
PAYMENT ENCLOSED
1 REVENUE PLACE
HARRISBURG PA 17129-0001

If you overpaid:
PA DEPT OF REVENUE
REFUND OR CREDIT REQUESTED
3 REVENUE PLACE
HARRISBURG PA 17129-0003

If you neither owe nor overpaid:
PA DEPT OF REVENUE
NO PAYMENT OR NO REFUND
2 REVENUE PLACE
HARRISBURG PA 17129-0002

B. Underreported Income

If after a return is filed a taxpayer discovers the income was underreported, credits were erroneously claimed or deductions were not allowed, the taxpayer must correct the error within 30 days by completing and filing an amended return and paying the additional tax, applicable penalty, and interest. A summary of interest rates is available on *REV–1611, Notice of Interest Calculations*.

C. Who May Not File an Amended Return

You may not file an amended return after the department issued an assessment if the amendment relates to the same taxable year and the same item of income or gain, deduction or loss involved in the assessment. In this case, you must either -

- File a timely petition for reassessment with the Board of Appeals within 90 days of the mailing date of the assessment, or

- Pay the assessment and file a petition for refund with the Board of Appeals within six months of the mailing date of the notice of assessment, billing notice, or other departmental document.

- You may order the petition, *REV–65*, by calling the Forms Ordering Message Service 1-800-362-2050. See Pennsylvania Department of Revenue e-Services – Board of Appeals Online Petition Center for additional information or to file a petition electronically at **www.boardofappeals.state.pa.us**.

Refer to Miscellaneous Tax Bulletin 2008-01 Practice before the Board of Appeals (Board) pursuant to Article 27 of the Tax Reform Code (Act 119 of 2006).

D. Refunds

If a taxpayer over-reported income or is entitled to credits or deductions not claimed and seeks a refund, the taxpayer must complete and file an amended return within three years from the original or extended due date. Filing an amended return to seek a personal income tax refund is appropriate in situations where a taxpayer is simply correcting a routine error, and when the three-year deadline for filing the amended return is not imminent. Additionally, filing an amended return does not stop the statute of limitations for filing tax refund petitions. If an amended return seeking a refund is denied or not acted upon by the department, a petition for a refund will only be considered by the Board of Appeals so long as it is filed within three years of the payment due date.

To pursue a personal income tax refund near the end of the three-year period from the payment due date or in a more complex scenario – any involving complicated factual, legal or policy issues that may require further documentation – taxpayers are encouraged to timely file a petition for refund with the Board of Appeals. A petition for refund must be filed within three years of the date the tax was paid, (generally the original due date of the return, unless tax was paid with a late filing or paid with the extended filing of the return) in order to be considered. See Pennsylvania Department of Revenue e-Services – Board of Appeals Online Petition Center for additional information or to file a refund petition electronically at **http://boardofappeals.state.pa.us**.

Refer to Miscellaneous Tax Bulletin 2008-01 Practice before the Board of Appeals (Board) pursuant to Article 27 of the Tax Reform Code (Act 119 of 2006).

IV. PENALTY AND INTEREST

A. Penalties for Not Filing or Filing a Late Return

The department imposes the penalty from the original due date of the return until the date the taxpayer files the return when -

1. A taxpayer does not file the required Pennsylvania personal income tax return on or before the due date, and

2. A taxpayer does not file the required Pennsylvania personal income tax return on or before the date to which the department recognized or granted an extension of time to file.

For each month or fraction of a month the return is late, the department imposes a penalty of 5 percent of the unpaid tax unless the taxpayer can prove reasonable cause for late filing. The maximum penalty is 25 percent of the unpaid or late-paid tax. The minimum penalty that the department will impose is $5. Any person who attempts to evade or defeat the tax may be prosecuted.

B. Interest and Penalties for Nonpayment or for Late Payment of the Tax

If you do not pay the tax due on or before the original due date, interest will be calculated from the date the tax was due and payable to the date of actual payment. The annual interest rate is that rate established by the U.S. Secretary of the Treasury and which is in effect on Jan. 1 of each calendar year. For 2011, the interest rate on both underpayments and overpayments was 3 percent. A summary of interest rates is available on *REV–1611, Notice of Interest Calculations*. The Act 46 of 2003 change that pays interest on overpayments on business taxes equal to the rate calculated for underpayments minus 2 percent does not apply to Article III of the Tax Reform Code of 1971. Article III applies to individuals, estates, trusts, partnerships (and their partners' Pennsylvania personal income tax), PA S corporations (and their shareholders' Pennsylvania personal income tax), and employer withholding of Pennsylvania personal income tax.

If you do not pay the full amount of your tax due with your return, a 5 percent underpayment penalty will be imposed.

If you fail to report an amount of taxable income that is more than 25 percent of the taxable income shown on your return, an additional penalty of 25 percent of the tax due on the unreported income will be imposed.

These penalties will be imposed if the underpayment of tax is due to negligence or intentional disregard of rules and regulations but without intent to defraud. If any part of any underpayment of the tax is due to fraud, 50 percent of the underpayment will be added to the tax.

Any taxpayer, who files a return which does not contain sufficient information on which to determine the correct liability or which contains information which indicates the liability is significantly incorrect and the return is filed frivolously or in a manner to delay or impede the administration of the tax law, shall pay a $500 penalty.

Any person required to furnish an information return who furnishes a false or fraudulent return shall be subject to a penalty of $250 for each failure.

You may be assessed both a late filing and underpayment penalty if you file your return after the due date (or extended due date) and do not pay your tax liability with your return.

V. CRIMINAL PENALITIES

A. Criminal Prosecution

In addition to civil penalties you may be subject to criminal prosecution for actions such as -

- Tax evasion;
- Willful failure to file a return, supply information, or pay any tax due;
- Fraud and false statements; or
- Preparing, aiding, and/or assisting in the filing of a fraudulent return.

B. Illegal Income

Illegal income that falls within any of the eight classes of income is subject to Pennsylvania personal income tax. The character or type of income relates where the income will be reported. For instance, a kickback would be identified under compensation while the illegal sale of a drug would either be reported under *PA-40 Schedule C, Profit or Loss from Business or Profession* or *PA-40 Schedule D*, Sale, Exchange or Disposition of Property.

Refer to PA PIT Guide Chapter 11, Net Income (Loss) from the Operation of a Business, Profession or Farm and PA PIT Guide Chapter 12, Net Gains (Losses) from the Sale, Exchange or Disposition of Property.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 6: BRIEF OVERVIEW OF PENNSYLVANIA PERSONAL INCOME TAX

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CHAPTER 6: BRIEF OVERVIEW OF PENNSYLVANIA PERSONAL INCOME TAX

I. OVERVIEW

Pennsylvania personal income tax (PA PIT) is levied against the taxable income of resident and nonresident individuals, estates and trusts, partnerships, S corporations, business trusts and limited liability companies that are not taxed as corporations for federal income tax purposes.

Pennsylvania taxes eight classes of income-

1. Compensation;
2. Interest;
3. Dividends;
4. Net profits from the operation of a business, profession or farm;
5. Net gains or income from the dispositions of property;
6. Net gains or income from rents, royalties, patents and copyrights;
7. Income derived through estates or trusts; and
8. Gambling and lottery winnings (except Pennsylvania Lottery winnings won on or after July 21, 1983).

A loss in one class of income may not be offset against income in another class, nor may gains or losses be carried backward or forward from year-to-year. A loss by the taxpayer in the filing of a joint return may not offset the income of the spouse on the same joint return and vice versa.

Act 4–1999 eliminated the 25 percent passive income test. A corporation with a valid S election under the Internal Revenue Code is allowed to have passive income in excess of 25 percent of total income and still qualify as a PA S corporation. The five-year waiting period for corporations whose S election was terminated for exceeding the passive income limitation is repealed.

Pennsylvania personal income tax does not provide for a standard deduction or personal exemption. However, individuals are able to reduce their tax liabilities through allowable deductions, credits and exclusions.

II. TAX RATE

Pennsylvania personal income tax is levied at a flat rate of 3.07 percent (effective for taxable years beginning on or after Jan. 1, 2004) on eight separate classes of income. Pennsylvania personal income tax has been imposed at the following rates-

Year		Rate
1971-1973		2.30%
1974- 1977		2.00%
1978-1982		2.20%
1983		2.45%
1984	**(1)**	2.40%
1985		2.35%
1986	**(2)**	2.16%
1987-1990		2.10%
1991	**(3)**	2.60%
1992	**(4)**	2.95%
1993-2003		2.80%
2004-2012		3.07%

(1) Effective tax rate after midyear rate change. Rate was 2.45 percent for the first half of the year and 2.35 percent for the second half of the year.

(2) Effective tax rate after midyear rate change. The rate for the first eight months of the tax year commencing on or after Jan. 1, 1986 was 2.2 percent and for the final four months was 2.1 percent, for an effective rate of 2.16 percent.

(3) Effective tax rate after midyear rate change. Rate was 2.1 percent for first half of the year and 3.1 percent for second half of the year.

(4) Effective tax rate after midyear rate change. Rate was 3.1 percent for first half of the year and 2.8 percent for second half of the year.

Note: There are special interest rules for employer withholding purposes. Refer to PA PIT Guide, Chapter 19.

III. EIGHT CLASSES OF INCOME

A. Gross Compensation

Gross compensation includes, but is not limited to, salaries, wages, tips, and gratuities; commissions, bonuses and incentive payments; vacation pay and holiday pay; and termination pay. Refer to PA PIT Guide, Chapter 7.

B. Interest

Taxable income for Pennsylvania personal income tax purposes includes interest derived from obligations that are not statutorily free from state or local taxation under any act of the General Assembly of Pennsylvania or under the laws of the U.S. Include all interest income except-

- Interest derived from purchase-money mortgages on real estate or land contracts that the taxpayer or reporting entity includes in determining net gain or loss from the sale, exchange or other disposition of property;

- Interest incidental to the production of rental or royalty income that the taxpayer or reporting entity includes in determining net rent and royalty income;

- Interest that is statutorily free from Pennsylvania tax;

- Interest derived from assets employed as working capital in a business and from accounts and notes receivable from sales of products or services sold in the ordinary course of business that the taxpayer or reporting entity includes in determining net profit or loss from its business, profession or farm.

Taxpayer cannot assume that if an obligation is exempt from the federal income tax it is also exempt from the Pennsylvania personal income tax. The exclusion for U.S. tax-exempt obligations does not automatically extend to those obligations whose sole statutory basis for exclusion is the Internal Revenue Code. Refer to PA PIT Guide, Chapter 8.

C. Dividends

Dividend income is any distribution to a taxpayer or reporting entity of cash or property from the accumulated earnings and profits or current earnings and profits of a corporation, association, or business trust.

The Pennsylvania definition of dividends is similar to, but not identical to, the federal definition. Distributions from mutual funds, money market funds and real estate investment trusts are classified as dividends for Pennsylvania purposes and interest for federal purposes. Distributions from PA S corporations are reportable as dividends only if they are from the earnings and profits of pre-election years. Refer to PA PIT Guide, Chapter 9.

D. Net Income or Loss from the Operation of a Business, Profession or Farm

A business or profession has certain common characteristics. A taxpayer can realize income from the operation of a business or profession if he or she meets ALL of the following-

1. The taxpayer markets, on a commercial basis, his or her products, goods, and services to customers in a marketplace; and

2. The taxpayer regularly and continuously conducts his or her commercial activities; and

3. The taxpayer does not limit or restrict his or her commercial activities to certain related or unrelated customers; and

4. The taxpayer computes his or her net income or loss solely from those items of revenue, cost, expense or liability that he or she receives from or incurs in-

   - The ordinary course and operation of his or her business, profession or farm; or
   - Securities employed as working capital in the ordinary operation of his or her business; or
   - Accounts and notes receivable from the sales of products and services in the ordinary operation of his or her business; or
   - Assets that serve an operational function in the ordinary operation of his or her business.

Refer to PA PIT Guide, Chapter 11.

E. Net Gain or Loss from the Sale, Exchange, or Disposition of Property

The taxpayer or reporting entity must report all sales, exchanges, or dispositions of capital assets and, with respect to S corporations, gains on the distribution of appreciated assets to shareholders. The taxpayer or reporting entity must report any gain on sale, exchange, or disposition of property the in the year in which the amount realized from the conversion of the property into cash or other property exceeds the adjusted basis of the property. A loss is recognized only in the taxable year in which the transaction, in respect to which loss is claimed, is closed and completed by an identifiable event which fixes the amount of the loss so there is no possibility of eventual recoupment. Refer to PA PIT Guide, Chapter 12.

F. Net Income or Loss from Rents, Royalties, Patents, and Copyrights

Rents and royalties include all items of gross income or receipts derived from rents, royalties, patents, copyrights, secret processes, formulas, goodwill, trademarks, trade brands, franchises and similar property, except-

1. Income or receipts derived from the sale, exchange, or other disposition of rents, royalties, patents, secret processes, formulas, goodwill, trademarks, trade brands, franchises and similar property;

2. Income or receipts derived from operating oil, gas, or mining interests includable in the computation of net profits or loss from a business, profession or farm, or otherwise derived in the ordinary course of and from the operation of a business.

Refer to PA PIT Guide, Chapter 13.

G. Net Income or Loss from Estates or Trusts

Income that an estate or trust realizes on its assets, that is currently distributable, paid, or credited to a beneficiary of the estate or trust is taxable to the beneficiary. An estate or trust reports Pennsylvania-taxable income to its resident or nonresident beneficiaries on individual *PA-20S/PA-65 Schedules RK-1* or *NRK-1*. Refer to PA PIT Guide, Chapter 14.

H. Gambling and Lottery Winnings

1. Resident

A Pennsylvania resident taxpayer or reporting entity with Pennsylvania resident owners/beneficiaries must report any winnings realized from gambling or lotteries, other than prizes awarded by the Pennsylvania Lottery. The taxpayer or reporting entity may not deduct any expenses related to realizing such income. However, the taxpayer or reporting entity may offset winnings and losses (cost of tickets), other than losses incurred in the Pennsylvania Lottery on or after July 21, 1983, within this income class. Submit a schedule or explanation of any amount reported.

Powerball or *Mega Millions* prizes purchased through a licensed Pennsylvania state lottery ticket vendor and prizes awarded by the Pennsylvania State Lottery won on or after July 21, 1983, are not subject to Pennsylvania tax.

2. Nonresident

Pennsylvania taxes nonresident individuals, estates or trusts on gambling and lottery winnings by reason of a wager placed in this Commonwealth, the conduct of a game of chance or other gambling activity located in this Commonwealth or the redemption of a lottery prize from a lottery conducted in this Commonwealth, other than prizes of the Pennsylvania State Lottery.

Nonresidents are not subject to Pennsylvania personal income tax on gambling or lottery winnings by reason of a wager placed outside this Commonwealth, the conduct of a game of chance or other gambling activity is located outside this Commonwealth or the redemption of a lottery prize from a lottery conducted outside this Commonwealth.

Nonresidents do include in taxable income gambling or lottery winnings derived from sources within Pennsylvania, other than prizes of the Pennsylvania State Lottery, when employed in the operation of a business, profession, or farm. Refer to PA PIT Guide, Chapter 11.

The provisions of Act 46 of 2003 apply to taxable years beginning after Dec. 31, 2003.

3. Reporting

Residents and nonresidents use a *PA-40 Schedule T, Gambling and Lottery Winnings,* to report the amount(s) of these winnings.

Act 46 of 2003 amended Section 335 requiring that any person required to make a Form W-2G return to the Secretary of the Treasury of the U.S. in regard to taxable gambling or lottery winnings from sources within the Commonwealth must also file a copy with the Pennsylvania Department of Revenue by March 1 of each year or, if filed electronically, by March 31 of each year. This applies to taxable years beginning after Dec. 31, 2003. Refer to PA PIT Guide, Chapter 15.

IV. DEDUCTIONS, EXEMPTIONS NOT ALLOWED IN COMPUTING PENNSYLVANIA INCOME TAX

A. Table 6-1 - Deductions Not Allowed for Pennsylvania Personal Income Tax which are Allowed for Federal Purposes in Arriving at Federal Adjusted Gross Income on the Federal Form 1040

The concept of adjusted gross income (AGI) provides all federal taxpayers with the ability to subtract certain specified deductions from gross income in addition to either the standard deduction or itemized deductions. For tax year 2005, the following deductions to arrive at AGI are permitted under federal law-

Table 6-1
Deductions Not Allowed for Pennsylvania Personal Income Tax which are Allowed for Federal Purposes in Arriving at Federal Adjusted Gross Income on the Federal Form 1040

Federal	Pennsylvania Personal Income Tax
IRA deduction	No provision
Student loan interest deduction	No provision
Archer MSA deduction	No provision
Moving expenses	No provision
One-half of self employment taxes	No provision
Self-employed health insurance deduction	No provision
Self-employed SEP, SIMPLE and qualified plans	No provision
Penalty on early withdrawal of savings	No provision
Alimony	No provision

Under Pennsylvania law, gross compensation is taxable. Consequently, deductions against gross income are not permitted (except unreimbursed employee expenses and contributions to the taxpayer's medical savings account, health savings account or tuition account program).

B. Table 6-2 - Deductions in Arriving at Federal Taxable Income but Not Allowed for Pennsylvania Personal Income Tax

1. Standard Deduction

The standard deduction is a federal deduction allowable in lieu of all other deductions but for those allowable in computing adjusted gross income.

Under Pennsylvania law, gross compensation is taxable. Consequently, a standard deduction is not permitted.

2. Itemized Deductions

Certain itemized deductions permitted under federal law are not allowed under Pennsylvania law. Deductions not allowed for Pennsylvania personal income tax which are allowed for federal purposes as itemized deductions are as follows–

Table 6-2
Deductions in Arriving at Federal Taxable Income but Not Allowed for Pennsylvania Personal Income Tax

Federal	**Pennsylvania Personal Income Tax**
Standard deduction	No provision
Medical and dental expenses	No provision
Taxes paid	No provision
Interest	No provision
Gifts to charity	No provision
Casualty and theft losses	No provision
Job expenses	Unreimbursed business expenses reportable on PA Schedule UE.
Miscellaneous deductions	No provision

C. Exemption, Other Computational Offsets and Additional Tax Not Allowed in Arriving at Pennsylvania Personal Income Tax

For federal purposes, an individual is allowed to deduct an amount equal to the number of personal and dependency exemptions provided for that individual multiplied by an exemption amount.

Under Pennsylvania law, gross compensation is taxable. Consequently, exemptions are not permitted.

D. Table 6-3 - Credits Not Allowed for Pennsylvania Personal Income Tax which are Allowed for Federal Income Tax Purposes

Table 6-3
Credits Not Allowed for Pennsylvania Personal Income Tax which are Allowed for Federal Income Tax Purposes

Federal	Pennsylvania Personal Income Tax
Foreign tax credit	No provision
Credit for child and dependent care expenses	No provision
Credit for the elderly or disabled	No provision
Education credits	No provision
Child tax credit	No provision
Adoption credit	No provision

V. EXPENSES ALLOWED UNDER PENNSYLVANIA PERSONAL INCOME TAX

A. Unreimbursed Business Expenses

Allowable employee business expenses for Pennsylvania purposes are similar to, but not exactly the same as, expenses for federal purposes. An allowable Pennsylvania employee business expense must be-

- Ordinary, customary, and accepted in the industry or occupation in which the taxpayer works; and
- Actually paid while performing the duties of the taxpayer's employment; and
- Reasonable in amount and not excessive; and
- Necessary to enable the taxpayer to properly perform the duties of his or her employment; and
- Directly related to performing the duties of the taxpayer's occupation or employment.

Unreimbursed employee business expenses are 100 percent allowable. These expenses are reported on *PA-40 Schedule UE, Allowable Employee Business Expenses*.

Pennsylvania law does not have federal expense and percentage accounting limitations and thresholds, such as 50 percent of meal and entertainment expenses and the 2 percent of adjusted gross income limitation.

B. Net Income or Loss from the Operation of a Business, Profession or Farm

Taxpayers' allowable business expenses are the direct, ordinary, necessary, and reasonable expenses that they paid or incurred during the taxable year. Expenses are allowable when directly related to, necessary for, and actually paid in the production and marketing of their products, goods or services. A taxpayer's personal expenses are never deductible.

Taxpayers may not deduct any tax imposed on, or measured by, gross or net earned or unearned income. Taxpayers may deduct any business privilege tax for which they would be liable even if they have no actual gross income. Refer to PA PIT Guide, Chapter 11.

C. Net Income or Loss from Rents, Royalties, Patents and Copyrights

Rents are income received for the use of real or tangible property. Royalties are income received upon the extraction of coal, oil, gas, or minerals, or for the use of a patent or copyright.

Taxpayers may offset their own net income and losses in determining net income or loss from rents, royalties, patents, and copyrights. Gross rents and royalties include all items of gross receipts from rents, royalties, patents, copyrights, secret processes, formulas, goodwill, trademarks, trade brands, franchises and similar property except-

- Receipts from the sale, exchange, or other disposition of rental, royalty and similar property; and

- Receipts from operating an oil, gas or mineral interest as a business, profession or farm, or otherwise derived in the ordinary course of, and from the operation of a business.

Taxpayers may deduct those expenses that they paid or incurred during the taxable year that are ordinary and necessary for-

- The production of, or collection of, rents and royalties; or

- The management, conservation, or maintenance of rents, royalties, patents, copyrights and similar property.

Such expenses include advertising, cleaning and maintenance, agent commissions, insurance, legal fees, management fees, interest, repairs, supplies, utilities, depreciation, and depletion. Deductions allowable under MACRS, including the IRC Section 179 deductions, in effect on Jan. 1, 1986, are acceptable deductions for Pennsylvania purposes. Taxpayers may not deduct the 30 percent additional first-year depreciation permitted under the Job Creation and Worker Assistance Act of 2002. In addition, Taxpayers may not deduct the 50 percent additional bonus depreciation permitted under the Jobs and Growth Tax Relief Reconciliation Act of 2003 or the KETRA/GOZA of 2005. Taxpayers may not deduct expenses for their own labor, capital investment or capital improvements. Taxpayers may not deduct personal expenses or any part of an allowable deduction that is personal. Refer to PA PIT Guide, Chapter 13.

D. Net Gain or Loss from the Sale, Exchange or Disposition of Property

Taxpayers must report any gain or loss from each sale, exchange or disposition of real or personal tangible property. A taxpayer may offset his or her own net gains and losses in determining net gain or loss from the sale, exchange or disposition of property.

Taxpayers recognize a loss only on a transaction they enter into for profit, such as investments, business property and real estate. Taxpayers recognize a loss only in the year in which an identifiable event closes and completes the transaction and fixes the amount of the loss so there is no possibility of any eventual recovery. Taxpayers do not recognize a loss on the sale of property that they did not acquire for profit, such as a personal car, furniture or a qualifying sale of the taxpayer's principal residence. Refer to PA PIT Guide, Chapter 12.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 7: GROSS COMPENSATION

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PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 7: GROSS COMPENSATION

I. OVERVIEW

A. Definition of Gross Employee Compensation for Pennsylvania Personal Income Tax

Employee compensation includes salaries, wages, commissions, and every other item of receipt related to an employment, whether received directly, through an agent, in cash, in property or otherwise, unless specifically excepted. It includes:

1. Current, deferred, or prepaid remuneration for services,

2. Remuneration for refraining from services,

3. Amounts paid as a result of an:

   a. Initiation, modification, rescission or breach of an employment contract,

   b. Unlawful practice with respect to terms, conditions or privileges of employment, or

   c. Unlawful discharge, failure, or refusal to hire or deprivation of employment opportunities.

Taxable employee compensation is not limited to remuneration received for positive action, remuneration that is contractually enforceable or remuneration paid directly by the employer. Taxable employee compensation includes:

1. Tips and other amounts, over which the employer does not have the control, receipt, custody, or payment;

2. A sum in excess of salary given an athlete for signing with a team or other bonus;

3. Payments to current and former employees for a covenant not to compete; and/or

4. Back or front pay for a period of time during which an individual was wrongfully separated from his job and front pay paid in lieu of reinstatement.

Compensation includes:

1. Salaries;

2. Wages;

3. Commissions;

4. Bonuses, and incentive payments, whether based on profits or otherwise;

5. Fees;

6. Tips; and/or

7. Similar remuneration received for services rendered by an individual whether directly or through an agent and whether in cash or in property.

Compensation paid in any medium other than cash is valued at its fair market value. The term compensation may include:

1. Cash;

2. Foreign currency;

3. Check or other negotiable instruments;

4. Freely transferable readily marketable obligations or other cash equivalents;

5. Property interests;

6. Below-market-rate loans; and/or

7. Discharge of liabilities.

Compensation does not include guaranteed payments to a partner even if they are for services.

B. Income Items Taxable as Federal Compensation Compared to Income Items Taxable as Pennsylvania Compensation

There are significant differences between Pennsylvania personal income tax (PA PIT) and federal income tax. Certain income items that are not taxable for federal income tax are taxable for Pennsylvania personal income tax. Certain income items that are taxable for federal income tax are not taxable for Pennsylvania personal income tax.

Please refer to the following tables for differences between federal and Pennsylvania:

1. Table 7-1, Income Items Always Taxable as Pennsylvania Compensation illustrates what items are included in compensation for Pennsylvania personal income tax purposes.

2. Table 7-2, Income Items Never Taxable as Pennsylvania Compensation illustrates what items are not included in compensation for Pennsylvania personal income tax purposes.

3. Table 7-3, Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances on the following pages for descriptions of these items illustrates what items may be taxable based on the facts and circumstances of the item for Pennsylvania personal income tax purposes.

Table 7-1 - Income Items Always Taxable as Pennsylvania Compensation

Type of Compensation
Salaries
Wages
Tips received directly by the employee or through his or her employer
Gratuities
Commissions
Bonuses
Incentive payments
Vacation/holiday pay
Termination/severance pay
Payment incentives for early retirement
Reimbursements and allowances in excess of allowable business expenses
Directors' fees
Jury fees
Witness fees (will constitute PA-40 Schedule C income if testifying as an expert in a field which is considered one's line of business)
Eligible reimbursed moving expenses in excess of allowable expenses on PA-40 Schedule UE
Honoraria (will constitute PA-40 Schedule C income if one's profession is being a professional speaker)
Executor's or administrator's fees (will constitute PA-40 Schedule C income if one's profession is being an executor or administrator)
Covenant not-to-compete or payments received as consideration for refraining from the performance of services
Proceeds from an employee stock ownership plan to extent of excess computed under cost-recovery method
Cash allowances for rent, utilities, or other expenses received by ministers
Reimbursements made by an employer for dependent care, legal services, or other personal services
National Service Education Awards
Income from Peace Corps, VISTA Job Corps and Americorp
Household employees pay
Employee contributions to an eligible Pennsylvania retirement plan and or contributions to a qualified deferred compensation plan
Distributions from a nonqualified deferred compensation plan (unless the deferral was previously taxed under rules prior to Act 40 of 2005)

Table 7-2 - Income Items Never Taxable as PA Compensation

Type of Compensation
Federal active-duty pay earned outside Pennsylvania
GI Bill benefits including tuition and living expenses
Alimony
Child support
Income in respect of a decedent
Inheritance
Social Security
Railroad retirement benefits
Public assistance
Unemployment compensation
Occupational Disease Act benefits (if included on the W–2 form attach explanation)
Meals and lodging provided to an employee by the employer
Personal use of employer-owned or leased property and/or services, at no cost or at a reduced cost. Personal use of company automobile, airplane or other employer-owned or leased property. These amounts are not taxable fringe benefits for Pennsylvania personal income tax
Employer-provided parking facilities. These amounts are nontaxable fringe benefits.
Employer-provided professional services paid for directly by the employer. These are nontaxable fringe benefits.
Premiums paid by an employer for group term life insurance (no limit)
Rental value of parsonage owned by the congregation and required to be occupied by the cleric
Foster care
Employer-paid group term life insurance premiums
Amounts received for permanent loss of body function, disfigurement, or reimbursed medical expense
Disability payments paid by employer arising under occupational disease acts or other legislation
Strike benefits
Life insurance proceeds or settlements
Employee contributions or deferrals to a nonqualified deferred compensation plan (all IRC Section 409A plans and some IRC Section 457b plans where the deferrals made are subject to a substantial risk of forfeiture or the employee deferrals made to the plan are not funded by the employer)
The State Employees' Retirement System, the Pennsylvania School Employees' Retirement System, the Pennsylvania Municipal Employees Retirement System and the U.S. Civil Service Commission Retirement Disability Plan are eligible Pennsylvania retirement plans and all distributions are exempt from Pennsylvania personal income tax. Retired or retainer pay of a member or former member of a uniform service calculated under Chapter 71 of Title 10, U.S. Code as amended is also exempt from Pennsylvania personal income tax
Distributions from eligible Pennsylvania retirement plans after retirement age*

*Regarding what plans qualify as "eligible Pennsylvania retirement plans," the fact that a plan is a qualified plan for federal income tax is not controlling for personal income tax.

Table 7-3 - Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances

Type of Compensation	Taxable Description	Non–Taxable Description
Sick pay, sick leave	Sick pay and sick leave are taxable compensation when representing regular wages. The employer must include them as compensation and withhold Pennsylvania tax. Request *REV–634, Employee Fringe Benefits and Wage/Salary Supplements*.	Payments, not representing regular wages, including payments made by third party insurers for sickness or disability, are not taxable income for Pennsylvania purposes. Your employer should not include periodic payments for sickness or disability in Box 16 of your federal Form W–2. If your employer includes this income and withholds Pennsylvania tax, you must obtain and submit a corrected federal Form W–2 or a statement from your employer explaining the error.
Disability benefit payments, including payments made by third party insurers for sickness or disability	Taxable if paid by employer.	Nontaxable if paid by third-party insurer.
A premature withdrawal from a regular IRA or Roth IRA	A premature withdrawal from a regular IRA or Roth IRA is taxable compensation to the extent that the taxpayer receives an amount that exceeds his or her previously taxed contributions. The cost-recovery method of accounting must be used to determine the taxable portion unless timely rolled over into an eligible Pennsylvania retirement plan. Please consult your summary plan description or plan administrator.	

Table 7.3 (cont'd)

Type of Compensation	Taxable Description	Non–Taxable Description
Payments received under worker's compensation acts, occupational disease acts, or similar legislation, including payments for injuries you received while working, and damages received, whether by suit or otherwise, for personal injuries (unless one is required to pay these monies back to the employer and receives regular salary in return)	Taxable when the employee must turn over the worker's compensation payments to the employer in order to receive his or her regular salary in return. The employee does not report the worker's compensation payments, but does report the full amount of his or her regular salary.	All other payments received under workers compensation acts is not taxable compensation. Occupational disease acts are not taxable.
Scholarships or fellowships and stipends	The recipient is required to apply the skill and training to advance research, creative work or some other project or activity.	Made on the basis of need or academic achievement, is not taxable if awarded to encourage or allow the recipient to further his or her academic achievement is not taxable compensation.
Employer-provided fringe benefits	Non-excludible fringes Refer to Pennsylvania Taxation of Fringe Benefits for a list of non-excludable fringes including an option to receive cash or reimbursement.	Excludible fringes (e.g. personal use of an employer's owned or leased property and/or services, at no cost or at a reduced cost, and using your employer's dependent care facilities) is not taxable compensation. Refer to Pennsylvania Taxation of Fringe Benefits.
Damage awards - Delayed damages received in connection with a court judgment or settlement	Delay damages received in connection with a court judgment or settlement is taxable compensation.	

Table 7-3 (cont'd)

Type of Compensation	Taxable Description	Non–Taxable Description
Federal-taxable punitive damages awarded and settlements from personal injury		Federal-taxable punitive damages received for personal physical injury or physical sickness, whether received by suit or by settlement is not taxable compensation.
Damages, awards, and settlements from personal injury or sickness		Damage awards and settlements from personal injury or sickness if pain and suffering, emotional distress, or another non-economic element was or would have been a significant evidentiary factor in determining the amount of the taxpayer's damages is not taxable compensation. Refer to Damage Awards.
All other damage awards	Other damage awards that are also taxable *e.g.* damage awards and settlements to the extent that the payments represent back wages or other uncollected entitlement to Pennsylvania-taxable incomes, damage awards for lost profits, etc.) is taxable compensation. Report on *PA-40 Schedule W-2S, Wage Statement Summary*.	

Table 7-3 (cont'd)

Type of Compensation	Taxable Description	Non–Taxable Description
Television Show winnings	A prize awarded to a participant in a game or "reality" show is considered non-employee compensation for Pennsylvania personal income tax purposes. The value of the prize should be reported on *PA-40 Schedule W-2S, Wage Statement Summary.* If the prize is taxed in another state, then the taxpayer can use *PA-40 Schedule G–S or PA-40 Schedule G–L* to claim the out-of-state tax credit.	
Awards	Awards given in recognition for past or future service are taxable compensation.	All awards not given in recognition for past or future service are not taxable compensation.
Gifts	Taxable if gift is a transfer of cash or property in payment for past or present services or as an inducement to perform future services.	Gifts made from detached or disinterested generosity is not taxable compensation.

Table 7-3 (cont'd)

Type of Compensation	Taxable Description	Non–Taxable Description
Tuition assistance or educational benefits unless the training or education is either: 1) Required by law or regulation; or 2) Required of the employee by the employer in order for the employee to retain the skills necessary for his or her present position. If the course, degree program, or training is designed to enable the employee to enter a new field or profession or to obtain a promotion, the reimbursement is taxable.	If employer reimburses employees for education cost then the reimbursement is fully taxable and the employee may deduct only those directly related to business expenses allowed on PA-40 Schedule UE, Allowable Employee Business Expenses is taxable compensation.	Employees of an institution of higher learning that receive free or low–cost education receive the tuition assistance tax free for Pennsylvania personal income tax purposes unless they receive cash grants (for themselves or their children) as reimbursements for the tuition paid at their institution of employment or any other institution of higher learning is not taxable compensation. Since Pennsylvania personal income tax has no distinction regarding taxability with respect to the amount of the benefits received for highly compensated employees, these benefits would also be considered tax free for Pennsylvania personal income tax purposes unless a cash grant is received. An employee's child who receives the cash grants directly instead of the employee receives the tuition benefits tax free as long as there is no requirement for past, present, or future services involved with receiving the grant is not taxable compensation.
Employer contributions to eligible Pennsylvania retirement plans and non-qualifying deferred compensation plans		Not taxable compensation

Table 7-3 (cont'd)

Type of Compensation	Taxable Description	Non–Taxable Description
Employee contributions to non-qualifying deferred compensation plans	Refer to PA PIT Bulletin 2005–03 -Deferred Compensation Under Nonqualified Plans.	Refer to PA PIT Bulletin 2005–03 -Deferred Compensation Under Nonqualified Plans.
Distributions from eligible Pennsylvania retirement plans and non-qualifying deferred compensation plans Refer to PA PIT Bulletin 2005–03 - Deferred Compensation Under Nonqualified Plans and PA PIT Bulletin 2005-05 - Qualified Employer Plans.	Act 2005–40 established the general rule that distributions from plans described in IRC §409A(d)(1) attributable to an elective deferral of income or the income on any elective deferral of income are always taxable, unless the contributions were previously taxed then use the cost recovery method.	

C. Costs, Expenses, and Deductions Against Gross Compensation

1. No Deduction Against Gross Compensation

For individuals, Pennsylvania law does not exempt~~,~~ or exclude from income, or allow a deduction for, any personal expenses, federal itemized deductions, or federal standard deductions. Pennsylvania only allows direct unreimbursed employee business expenses and other direct costs to earn, receive, or realize income.

2. Exception - Unreimbursed Employee Expenses

Allowable employee business expenses for Pennsylvania purposes are similar to, but not exactly the same as, expenses for federal purposes. An allowable Pennsylvania employee business expense must be:

a. Ordinary, customary, and accepted in the industry or occupation in which the taxpayer works; and

b. Actually paid while performing the duties of the taxpayer's employment (federal per-diem amounts not permitted); and

c. Reasonable in amount and not excessive; and

d. Necessary to enable the taxpayer to properly perform the duties of his or her employment; and

e. Directly related to performing the duties of the taxpayer's occupation or employment.

Unreimbursed employee business expenses are 100 percent allowable. These expenses are reported on *PA-40 Schedule UE, Allowable Employee Business Expenses.*

Pennsylvania law does not have federal expense and percentage accounting limitations and thresholds, such as 50 percent of meal and entertainment expenses and the 2 percent of adjusted gross income limitation.

D. Pennsylvania Resident Compensation

A Pennsylvania resident is taxed on all compensation received regardless of the source.

E. Nonresident Pennsylvania Compensation

A nonresident of Pennsylvania is taxed on Pennsylvania-source income in the same classes as residents.

II. PENNSYLVANIA COMPENSATION – GENERAL RULES

A. Pennsylvania Regulations

The department has issued regulations to interpret the definition of compensation and its exclusions, as follows:

Compensation includes items of remuneration received, directly or through an agent, in cash or in property, based on payroll periods or piecework, for services rendered as an employee or casual employee, agent or officer of an individual, partnership, business or nonprofit corporation, or government agency. These items include salaries; wages; commissions; bonuses; stock options; incentive payments; fees; tips; dismissal; termination or severance payments; early retirement incentive payments; and other additional compensation contingent upon retirement, including - payments in excess of the scheduled or customary salaries provided for those who are not terminating service; rewards; vacation and holiday pay; paid leaves of absence; payments for unused vacation or sick leave; tax assumed by the employer; or casual employer signing bonuses; amounts received under employee benefit plans and deferred compensation arrangements, and other remuneration received for services rendered.

B. W–2 Wage and Tax Statement (*PA-40 Schedule W2–S, Wage Statement Summary)*

A *W-2 Wage and Tax Statement* (federal Form W-2*)* or *PA-40 Schedule W2–S, Wage Statement Summary* must be submitted with the PA–40 Individual Income Tax Return, as evidence of compensation paid and taxes withheld by an employer. When submitting federal Form W–2, the taxpayer must submit a separate form for each employer. The federal Form W–2 must be submitted with a written explanation if any of the following applies:

1. Federal Form W–2 shows income earned or taxes withheld in another state;

2. Federal Form W–2 shows incorrect income or tax withheld;

3. The federal Form W–2 shows Pennsylvania tax withheld of more than 2.8 percent or 3.07 percent;

4. You were a resident of a reciprocal compensation agreement state and your employer withheld Pennsylvania income tax;

5. You are a Pennsylvania resident, working in another state or country and did not have Pennsylvania income tax withheld by your employer;

6. Your employer gave you a handwritten federal Form W–2;

7. The Medicare wages in Box 5 on federal Form W–2 is greater than Pennsylvania wages in Box 16; or

8. You have a distribution from a nonqualified deferred compensation plan included in Box 1 of federal Form W–2.

If you receive distributions of previously taxed contributions from a nonqualified deferred compensation plan, you should complete and include with your *PA–40 Individual Income Tax Return* the *PA–40 W–2 RW, Reconciliation Worksheet*.

If submitting *PA-40 Schedule W2–S, Wage Statement Summary*, the taxpayer copies the information from each federal Form W-2 over to the *PA-40 Schedule W2–S*. In addition, the taxpayer must enter the employer identification number (EIN) from Box B, the amount of federal wages from Box 1, the Pennsylvania-taxable wages from Box 16, and Pennsylvania tax withheld from Box 17 for each employer. Federal Form W–2 does not need submitted if using a *PA-40 Schedule W2–S*, *Wage Statement Summary,* although the department reserves the right to request them if needed. When calculating Pennsylvania compensation from a federal Form W–2, it is important to use state wages from block 16 of federal Form W–2 and not the federal wages. This is a common mistake. The state number is often higher because Pennsylvania taxes the employee’s contributions or elective deferrals. If the taxpayer was not furnished with or was unable to obtain a federal Form W–2, a federal Form 4852, Substitute for Form W-2, Wage and Tax Statement, must be provided or copies of evidence of compensation paid and tax withheld such as pay stubs. Also, include an explanation.

Use Part B of *PA-40 Schedule W2–S, Wage Statement Summary,* to list all the sources of non-employee and other compensation. Report Pennsylvania-taxable compensation and any Pennsylvania tax withheld from that income. Include Pennsylvania-taxable amounts from federal Form 1099 that show pensions, retirement plan distributions, executor fees, jury duty pay and other miscellaneous compensation.

C. Withholding Requirements

Under the Tax Reform Code of 1971, every "employer" who has an office or transacts business within Pennsylvania must deduct and withhold Pennsylvania personal income tax from all wages paid to its resident employees, regardless if the services are performed inside the state or outside. The same is required for all wages paid to nonresidents for services rendered inside Pennsylvania unless the employee is a resident of a reciprocal state. 72 P.S. §7316.

Pursuant to 72 P.S. §§7316 & 7301(h), "employer" means an individual, partnership, association, corporation, governmental body or unit or agency, or any other entity who or that is required under the Internal Revenue Code (IRC) to withhold federal income tax from wages paid to an employee.

The department does not have a form similar to federal Form 1099–MISC. Therefore, Pennsylvania currently does not require an employer party to report payments it makes to an independent subcontractor.

D. Reciprocal Compensation Agreements

Pennsylvania currently has reciprocal agreements with Indiana, Maryland, New Jersey, Ohio, Virginia, and West Virginia. See Regarding Ohio Reciprocal Compensation Agreement.

Under these agreements, one state will not tax a resident of the other state on compensation that is subject to employer withholding. These agreements apply to employee compensation only. They do not apply to income reported as compensation, such as executor fees or director fees, on which there is no federal withholding requirement, nor does it apply to any other class of income.

Residents of these states must file REV-419, Employee's Non Withholding Application Certificate*,* so your employer can withhold the correct Pennsylvania personal income tax from your pay. Complete a new REV-419 every year or when your personal or financial situation changes. Photocopies of this form are acceptable.

If you are a Pennsylvania resident working in one of these states and your employer withheld the other state's income tax, you must file for a refund from that state. File early so you will have your refund before the due date for paying your Pennsylvania tax liability.

If you are a resident of a reciprocal agreement state working or performing services in Pennsylvania and your employer withheld Pennsylvania income tax, you may request a refund of the Pennsylvania tax. You report zero taxable compensation on Line 1a and the Pennsylvania tax withheld on Line 13. Submit federal Form W–2 or a photocopy and a signed copy of the resident income tax return that you filed/will file with your resident state and REV-419, Employee's Non Withholding Application Certificate. Also, submit a statement explaining that you are a resident of a reciprocal agreement state.

Note. Ohio Reciprocal Compensation Agreement: Commencing Jan. 1, 2004, remuneration paid to a Pennsylvania resident twenty percent shareholder-employee of an Ohio S corporation for services performed in Ohio is not covered by the Pennsylvania/Ohio Reciprocal Compensation Agreement and is (can be) subject to tax in Ohio.

E. Federal/Pennsylvania Personal Income Tax Differences in Arriving at Box 16 Wages

Under Act 2005-40, the federal constructive receipt rules relating to nonqualified deferred compensation plans and unfunded section 457 deferred compensation plans were made applicable for personal income tax purposes. If you receive distributions of previously taxed elective deferrals, complete and include with your return the *PA-40 W-2 RW, Reconciliation Worksheet.* Refer to PIT Guide, Chapter 19, Tax Withholding and Estimated Tax Payments.

F. Nonresident Pennsylvania Compensation

Pennsylvania imposes personal income tax on eight classes of income received by residents of Pennsylvania during each taxable year. Nonresidents are not taxed on interest, dividends or intangible gains. Refer to PA PIT Guide, Chapter 8, Interest; Chapter 9, Dividends and Chapter 12, Net Gains or Losses from the Sale, Exchange, or Disposition of Property. Also, refer to PIT Policy Guidance for PIT Bulletin 2005–02 Gain or Loss Derived From The Disposition Of A Going Concern.

Pursuant to the Tax Reform Code of 1971, a resident individual is "an individual . . . who is not domiciled in this commonwealth but maintains a permanent place of abode in this commonwealth and spends in the aggregate more than one hundred eighty-three days of the taxable year in this commonwealth." (72 P.S. §7301(p).) A permanent place of abode is defined as a "dwelling place maintained by the taxpayer, whether or not owned by him." (61 Pa. Code §101.1.) An abode is not permanent if it is occupied during a fixed or limited period of time for a particular purpose.

1. Nonqualified Deferred Compensation for Payments When Taxpayer Leaves Pennsylvania

Distributions from nonqualified deferred compensation arrangements, when the income deferred is associated from employment within Pennsylvania, are subject to personal income tax even though the distributions may be made while the individual is a resident of another state, subject to the limitations found in Title 4 of the U. S. Code.

For example, taxpayer was employed as an executive by a corporation for 15 years and had elective deferrals of salary under a nonqualified deferred compensation plan during the final 10 years of his employment with the corporation. The taxpayer was employed for the first seven of those final ten years at one of the corporation's Pennsylvania operating facilities and lived in Pennsylvania for those seven years. The taxpayer retired and began taking payments of the amounts deferred while living in Florida. The distributions the taxpayer receives from the nonqualified deferred compensation arrangement are partially taxable to Pennsylvania as they relate to payment for work that was performed in Pennsylvania. If equal amounts were deferred in each of the ten years deferrals were made, seven tenths of each distribution is subject to Pennsylvania personal income tax. The taxpayer's employer should withhold Pennsylvania personal income tax on each distribution made to the taxpayer and the taxpayer should file a PA-40, Individual Income Tax Return to report the income.

2. Stock Options

Stock options earned while working in Pennsylvania would be subject to personal income tax even though exercised while a resident of another state.

Examples. Taxpayer was employed by a corporation for 35 years (July 1974 through September 2009.) He lived and worked in several locations during that time period, including Alabama, Louisiana, Texas, and Pennsylvania. He was awarded stock options in 2007 and 2008, during which time he was a Pennsylvania resident. These options were exercised in 2011. Taxpayer was a Texas resident in 2011 and lived in Texas since his retirement in 2009.

Under Article III of Pennsylvania's Tax Reform Code of 1971, (The Personal Income Tax Act), individuals, trusts and estates are subject to the income tax received in any of the eight separate classes of income. 72 P.S. §7302 and 7303. The tax rate tax year 2011 was 3.07 percent (.0307). Nonresident individuals, estates and trusts are subject to tax on income derived from sources within the commonwealth and the tax rate was also 3.07 percent for 2011. *Id.* at 7301(k).

Pennsylvania defines compensation as follows:

"Compensation" means and shall include salaries, wages, commissions, bonuses and incentive payments whether based on profits or otherwise, fees, tips and similar remuneration received for services rendered, whether directly or through an agent, and whether in cash or property.

72 P.S. §§ 7301(d)

The department's regulation relating to the tax treatment of stock options under the personal income tax imposed on compensation provides:

(f) Compensation in the form of incentive, qualified, restricted or nonqualified stock options shall be considered to be received:

(1) When the option is exercised if the stock subject to the option is free from any restrictions having a significant effect on its market value.

(2) When the restrictions lapse if the stock subject to the option is subject to restrictions having a significant effect on its market value.

(3) When exchanged, sold or otherwise converted into cash or other property.

61 Pa. Code § 101.6(f)

For Pennsylvania purposes, a stock option is considered received when the stock option is exercised. The compensation earned would be the difference between the price paid to exercise the option and the fair market value of the stock on that date. Even though the stock option was exercised at the time the taxpayer was a resident of Texas, it is Pennsylvania's position that the stock option was earned for services that were performed partly in Pennsylvania. Because the taxpayer worked in a number of different states during his employment, the taxpayer is entitled to pro-rate the income earned based on the time taxpayer worked in Pennsylvania. Please refer to regulatory section 109.8 for guidance on how to apportion this income. 61 Pa. Code § 109.8.

Example 1.
Tom receives a stock option. Tom would be considered an insider under Section 16(b) of the SEC. There are no other limitations on Tom's stock option. The employer is required to withhold taxes on the income from the stock option exercise as it is considered taxable compensation to the recipient employee.

Example 2.
Tom receives restricted stock. There is a five-year restriction imposed on the ability to sell the stock. Tom will be taxed on the fair market value of the stock in five years when the stock is no longer subject to substantial restrictions.

G. Apportioning Pennsylvania-Taxable Income

A nonresident employee who performs services both inside and outside Pennsylvania is subject to Pennsylvania personal income tax on the net compensation for services performed within Pennsylvania. Usually the employer will allocate and separately report on federal Form W–2, Wage and Tax Statement, the Pennsylvania nonresident employee's gross Pennsylvania compensation.

If the employer did not report your Pennsylvania gross compensation on federal Form W–2; or reported an incorrect amount as Pennsylvania gross compensation on federal

Form W–2; or the taxpayer incurred unreimbursed employee business expenses in earning or receiving Pennsylvania gross compensation, the *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals,* must be completed.

A separate *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals,* must be completed for each employer for whom services were performed both within and outside Pennsylvania.

III. CURRENT COMPENSATION – PENNSYLVANIA WAGES

A. Covenants Not-To-Compete or to Surrender a Right to Future Employment and Early Separation Incentive Payments

1. Payments for Covenant Not-To-Compete

A "covenant not-to-compete" is generally treated as compensation if the covenant is a separately negotiable item in the sales contract and it is intended as remuneration for non-competition. If the "covenant not-to-compete" is actually for goodwill, or to insure the goodwill purchased, the covenant is an asset and includable in the sales of business assets on *PA-40 Schedule D, Sale, Exchange, or Disposition of Property.*

Any payment received on account of a covenant not to compete constitutes taxable compensation. The personal deliberate failure to act is expressly what has been bargained for. Such personal refraining to engage in competition constitutes the rendition of personal services. The terminology "services rendered" does not have to involve some positive action; just affirmatively refraining from doing something the person has the right to do (*Snap-Drape v. Commissioner,* 105 T.C. 16, *Ullman v. Commissioner*, 29 T.C. 129).

2. Amounts Paid to Surrender a Right to Future Gainful Employment

Payments constitute taxable compensation for the relinquishment of the right to future employment as opposed to deferred compensation attributable to prior employment if:

a. The employment agreement secures for the employee a right to future gainful employment; and

b. The only consideration given by the employee to obtain that right is the promise to work in the future.

"Front pay" paid in lieu of reinstatement also constitutes taxable compensation.

B. Reduction In Force ("RIF") Entitlements

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

1. Introduction

When reducing their workforces, many employers offer temporary incentives for employees voluntarily to separate from employment, including affording early retirement incentives that are available only for a limited period of time. Many employers also afford involuntarily terminated employees extra pay. The extra pay may be paid in return for agreements releasing legal claims to avoid the risk of RIF-related litigation. It may also be paid to help workers transition to new employments or simply to part ways with employees on as amicable a basis as possible. Conversely, employers or labor organizations may establish or maintain supplemental unemployment benefit plans (“SUB plan”) or early retirement incentives that are not limited or temporary in nature.

The taxation of such entitlements is explained in this subsection.

2. Limited Plans of Termination

(a) TAXATION

All actual or constructive distributions of cash or property upon dismissal, termination or severance of employment (whether by retirement or otherwise) under a limited plan of termination constitutes severance pay for personal income tax purposes.

(b) LIMITED PLAN OF TERMINATION EXPLAINED

A limited plan of termination is an employee benefit plan that has one or more of the following attributes:

(i) The plan, when begun, is scheduled to be complete on a certain date or upon the occurrence of one or more specified events.

(ii) The number, percentage or class of employees whose services are to be terminated are specified in advance of the employees’ terminations of service.

(iii) The plan is otherwise temporary or limited.

3. Supplemental Unemployment Benefits

(a) Taxation

Amounts paid from a supplemental unemployment benefits trust (“SUB trust”) that forms part of a permanent, nondiscriminatory supplemental unemployment benefit plan (“SUB plan”) are excludible from tax. However, amounts actually or constructive paid by an employer under a temporary, limited, unfunded or discriminatory SUB plan constitute taxable severance pay.

(b) Sub Plan Explained

A supplemental unemployment benefit plan is a plan established or maintained by an employer or by an employee organization, or by both, that has all of the following attributes:

(i) No benefit is payable to, or can be taken, assigned, pledged or otherwise charged or dealt with by, any plan participant except upon lay-off or involuntary separation from the employment of the employer (whether or not the separation is temporary) resulting directly from a reduction in force, plant closing, change in organizational structure, discontinuance of an operation, the participant's failure to meet or maintain standards of performance for the position due to inability to carry out the responsibilities of the position, health, obsolescence, failure to meet the changed responsibilities of the position or similar circumstance beyond the control of the participant.

(ii) No benefit is payable to, or can be taken, assigned, pledged or otherwise charged or dealt with by, any plan participant if the participant either voluntarily separates from service or is separated or discharged from service for any of the following reasons:

- Refusal to accept another position with reasonably comparable compensation.
- The commission of illegal acts.
- Insubordination, failure or refusal to comply with rules or regulations or similar acts within the control of the participant.

(c) Voluntary Discontinuance of Plan
The voluntary discontinuance of a SUB plan within 3 years after it has taken effect, for any reason other than business necessity, will be evidence that the plan was temporary and limited.

4. Early retirement enhancements

(a) General Rule
Any portion of a payment that is only available for a limited period of time as an early retirement "window benefit" is taxable as severance pay.

(b) Exceptions
The added benefits payable to retired persons under Federally qualified defined benefit plans that are attributable to:

(i) Adding additional years to the employee's actual age and/or actual service to reduce or eliminate the effect of actuarial reductions in benefits on account of early retirement;

(ii) Crediting additional years of service to the employee in calculating benefits under a plan's benefit formula;

(iii) Offering social security "bridge payments" to plan participants in order to increase benefits under the employer's retirement benefit plan until they become eligible for social security benefits; or

(iv) Offering subsidized joint and survivor annuities —

constitute excludible retirement benefits, even if offered only on a temporary or limited basis.

C. Clergy

If a member of the clergy is considered a "common law employee," the cleric's occupancy of a parsonage owned by the congregation and provided for the convenience of the congregation is not taxable as compensation. All housing allowances provided to clergy are taxable as compensation.

If a member of the clergy is not a "common law employee" and is a sole proprietor who offers his services in a market place (i.e. to a nonexclusive, indefinite number of individuals or congregations), income is considered to be derived from a business or profession and is reported on *PA-40 Schedule C, Profit or (Loss) From Business or Profession.* Summary:

1. Where the employer provides housing for the clergy, the value of the housing is not taxable;

2. Where the employer pays the costs of housing directly and not as a reimbursement to the clergy, the direct costs are not taxable;

3. Where the employer pays a housing allowance to the clergy for living in provided housing on the employer's property, the payments are taxable – cash is always taxable;

4. Where the employer pays a housing allowance to the clergy for living in housing that the clergy obtains, the housing allowance is fully taxable as Pennsylvania compensation, and the clergy may deduct directly related business expenses allowed on *PA-40 Schedule UE, Allowable Employee Business Expenses.*

D. Statutory Employees

For federal employment tax purposes, a "statutory employee" is defined as an individual that performs services for remuneration for any person:

1. As an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than

milk), or laundry or dry-cleaning services, for his principal;

2. As a full-time life insurance salesman;

3. As a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned to such person or a person designated by him; or

4. As a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations; if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction, not part of a continuing relationship with the person for whom the services are performed.

"Statutory employees" are independent contractors who are deemed "employees" for Federal employment tax purposes because of special Federal statutory rules.

For Pennsylvania personal income tax purposes, individuals shall report all taxable remuneration they receive as a statutory employee as non-employee compensation unless their activities constitute a business, profession, or other activity engaged in as a commercial enterprise. *See PA PIT GUIDE Chapter 11: NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM*. Those of their expenses that are not reported in a specific part of the *PA-40 Schedule UE, Allowable Employee Business Expenses* should be itemized and claimed in Part C, Miscellaneous Expenses.

However, if such expenses are extensive, a *PA-40 Schedule C, Profit or (Loss) From Business or Profession* may be used in lieu of the *PA-40 Schedule UE, Allowable Employee Business Expenses*, provided that the PA wages shown on the W-2 are included on Line 1a, Gross Compensation, and the expenses from Schedule C are included on Line 1b, Unreimbursed Business Expenses.

E. Members of the U.S. Armed Forces or Foreign Service

Unless there is an intention to change his or her domicile by following military procedures to do so, a person generally does not acquire a new domicile by entering the U.S. Armed Forces or lose the domicile that the person had upon entering. A person in the U.S. Armed Forces is not precluded from acquiring a new domicile where his or her family is stationed. A person in the U.S. Armed Forces or Foreign Service, or a person living in a foreign country for other than a temporary or transitory purpose while a lawful permanent resident or citizen of that country, is treated as a domiciliary of that country if the person:

1. Is not an employee of the U.S., its agencies, or instrumentalities (including members of the Armed Forces and career appointees in the U.S. Foreign Service); and

2. Does not hold an appointive office in the executive branch of the U.S. government.

However, special rules may apply if the employee or officer maintains a permanent place or abode there. An individual who has a domicile in Pennsylvania is considered a nonresident if meeting all three of the requirements listed under Pennsylvania Resident in Chapter 4 of the PA PIT Guide.

1. Resident Members of the U.S. Armed Forces

Military pay, including housing allowances, earned or received by a Pennsylvania resident member of the U.S. Armed Forces (Army, Air Force, Navy, Marine Corps, and Coast Guard) while not on federal active duty or not on federal active duty training, is fully taxable regardless of where the military service is performed.

Also, military pay, including housing allowances, earned or received by a Pennsylvania resident for military service on federal active duty in Pennsylvania is subject to the Pennsylvania personal income tax, 72 P.S. § 7303(a)(1).

Full-time federal active duty military pay and federal active duty for training pay, including housing allowances, earned or received by a Pennsylvania resident member of the U.S. Armed Forces while serving outside the state is not taxable for Pennsylvania personal income tax purposes. However, a taxpayer must include such compensation when determining eligibility for tax forgiveness on *PA-40 Schedule SP.*

While on federal active duty or federal active duty for training, any other income that the Pennsylvania resident earns, receives, or realizes remains taxable for Pennsylvania personal income tax purposes.

The taxpayer has the burden of establishing that income received for military service outside the commonwealth was earned while on federal active duty. The Department of Revenue requires a copy of the military orders directing the taxpayer to federal active duty outside the commonwealth. Residents must file a Pennsylvania personal income tax return and include their W–2 form(s) and copies of their military orders as evidence of active duty military pay earned outside Pennsylvania.

Pennsylvania residents in the U.S. Foreign Service are not on active duty for Pennsylvania personal income tax purposes, and his or her compensation is subject to tax.

2. Nonresident Members of the U.S. Armed Forces

Nonresident military personnel who are serving in Pennsylvania are exempt from Pennsylvania personal income tax on their federal active duty military pay and housing allowances. They and their families are, however, subject to tax on any other income normally taxable to nonresidents. This includes duty pay that is not active duty pay, such as weekend drills. Refer to <u>Military Spouses Residency Relief Act.</u>

3. Resident Members of the U. S. Armed Forces Reserves or National Guard

Pennsylvania resident Reservists and National Guardsmen ordered to active duty for training at a two-week summer encampment pursuant to Title 10 or Title 73 of the U.S. Code are presumed to be on federal active duty. For example, all income received for inactive duty while attending weekend drills is taxable.

Military pay, including housing allowances (this includes a reserve unit's two-week summer training) received for service performed while on federal active duty is excludable from taxable compensation provided the active duty training is performed outside the commonwealth. In addition, scholarships or remuneration received by cadets and midshipmen at U.S. military academies are not taxable because none of these academies is within Pennsylvania and such individuals are on federal active duty.

Beginning with tax years after Dec. 31, 2006, compensation earned by National Guard members on active duty and responding to an emergency shall not be considered taxable income. Act 182 of 2006 amended the Tax Reform Code to expand the definition of active duty military income to include income from the U.S. government or the Commonwealth of Pennsylvania for active state duty for emergencies within or outside the commonwealth. This addition includes duty ordered pursuant to 35 PA.C.S. Ch. 76 (relating to the Emergency Management Assistance Compact).

When a civilian employer voluntarily either makes up the difference in a National Guardsman's or U.S. Reservist's regular wages or continues at full pay for the Guardsman or Reservist during the term of their active duty, the differential or full pay continuation will be considered state taxable compensation subject to Pennsylvania personal income tax withholding. The term differential pay includes military continuation pay, active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty.

Unless otherwise excluded by a preceding section, military differential pay may be taxable non-employee compensation, whether it is subject to withholding or not. Employers should report military differential pay on federal Form 1099–MISC, Box 3 - Other Income.

A full-time Pennsylvania National Guardsman is taxed on all of the following components of military compensation:

a. Inactive State duty pay received for services both within and outside the commonwealth;

b. Inactive federal duty pay received for services as a member of the U.S. Armed Forces both within and outside the commonwealth;

c. Active federal duty pay received for services within the commonwealth;

d. Active State duty pay received for services both within and outside the commonwealth.

4. U.S. Foreign Service

A Pennsylvania resident in the U.S. Foreign Service is not on active duty for Pennsylvania purposes, and his or her compensation is subject to tax.

5. Members of the Merchant Marine and Employees of U.S. Public Health Service

Pennsylvania residents serving in the Merchant Marines, U.S. Public Health Service, the National Oceanic and Atmospheric Administration, or the U.S. Foreign Service are subject to tax on compensation whether earned within or outside Pennsylvania. However, compensation earned by Pennsylvania residents serving in the Merchant Marines or U.S. Public Health Service called to active duty in a combat zone or hazardous duty zone is not subject to tax in Pennsylvania. Copies of executive orders that make the active duty military active duty are required to be included with the Pennsylvania personal income tax return.

6. Combat Zone and Hazardous Duty Service

a. Military Personnel

Combat zone pay and hazardous duty zone pay received by a member in the U.S. Armed Forces is not taxable for Pennsylvania personal income tax purposes (Refer to Title 72 P.S. §7301(d)(vii)). Combat zone and hazardous duty zone pay received by a member of the U.S. Armed forces is not considered "*poverty income*" for purposes of tax forgiveness (Refer to Title 72 P.S. §7301(o.2)(vii)).

Combat zone for Pennsylvania personal income tax purposes means any area designated by the President of the U.S. by Executive Order as a combat zone for any time period designated by the President by Executive Order as the period of combatant activities. Hazardous duty zone is also designated by Executive Order.

U.S. reservists and Pennsylvania National Guardsmen are members of the U.S. Armed Forces while they are serving in a combat zone for purposes of this exclusion. The $500 "combat zone" pay exclusion limit for military officers contained in the Internal Revenue Code is not in the state taxing statute.

b. Civilians Working in Combat Zones

The Internal Revenue Service has concluded that no civilian contractor, or other civilian employee, working in a combat zone is eligible for the combat zone exclusion provided by U.S. Code Section 112. Likewise, there exists no comparable exclusion or exemption provided by the Pennsylvania personal income tax statutes or regulations.

7. Military Spouses Residency Relief Act

The Military Spouses Residency Relief Act (MSRRA) affects the treatment of residency and income for spouses of military personnel for state tax purposes for tax years 2009 and after. If a Pennsylvania resident service member is serving outside Pennsylvania and their nonmilitary spouse earns income in that other state – and the spouse claims relief under the MSRRA – the spouse's income is only taxable to Pennsylvania. If a Pennsylvania nonresident service member is serving in Pennsylvania and their nonmilitary spouse earns income in Pennsylvania, the spouse's income is not taxable to Pennsylvania under MSRRA, when the service member and spouse are both residents or domiciliaries of the same other state, and if the spouse is in Pennsylvania solely to be with the service member. Pennsylvania source income, from a business, profession, farm, rental or royalty property, related to a business or property located in Pennsylvania remains taxable to Pennsylvania nonresident military personnel and their spouses and is not covered by the MSRRA. For detailed information on how MSRRA impacts state taxation of income earned by a service member's nonmilitary spouse, please review Personal Income Tax Bulletin 2010-01 Military Spouses Residency Relief Act on the department's website, www.revenue.state.pa.us.

8. Eligibility Income for Tax Forgiveness Purposes

Active duty pay and active duty for training pay received by a member of the U.S. Armed Forces is not taxable for Pennsylvania personal income tax purposes. A taxpayer must include such compensation when determining eligibility for tax forgiveness on *PA-40 Schedule SP.*

Combat zone pay and hazardous duty zone pay received by a member in the U.S. Armed Forces is not taxable (Refer to Title 72 P.S. §7301(d)(vii)). Combat zone and hazardous duty zone pay received by a member of the U.S. Armed forces is not considered "poverty income" for purposes of tax forgiveness (Refer to Title 72 P.S. §7301(o.2)(vii)).

Combat zone for Pennsylvania personal income tax purposes means any area designated by the President of the United States by Executive Order as a combat zone for any time period designated by the President by Executive Order as the period of combatant activities. Hazardous duty zone is also designated by Executive Order.

United States reservists and Pennsylvania National Guardsmen are members of the U.S. Armed Forces while they are serving in a combat zone for purposes of this exclusion. The $500 "combat zone" pay exclusion limit for military officers contained in the Internal Revenue Code is not in the state taxing statute.

9. Military Differential Pay

Differential pay is defined as payments made voluntarily by an employer to represent the difference between the regular salary of an employee called to military active duty and the amount being paid by the military, if the regular salary was higher. The term differential pay also includes military continuation pay, active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty.

Unless otherwise excluded by a preceding section, military differential pay may be taxable non-employee compensation, whether it is subject to withholding or not.

Employers should report military differential pay on federal *Form 1099–MISC*, Box 3 - Other Income.

10. Personal Income Tax Exemption for Active Duty National Guard Members

Beginning with tax years after Dec. 31, 2006, compensation earned by National Guard members on active duty and responding to an emergency shall not be considered taxable income. Senate Bill 1139 amended the Tax Reform Code to provide an exemption for personal income tax on compensation earned by National Guard members who respond to active state duty for emergencies within or outside the commonwealth. This includes duty ordered pursuant to Title 35, Chapter 76 (relating to emergency management assistance compact) of the Pennsylvania Consolidated Statutes.

11. Combat Zone and Hazardous Duty Service

Pennsylvanians serving in combat zones or qualified hazardous duty areas designated by the President of the U.S. are given the same additional time to file and pay their Pennsylvania income tax returns and make payments as allowed for federal income tax purposes. The deadline is automatically extended to 180 days from the last day of service or the last day of continuous hospitalization for injury incurred in one of these areas.

Print "COMBAT ZONE" at the top of your return. Mail your return and military orders to:

Regarding - COMBAT ZONE
PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280600
HARRISBURG PA 17128-0600

If you are filing your return electronically, you must still fax or mail copies of your orders. Print "COMBAT ZONE" at the top of your orders. Fax your orders to (717) 772-4193 or mail your orders to:

Regarding - COMBAT ZONE
PA DEPARTMENT OF REVENUE
ELECTRONIC FILING SECTION
PO BOX 280507
HARRISBURG PA 17128-0507

12. Military Family Relief Assistance Program
Help those who serve our Nation and commonwealth by making a gift to the Military Family Relief Assistance Program. Your gift will help Pennsylvania service members and their families by providing financial assistance to those with a direct and immediate financial need as a result of military service.

You can also send a direct, tax-deductible, gift to the Military Family Relief Assistance Program, c/o Department of Military and Veterans Affairs, Fort Indiantown Gap, Annville, PA 17003-5002. For more information visit - www.dmva.state.pa.us or call toll free 1-866-292-7201.

F. Athletes and Entertainers

1. Resident Professional Athletes and Entertainment Performers
A professional athlete or entertainment performer who is a full-year resident of Pennsylvania must report all the compensation he or she earns, directly or indirectly, from his or her professional sport or professional athletic team, or from professional performances. Such compensation includes, but is not limited to, any prize, contest, tournament or race winnings, and remuneration, such as, but not limited to - the individual's regular wages; any signing bonus; any incentive payments or performance bonuses; any severance or termination payments or any payments received for refraining from performing services (*i.e.*, covenant not-to-compete payment); or any reimbursements for travel expenses except to the extent the reimbursements are for vouchered expenses which do

not exceed the federal *per diem* rate for the city in which the athlete or performer is located. In addition, product endorsement fees, honoraria for public speaking engagements, or fees received for attendance at card shows, autograph signings, or sports memorabilia events, would all have to be reported as Pennsylvania taxable compensation.

2. Nonresident Professional Athletes and Entertainment Performers

A nonresident professional athlete or performer is required to pay Pennsylvania personal income tax on wages or compensation received for services rendered within Pennsylvania unless the individual is a resident of one of the reciprocal agreement states.

3. Allocation and Apportionment Rules for Nonresident Professional Athletes and Performers

Nonresident professional athletes or performers who are not members of professional athletic teams or performing companies and who do not have an established employer-employee relationship with the payer of their remuneration must report all of their remuneration received from professional sporting events or professional performances in which they participate within the commonwealth as "net income from the operation of a trade, profession or business" (*i.e.*, golfers, tennis players, jockeys, race car drivers, boxers, wrestlers, bicyclists, comedians, musicians, *etc.*). Gross receipts and business expenses attributable to such gross receipts must be specifically apportioned on a strict state-by-state accounting basis by such individuals. However, such individual's general overhead expenses (*i.e.*, association dues and fees, traveling manager, booking agent, rehearsal costs, joke writer, *etc.*) may be allocated to Pennsylvania under rules similar to those found below.

Nonresident professional athletes or performers who are members of professional athletic teams or performing companies must apply the following allocation and apportionment rules:

a. Compensation received by such nonresident employees will not be taxable if the employee is a resident of one of the following states at the time he receives the compensation:

- New Jersey
- Ohio
- Maryland
- Indiana
- West Virginia
- Virginia

b. Compensation received by nonresident employees of professional teams or performing companies who are residents of states other than those reciprocal compensation states above must use the following apportionment formulas:

- **Members of professional athletic teams**
  Calculate the "total number of working days within the Commonwealth" versus the "total working days" fraction. A "working day" includes all days (including Saturdays, Sundays and holidays) in which the professional athlete must engage in services in the context of a game, practice, training, promotional activity, or any other activity aimed at furthering the team's objectives. In addition, a "working day" includes all days in which an athlete is required to receive rehabilitation or other treatment aimed at furthering the team's purpose. A "working day" does not include absences due to illness, injury, vacation, or leave without pay.

- **Non-player personnel of professional athletic teams**
  Non-player personnel shall apportion their working days in the same manner as that set forth above for athletes.

- **Members of professional performing companies**
  Calculate a "total performances within the commonwealth " versus "total performances" fraction. Multiply this fraction against the taxpayer's total apportionable compensation. For example, if a traveling circus has 200 performances in 2006 and 10 of those performances were in Pennsylvania, then five percent of the lion tamer's total compensation from the traveling circus would be apportionable to Pennsylvania if the lion tamer performed his act at each performance.

4. Apportionable Income

"Apportionable income" includes the athlete's or performer's regular wages received under his or her contract, signing bonuses, and any incentive payment or performance bonus received, regardless of whether the incentive or performance bonus is based on any single game, season, or career record mark (*i.e.*, doing something specific in a game or a performance, throwing a perfect game, hitting two or more home runs in a game, scoring more than fifty points in a game, selling out the auditorium, *etc.*), being chosen to appear in an all-star game, being chosen as a most valuable player, or whether based on team performance (*i.e.*, making the playoffs, winning the World Series, *etc.*).

Payments for prior services rendered (such as performance bonuses, commissions, vacation pay, overtime pay, and so forth, attributable at least in part to services performed prior to current payroll period) shall be allocated in proportion to the total number of working days within the Commonwealth to total working days in the payment's accrual period.

Payments for services to be rendered shall be allocated (once there is no substantial risk of forfeiture) in proportion to the total number of working days within the Commonwealth to total working days in the payment's accrual period.

5. **Classification of Income into Appropriate Income Class**
For Pennsylvania personal income tax purposes, income, profits or gain earned, received, or acquired which fall within the definition of one class of income cannot be offset by losses incurred in another class of taxable income. Therefore, classification of income into its proper class is important. For Pennsylvania personal income tax purposes, income received by professional athletes must be classified under the following guidelines:

a. Remuneration received by members of professional athletic teams or performing companies – is classified as employee compensation subject to employer withholding.

a. Remuneration received by professional team athletes for services rendered outside of the contest of their sport (*i.e.*, public speaking functions, attendance at card shows, product endorsements, paid participation in sporting events outside of their sport, *etc.*) – is classified as nonemployee compensation.

c. Receipts received by professional athletes or performers who are not members of professional athletic teams or performing companies (*i.e.*, golfers, tennis players, boxers, wrestlers, race car drivers, bicyclists, comedians, musicians, *etc.*) must be reported as "net income from the operation of a business or profession" and reported on a strict state-by-state accounting of income and expenses.

d. Income derived from book or magazine royalties by professional sports or entertainment figures must be reported as "net income derived from rents, royalties, patents and copyrights". Nonresidents would have to report only on the royalties attributable to their Pennsylvania sales.

G. Bonuses

Bonuses are always taxable as Pennsylvania personal income tax compensation.

H. Incentive Pay

Incentive pay is always taxable as Pennsylvania personal income tax compensation.

I. Commissions

Commissions are always taxable as Pennsylvania personal income tax compensation.

J. Tips and Gratuities

Tips and gratuities are always taxable as Pennsylvania personal income tax compensation.

K. Vacation Pay/Holiday Pay

Any vacation, holiday, sabbatical, sick leave, or other guaranteed pay an employee receives as an incident or benefit under a work agreement is taxable on the same basis as the base pay the employee receives for periods the employee is not absent from work, provided the payment is:

1. Calculated with reference to the period the employee is absent from work, and

2. Paid in full or partial replacement of the base pay the employee could have earned for such period but for such absence.

Also, note that payments to an employee are not excluded from compensation merely because of a failure to render services during the period covered by the payment.

L. Sick Pay

Regular Wages – Pennsylvania-Taxable

Sick pay and sick leave are taxable compensation when representing the taxpayer's regular wages and his or her employer must include them as compensation and withhold Pennsylvania tax.

Other than Regular Wages – Pennsylvania Nontaxable

Payments, including payments made by third party insurers for sickness or disability, are not taxable income for Pennsylvania purposes. The employer should not include periodic payments for sickness or disability in box 16 of the employee's W–2 form. If the employer includes this income and withholds Pennsylvania tax, the taxpayer must obtain and submit a corrected W–2 form or a statement from the employer explaining the error.

M. Commercial Accident and Health Insurance; Self-Insured Accident and Health Plan Coverage and Benefits

1. **Insurance Issued by a Commercial Third Party Insurance Company**
   Generally, coverage and amounts paid under policies of accident or health insurance issued by a commercial third party insurance company, including loss of income insurance or accident or health plans, are not taxable. Exceptions apply, however, if the insurance or plan discriminates in favor of highly compensated individuals.

2. **Accident or Health Plan**
   Any trusteed or self-insured arrangement established or maintained by an employer or employee organization in order to provide such care or benefits in the event of sickness, accident, or disability that meets all of the following requirements qualifies as an accident or health plan:

a. No program benefits are payable or subject to anticipation, assignment, or pledge until the commencement of a covered sickness or disability or death except:

- The return of the participant's own contributions and taxable income or gains thereon;
- Amounts paid for the prevention of sickness or disability; or
- Amounts paid for a policy of accident, health, or term life insurance issued by a commercial insurance company.

b. The only means of obtaining entitlement to program benefits other than the return of the participant's own contributions and taxable income or gains thereon, or amounts paid for the prevention of sickness or disability, or commercial insurance is proof of hospitalization, sickness, disability, or death.

c. The program offers no benefit that defers the receipt of compensation or operates in a manner that enables no participant to defer the receipt of compensation to another taxable year.

3. Discriminatory Programs

Except as provided in "Disability Annuities" below, compensation includes the entire cost of employer-provided coverage provided to a highly compensated participant under a discriminatory program covering hospitalization, sickness, or disability.

4. Disability Annuities

A plan payment that is attributable to the plan participant's becoming sick or injured and is part of a series of substantially equal periodic payments made for the entire period of disability of the participant, or for the life of the participant, or the joint lives of such participant and his designated beneficiary, is not taxable. This exclusion includes disability retirement benefits paid to persons retired from service upon the employee's own application or on application by the employee's employer, for disability retirement and amounts received as a disability pension, disability annuity, or similar allowance for physical injuries or sickness resulting from active service in the armed forces of the United States.

5. Plan Payments

A plan payment that is attributable to the plan participant's becoming sick or injured and is part of a series of substantially equal periodic payments made for less than the entire period of disability to provide participants and their beneficiaries with a substitute source of income during a period of disability is also not taxable unless all of the following conditions apply:

a. The periodic payments have some direct relationship to the employee's usual rate of compensation;

b. The periodic payments are computed without reference to the nature of the disability and with regard to the employee's job classification;

c. Periodic payments would not be reduced by payments arising under Workmen's Compensation Acts, Occupational Disease Acts, Social Security Disability, or similar legislation by any government;

d. The periodic payments cannot exceed the employee's usual compensation for the period.

Payments are considered to be computed without reference to the nature of a disability if, under the plan, they can be made for injuries or diseases:

a. For which the employer, but for his agreement to indemnify his employees against loss arising from such contingencies, would, otherwise, have had no legal or moral duty whatsoever to make payment;

b. Which did not arise out or in the course of, and were not incidental to, any employment relationship; and

c. Which may be temporary, non-chronic, and of short duration, with no long-term or permanent impact.

Additionally, payments are considered to be computed without regard to an employee's job classification if:

a. The amount payable for a period to a participant under the plan may differ from the amount payable to another participant for the period, even if both participants have the same job classification; and

b. The amount payable for a period to a participant under the plan may be the same as the amount payable to another participant for the period, even if both participants do not have the same job classification.

The disability annuity exclusions apply even if the plan does not qualify as a nondiscriminatory accident or health plan.

6. Taxable Amounts

All of the following are taxable:

a. Amounts received during a period of sickness or disability for services performed during another period or to which the employee would have been entitled regardless of whether he was sick or disabled;

b. Paid leaves of absence due to sickness or disability;

c. Payments for unused sick leave.

Also taxable are payments under a wage continuation plan paid in lieu of wages for a period during which the employee is absent from work on account of injury or sickness and computed with reference to the period the employee is absent from work and the employee's regular rate of compensation and without regard to the nature of such injury or sickness. Such payments are taxable even if length of service is not a factor either in determining eligibility for, or the amount of, payment.

7. Payments for Accident and Health Insurance and Plan Coverage and Disability Annuities

Except in the case of cafeteria plans:

a. Any amount lawfully deducted by an employer from the remuneration of an employee for accident or health insurance or plan coverage or a disability annuity shall be deemed to be a part of the employee's taxable remuneration and to have been paid to the employee as compensation at the time the deduction is made.

b. Any amount paid for accident or health insurance or plan coverage or a disability annuity by an employer to a third party or fund on behalf of an employee without deduction from the remuneration of, or other reimbursement from, the employee is excludible from the employee's income unless:

- The payment is made pursuant to a cash or deferred arrangement under which an employee may unilaterally elect to have the employer make payments to such third party or fund for the benefit of the employee or to the employee directly in cash (in this instance, the payment shall be deemed to be paid to the employee as compensation at the time the payment is made).

- The payment is made pursuant to an arrangement under which an employee may unilaterally choose between accident or health insurance or plan coverage (or a disability annuity) and coverage under another employee benefit plan (in this instance, the payment shall be deemed to be paid to the employee as compensation at the time the payment is made).

However, amounts specified in a qualifying cafeteria plan document as being available to the employee for the purpose of selecting or purchasing benefits under a plan or as additional cash remuneration received in lieu of coverage under a plan are excludible from tax and withholding if the following apply:

a. They were not actually or constructively received, after taking IRC Section 125 into account.

b. The benefits selected or purchased are nontaxable under the Internal Revenue Code when offered under a cafeteria plan described in IRC Section 125.

c. The payments made for the plan would be nontaxable under Pennsylvania personal income tax if made by the employer outside a cafeteria plan described in IRC Section 125.

8. Contributions by, on Behalf of, or Attributable to a Self-Employed Individual are Not Excludible from Income

Employer payments to reimburse employees for uninsured medical or dental expenses are taxable as compensation if the employee is assured of receiving (in cash or any other benefit) amounts available but unused for covered reimbursement during the year without regard to whether he incurred covered expenses or not.

If the amounts available for covered reimbursement cannot be cashed out or used for any other purpose during the taxable year or be carried over to any other taxable year, normal cash compensation that is forgone by an employee under a spending account or otherwise and credited to a self-insured medical reimbursement account and drawn upon to reimburse the employee for uninsured medical or dental expenses to which Internal Revenue Code Section 105(b) applies is excludable from tax.

N. Disability

1. Regular Wages – Pennsylvania-Taxable

Payments made by the employer and not a third party insurer for disability amounts are considered regular wages.

2. Other than Regular Wages - Pennsylvania Nontaxable

Payments not representing regular wages, including payments made by third-party insurers for sickness or disability, are not taxable.

O. Strike Benefits

Strike benefits are not taxable for Pennsylvania personal income tax purposes.

P. Group Term Life Insurance

Group term life insurance is never taxable for Pennsylvania personal income tax purposes, regardless of the amount.

Q. Unemployment Compensation

Unemployment compensation is not taxable for Pennsylvania personal income tax purposes.

R. Workers Compensation

Workers compensation is never taxable for Pennsylvania personal income tax purposes.

S. Occupational/Disability Act Benefits

Occupational/Disability Act Benefits are never taxable for Pennsylvania personal income tax purposes.

T. Stipends

1. Pennsylvania-Taxable

Stipends paid to medical interns and residents pursuant to an internship or residency program that conforms to the Essentials of an Approved Internship or the Essentials of an Approved Residency as established by the American Medical Association are taxable.

2. Pennsylvania Nontaxable

Fellowship awards and stipends do not constitute taxable compensation for services if the recipient is required to apply his skill and training to advance research, creative work, or some other project or activity, and the recipient can show that:

a. The benefits resulting from the services of the recipient are so minimal, given the actual services performed or expected to be performed, that they constitute no realistic basis for compensation by the institution sponsoring the fellowship or stipend; or

b. The activities of the recipient are so closely and directly supervised and immediately controlled by regular faculty members so as to constitute a burden on the institution which would offset any benefit it receives from the recipient's activities; or

c. The recipient is a candidate for a degree and the same activities are required for all candidates for that degree as a condition for receiving such a degree.

U. Scholarships/Fellowships

Generally, a scholarship or fellowship award made on the basis of need or academic achievement is not taxable if awarded to encourage or allow the recipient to further his or her educational development. If the recipient is required to apply his skill and training to advance creative worth or some other project, the scholarship may be taxable. Refer to above discussion on stipends.

In order to substantiate that a scholarship or fellowship is not taxable, include a letter with an original signature of the department head or other official detailing the description of the program under which the award was received. A form letter is not acceptable.

V. Moving Expense Reimbursements

Moving expense reimbursements for the personal expenses of an employee are considered compensation for personal income tax purposes. Reimbursements for title insurance premiums, notary fees, mortgage service charges, appraisal fees, credit report fees, daily living expenses, etc. are included in compensation even if the reimbursement is a "payment to reimburse actual expenses". *See* Section VII, Employee Expenses for Pennsylvania, and the Moving Expenses section under letter D.

W. Awards/Prizes from Employers

When an employer rewards an employee in recognition for his or her performance, the cash or value of the award, unless *de minimis* under federal rules under IRC Section 132, is taxable Pennsylvania compensation. However, an award out of detached generosity or in recognition for civic or humanitarian services is not taxable Pennsylvania compensation.

1. National Service Education Awards and Income from Peace Corps

Such income is taxable for Pennsylvania personal income tax purposes.

X. Golden Parachute Agreement Payments

1. Explanation

A golden parachute agreement payment is any payment or property transfer made in addition to the amounts otherwise payable upon termination of employment that is payable on account of a change in ownership or control or change of a significant part of assets of a corporation.

2. Taxation

Any golden parachute agreement payment to a highly compensated participant is taxable as compensation.

Y. Supplemental Wage Payments

Supplemental wages are compensation paid by or on behalf of a service recipient that are neither regular wages nor planned deferred compensation. Common examples include tips, overtime pay, bonuses, back pay, commissions, wages paid under reimbursement or other expense allowance arrangements, wages paid as noncash fringe benefits, sick pay paid by a third party as an agent of the service recipient, income recognized on the grant or exercise of a nonstatutory stock option, and income recognized on the lapse of a restriction on restricted property transferred from an employer to an employee.

IV. PENNSYLVANIA TAXATION OF STOCK OPTIONS

A. Overview

In general, Sections 421, 422 and 423 of the Internal Revenue Code are inapplicable. Section 451 of the Internal Revenue Code, and related rules and regulations govern the taxability for Pennsylvania personal income tax.

Incentive, statutory, and non-statutory stock options are taxable as Pennsylvania compensation on the earliest of the following dates:

1. Date of exercise of the option unless there are substantial restrictions; or

2. Date that substantial restrictions on the option lapse; or

3. Date of sale of the option.

The difference between the fair market value of the stock on the date of exercise or lapse as applicable and the amount paid by the employee to obtain the option, if any, is the amount subject to Pennsylvania tax when sold before lapse or exercise.

See Page 20, Stock Options, for when residency changes during the holding period.

B. Federal and Pennsylvania Personal Income Tax Differences Relating to Stock Options

Pennsylvania personal income tax, unlike the Internal Revenue Code, does not contain provisions that distinguish between or among various types of stock options. There is no distinction drawn between qualified and nonqualified (sometimes referred to as "statutory" and "non-statutory") stock options. Moreover, there are no PA provisions that distinguish between qualified stock options and those options granted under employee stock purchase plans.

For federal income tax purposes, nonqualified stock options are taxable in the year they are granted if the option has an ascertainable market value at that time. If the stock is not traded in an established market and the stock's value is not ascertainable under federal regulations, the option is taxed upon exercise for federal purposes.

As a general rule, qualified stock options are subject to a greater number of conditions than other options and they must be satisfied for the employee to receive the favorable tax treatment under the Internal Revenue Code (e.g. the option can only be exercised by the individual to whom granted, options must be exercisable within 10 years of date of grant, option price may not be less than fair market value of stock on date of grant, etc.). A qualified stock option is not taxable under the Internal Revenue Code at the time of its grant or at the time, the employee exercises the option (IRC Section 421); rather, the taxation of the stock option is deferred and is imposed as a capital gain when the employee sells the stock.

C. Pennsylvania Taxation of Stock Options

Under Pennsylvania personal income tax law, the exercise of a stock option is "compensation" in the form of intangible property. By regulation, it is taxable and subject to withholding if, the employer is required to withhold tax from the wages of its employee. The difference between the fair market value of the stock on the date of exercise and the amount paid by the employee to obtain the option, if any, is the amount subject to Pennsylvania tax.

Stock options are subject to withholding and reporting in the year that they are exercised unless the underlying stock is subject to substantial limitations or restrictions on its transferability or alienability. The difference between the option cost and the fair market value of the stock at the time the employee exercises the option is the amount subject to withholding and reporting.

There is no Pennsylvania personal income tax provision similar to an IRC Section 83(b) election for federal income tax purposes.

D. Substantial Restrictions/Constructive Receipt for Pennsylvania Income Tax

If the underlying stock can only be sold after a stated period of time, if it cannot be sold to any party other than one's employer and then only at some previously agreed upon price, or it can only be sold or assigned upon termination of one's employment with the company, or is subject to forfeiture if the employee obtains employment with a competitor within a number of years, the department does not consider the employee to be in constructive receipt of the stock. The restrictions imposed upon insider trading by Section 16(b) of the Securities and Exchange Act is not considered substantial limitations or restrictions. The department also considers the one-year qualification rule imposed by IRC Section 422 on employees' ability to sell their stock not to be a substantial restriction.

If there are substantial lapsing restrictions on stock options, they are not considered when determining either the value of the underlying stock or the recipient's tax liability. If there are some restrictions on the stock that are insubstantial, they will be a factor when determining the value of the option and underlying stock. Restrictions of this nature are one of many factors that may affect a stock's fair market value. Only when one has actual or constructive receipt of his stock options does he have income for purposes of Pennsylvania personal income tax.

The income realized will be the difference between the fair market value of the stock at time the restriction lapses and the fair market value at the time the options are recognized.

E. Examples

Example 1.
Tom receives a stock option. Tom would be considered an insider under Section 16(b) of the Security Exchange Commission (SEC). There are no other limitations on Tom's stock option. The employer is required to withhold taxes on the income from the stock option exercise as it is considered taxable compensation to the recipient employee.

Example 2.
Tom receives restricted stock. There is a five-year restriction imposed on the ability to sell the stock. Tom will be taxed on the fair market value of the stock in five years when the stock is no longer subject to substantial restrictions.

Table 7-4 - Federal Statutory Stock Option (Qualified Stock Option)

Applicable Option Date	**Federal Statutory Stock Option Also Called Incentive Stock Option and Qualified Stock Option**		**Pennsylvania**	
	Federal Treatment Employee	**Federal Treatment Employer**	**Pennsylvania Personal Income Tax Treatment Employee**	**Pennsylvania Personal Income Tax Treatment Employer**
Grant Date	No tax impact	No tax impact	No tax impact	No tax impact
Exercise Date	Alternative minimum tax adjustment equal to the difference between exercise price of stock and fair market value of stock on exercise date	No tax impact	The value of the option less any amount paid for the option will be taxed as compensation	Compensation deduction equal to income withheld as Pennsylvania wages
Lapse Date	No tax impact	No tax impact	No tax impact	No tax impact
Stock Disposition Date	Capital gain equal to difference between sale price of stock and exercise price of option.	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact

Table 7–5 - Non-statutory Stock Option (Nonqualified Stock Option) Option Fully Transferable or Not Subject to Risk of Forfeiture

Applicable Option Date	**Federal Nonqualified**		**Pennsylvania**	
	Federal Treatment Employee	**Federal Treatment Employer**	**Pennsylvania Personal Income Tax Treatment Employee**	**Pennsylvania Personal Income Tax Treatment Employer**
IRC § 83	Election to include in gross income in year of transfer. .		PA PIT was amended to make, with certain exceptions, section 83 of the IRC of 1986 and regulations applicable for taxable years beginning after December 31, 2004, respect to property transferred to a service provider (or beneficiary) in connection with the performance of services.	No tax impact
Option has readily ascertainable fair market value on date of grant (Option fully transferable or not subject to risk of forfeiture)				
Grant Date	The value of the option less any amount paid for the option will be taxed as compensation.	Compensation (ordinary) deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor.	No tax impact	No tax impact

Table 7–5 (cont'd)

Applicable Option Date	Federal Nonqualified		Pennsylvania	
Exercise Date	No tax impact	No tax impact	The value of the option less any amount paid for the option will be taxed as compensation	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor
Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact
	Federal Treatment Employee	**Federal Treatment Employer**	**Pennsylvania Personal Income Tax Treatment Employee**	**Pennsylvania Personal Income Tax Treatment Employer**
Option not publicly traded or does not have readily ascertainable fair market value on date of grant (Option fully transferable or not subject to risk of forfeiture)				
Grant Date	No tax impact	No tax impact	No tax impact	No tax impact
Exercise Date	The fair market value of the stock less any amount paid for the stock will be taxed as compensation	Compensation (ordinary) deduction equal to income amount recognized by employee	The fair market value of the stock less any amount paid for the stock will be taxed as compensation	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor

Table 7–5 (cont'd)

Applicable Option Date	Federal Nonqualified		Pennsylvania	
Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact
Exercise Date	No tax impact	No tax impact	The value of the option less any amount paid for the option will be taxed as compensation	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor

Table 7–6 - Non-statutory Stock Option (Nonqualified Stock Option) Option is NOT Fully Transferable or Subject to Risk of Forfeiture

Applicable Option Date	Federal (Nonqualified)		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
Option has readily ascertainable fair market value on date of grant (Option NOT transferable or subject to risk of forfeiture)				
Grant Date	The value of the option less any amount paid for the option will be taxed as compensation	Compensation (ordinary) deduction equal to income amount recognized by employee	No tax impact	No tax impact
Exercise Date	No tax impact	No tax impact	No tax impact	No tax impact
Lapse Date			The value of the option less any amount paid for the option will be taxed as compensation.	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor.

Table 7–6 (cont'd)

Applicable Option Date	Federal (Nonqualified)		Pennsylvania	
	Federal Treatment Employee	**Federal Treatment Employer**	**Pennsylvania Personal Income Tax Treatment Employee**	**Pennsylvania Personal Income Tax Treatment Employer**
Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact
Option does not have readily ascertainable fair market value on date of grant (Option not transferable or subject to risk of forfeiture)				
Grant Date	No tax impact	No tax impact	No tax impact	No tax impact
Exercise Date	The value of the option less any amount paid for the option will be taxed as compensation	Compensation (ordinary) deduction equal to income amount recognized by employee	No tax impact	No tax impact
Exercise Date	No tax impact	No tax impact	No tax impact	No tax impact

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Table 7–6 (cont'd)

Applicable Option Date	Federal (Nonqualified)		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
Lapse Date			The value of the option less any amount paid for the option will be taxed as compensation	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor
Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact

V. PENNSYLVANIA TAXATION OF CAFETERIA PLANS

A. Overview – Federal/Pennsylvania Differences

1. Federal

Cafeteria plans are federal plans pursuant to Internal Revenue Code Section 125 under which employers sponsor benefit packages that offer employees choices between cash and qualified benefits. If the employees choose cash, the cash amounts are included in taxable compensation. If the employees choose qualified benefits, the values of the benefits are not included in gross income. Qualifying benefits include:

- Accident coverage;
- Health coverage;
- Group-term life insurance coverage;
- Dependent care programs;
- Certain employer payments for educational expenses;
- On-site athletic facilities provided and operated by the employer; and
- A profit-sharing or stock bonus plan or rural cooperative plan as defined in IRC Section 401(k)(7) that includes a qualified cash or deferred arrangement as defined in IRC Section 401(k)(2).

2. Pennsylvania

If a taxpayer's employer maintains a federally qualified cafeteria plan pursuant to IRC Section 125, certain amounts deducted from taxpayer's salary (*e.g.*, health/accident insurance) are not subject to Pennsylvania personal income tax to the extent excluded for federal purposes.

Employer-provided flex dollars that an employee must use to pay for Pennsylvania-exempt benefits, such as health insurance or life insurance, are excludable from income taxation. Employee contributions to a qualified IRC Section 125 plan for coverage for hospitalization, sickness, disability or death, supplemental unemployment benefits, or strike benefits, like employer contributions, are exempt, but only to the extent they are exempt for federal income tax purposes. If an employer has an employee benefit plan that is not a qualified IRC Section 125 plan, employee contributions, even for the same kinds of coverage, are not excludable from Pennsylvania-taxable compensation.

Employee payments and contributions for other benefits, including dependent care and contributions to an IRC Section 401 plan, are not excludable from Pennsylvania-taxable compensation. If the employer's plan provides life insurance coverage that includes coverage for an employee's spouse and/or dependent child and the employee pays a portion of the premium for that coverage, that portion of the employee's payment is not excludable.

Article III of the Tax Reform Code was amended in 1997 to incorporate some features of federally qualified cafeteria plans. Under the Pennsylvania Income Tax Act:

> "Compensation" shall not mean or include . . . payments made by

> employers or labor unions including payments made pursuant to a cafeteria plan qualifying under section 125 of the Internal Revenue Code of 1986 . . . for employee benefit programs covering hospitalization, sickness, disability or death, supplemental unemployment benefits or strike benefits provided that the program does not discriminate in favor of highly compensated individuals . . . 72 P.S. § 7301(d)(vi).

The department's proposed regulation interprets this statutory exclusion and provides that:

a. Payments made after Dec. 31, 1996, for employee welfare benefit plans under a cafeteria plan qualifying under section 125 of the IRC will be deemed to be an 'employer contribution' for Pennsylvania Income tax purposes if the following apply:

   - They were not actually or constructively received after taking section 125 of the IRC into account; and

   - They were specified in a written cafeteria plan document as being available to the participant:

     - For the purpose of selecting or purchasing benefits under a plan; and

     - As additional cash remuneration received in lieu of coverage under a plan; and

     - The benefits selected or purchased are nontaxable under the IRC when offered under a cafeteria plan.

b. If these conditions are satisfied, cafeteria plan contributions are taxed under the rules as applied to employer payments for employee welfare benefit plans . . . Refer to 61 Pa. Code §125.28(a)&(b).

B. Pennsylvania Taxable Benefits

All benefits other than for death, disability, hospitalization, and sickness are taxable under Pennsylvania personal income tax.

C. Pennsylvania Nontaxable Benefits

Hospitalization, sickness, disability, death, supplemental unemployment benefits, or strike benefits are nontaxable under Pennsylvania personal income tax provided that the program does not discriminate. Additionally, Pennsylvania does not tax the employee's use of employer property.

VI. PENNSYLVANIA TAXATION OF FRINGE BENEFITS

A. Federal Income Tax – Overview

While certain benefits can be offered by employers to employees on an income-tax-free basis under Internal Revenue Code Section 125 Cafeteria Plans, the following non-cash benefits qualify for a federal exclusion from an employee's gross income but are specifically excluded from IRC Section 125 plans:

1. No additional cost services (*i.e.* free stand-by flights for airline employees);

2. Qualified employee discounts (*i.e.* reduced prices on goods and services);

3. Working condition fringe benefits (*i.e.* use of a company car for business purposes);

4. *De minimis* fringe benefits (*i.e.* personal use of a company copy machine);

5. Qualified transportation fringe benefits (*i.e.* commuter highway vehicle, transit passes, and qualified parking);

6. Qualified moving expense reimbursements;

7. On-site athletic facilities provided by and operated by the employer;

8. Medical Savings Accounts;

9. Scholarships and fellowship grants for teaching, research, or other services performed as a condition for receiving the grants;

10. Educational assistance provided for graduate teaching and research assistants and excludable fringe benefits (*i.e.*, *de minimis* fringe benefits, no additional cost services, employee discounts, and working condition fringe benefits) ; and

11. Cash and contributions by employers to provide coverage for long-term care services through a flexible spending or similar arrangement.

B. Pennsylvania Nontaxable – Overview

The right to receive cash in lieu of the benefit is always taxable as Pennsylvania compensation. Under Pennsylvania personal income tax law, the following fringe benefits are not taxable:

1. Employer use of property including, but not limited to:

   a. Employer dependent-care facilities;

b. Employer office equipment;

c. Employer-provided aircraft;

d. Employer-provided vehicles;

e. Employer recreational facilities;

f. Employer-provided professional services such as accountants and personal financial planners;

g. Qualified employee discounts; and

h. Any other *de minimis* fringe benefit defined under IRC Section 132.

C. Tuition Benefits/Educational Assistance Payments – Pennsylvania Rules

1. Direct

If employees (or their dependents) of an institution of education receive free or low-cost education at that institution or at a college or university with which the employer has a reciprocal agreement, then the value of the education is not taxable.

2. Reimbursement

If the employer reimburses an employee for education costs then the reimbursement is fully taxable as compensation and the employee may deduct only those directly related business expenses allowed on *PA-40 Schedule UE, Allowable Employee Business Expenses*. Refer to Unreimbursed Employee Expenses for discussion of eligible business expenses.

VII. EMPLOYEE EXPENSES FOR PENNSYLVANIA

A. Historical Background

The Pennsylvania Tax Reform Code of 1971 does not explicitly address how business expenses are treated. However, the Pennsylvania Supreme Court has interpreted an exclusion for "payments to reimburse actual expenses" to mean that all legitimate business expenses are excludable from compensation. *Commonwealth v. Staley*, 476 Pa. 171, 381 A.2d 1280 (1978). Further, the Court has held that amounts reimbursed by an employer for ordinary, actual, reasonable, and necessary business expenses are excluded from compensation. *Ritz v. Commonwealth*, 495 Pa. 1, 432 A.2d 169 (1981).

If parties to an employment contract recognize that the employee will pay for some business expenses out of his or her own pocket, these amounts may be excluded from income. *Id.* However, personal expenses, including daily living expenses of an employee, may not be excluded from compensation. *Williamson v. Commonwealth*, 525

A.2d 475 (Pa. Cmwlth. 1987).

B Overview Federal/Pennsylvania Differences

Under federal law, employee expenses are accounted for on federal Form 2106. Under Pennsylvania personal income tax law, employee expenses are accounted for on *PA-40 Schedule UE, Allowable Employee Business Expense.*

C. Accountable Plan

Pennsylvania follows federal rules regarding accountable plans. Accordingly, if a plan is properly maintained under federal rules, reimbursed amounts are not included in Pennsylvania wages.

D. Unreimbursed Employee Expenses – *PA-40 Schedule UE, Allowable Employee Business Expenses*

Pennsylvania personal income tax law allows a deduction of "allowable employee business expenses" for which the taxpayer was not reimbursed. In order to be claimed as an expense, the item must be ordinary, necessary, reasonable, actually incurred in performing the duties of the job, and directly related to present employment.

The *PA-40 Schedule UE, Allowable Employee Business Expenses* covers these expenses:

1. Travel and mileage;

2. Union dues/agency fees (or collective bargaining expenses, both of which are deductible over the life of the contract)/initiation fees;

3. Work clothes not suitable for street wear required to be purchased. This includes cleaning, altering, and repairs;

4. Small tools and supplies;

5. Professional license fees, malpractice insurance, and fidelity bond premiums where required by law or employer;

6. Moving expenses – provided the transfer is from one permanent duty station to another and provided that the net distance difference between the residence and the old duty station and the original residence and the new duty station is 35 miles or more. Expenses are limited to those incurred in moving family, self, and household goods from point of departure to point of arrival. Expenses associated with job-hunting trips are not deductible. Personal living expenses and other personal expenses are not deductible even if reimbursed for those expenses.

   a. *Allowable Expenses* - Expenses a taxpayer pays or incurs in moving himself, his immediate family, his household goods, and his personal effects are an allowable offset against the taxpayer’s taxable compensation if the move is made for the benefit of the employer. Allowable moving expenses include the cost of transportation to one's new home. One may use actual out-of-pocket costs or the federal mileage allowance. The expenses for the storage of household goods, for meals and lodging on the way, including such costs on the day you arrive, and parking fees and tolls are also allowable.

b. *Nondeductible Expenses* - Pennsylvania personal income tax law does not allow expenses to sell or purchase a home and costs to break a lease. One may not deduct pre-move house hunting expenses, temporary lodging prior to moving, and any costs or expenses not directly related to actually moving. Other nondeductible expenses include title insurance premiums, notary fees, mortgage service charges, appraisal fees, credit report fees, daily living expenses, *etc.* even if reimbursed for those expenses. Such reimbursements are included in compensation. *See* Section III, W.

c. *EXAMPLE* - In <u>Williamson v. Commonwealth</u>, 525 A.2d 475 (Pa.Cmwlth. 1987), an individual was transferred from St. Louis, Missouri to Pennsylvania and was reimbursed by his employer for certain expenses including costs associated with buying a new home (title insurance premium, notary fee, 1% mortgage service charge, appraisal fee, credit report fee), certain state and local taxes, and the costs associated with replacing his driver's license and license plates. In that case, the taxpayer argued that the reimbursement fit within the exclusion from compensation of "payments to reimburse actual expenses" noted above. 72 P.S. §7301(d)(v). The Commonwealth Court of Pennsylvania rejected this argument.

d. *Distance Test* - One's new workplace must be at least 35 miles farther from his old residence than his old workplace was. If one is in the military service, he does not have to meet the distance test if his move is a permanent change of duty station. If one, one's spouse, and dependents are moving to the new duty station from different locations, he may claim all the allowable expenses.

e. *EXAMPLE* - If one's old workplace was three miles from his old residence, his new workplace must be at least 38 miles from his old residence. Measure the distance using the shortest of the most commonly traveled routes.

7. Educational expenses. An individual taxpayer's education expenses are deductible if the education maintains or improves the skills used in the taxpayer's employment or trade or business (*i.e.* continuing education requirements prevalent in many professions or occupations) or is required for the taxpayer to keep his salary, status, or employment. However, the expenses are not deductible if the education qualifies the taxpayer for a new trade or business (*i.e.* a current teacher qualifying to be a principal of the educational institution), or is required to meet the minimum educational requirements of the taxpayer's current employment, trade, or business

8. Office work area expense;

9. Miscellaneous expenses:

   a. Breakage fees;

   b. Cash shortages;

   c. Blind employees' costs incurred to pay readers;

   d. Business gifts;

   e. Fees on federal Form W–2 which must be paid back to employer (*e.g.* Jury duty where employer continues full wages and requires repayment of monies received for jury duty);

   ~~f.~~ Reimbursements not received on federal Form W–2 must be deducted from expenses claimed on *PA-40 Schedule UE, Allowable Employee Business Expenses*~~;~~

   g. Depreciation expense; and

   h. *Per diem* expenses if the *per diem* income is included in compensation.

The *PA-40 Schedule UE, Allowable Employee Business Expenses* does not cover these expenses:

1. Deductions not allowable as business expenses;

2. Personal, living, or family expenses;

3. Capital expenditures normally are not an allowable business expense except through depreciation. Certain depreciation expense exclusions may be taken. Federal depreciation or cost-recovery deductions are acceptable for Pennsylvania purposes as an administrative convenience to compute allowable business expense deductions;

4. Dues to professional or fraternal societies, Chambers of Commerce, or recreational club memberships;

5. Subscriptions to publications;

6. Campaign or political contributions;

7. Charitable contributions;

8. Commuting expenses;
9. Cost of meals while working late except while traveling away from home overnight;
10. Occupational privilege taxes;
11. Child care and elderly care expenses;
12. Life, disability income, and health service insurance premiums;
13. Malpractice insurance premiums except where required by law or employer;
14. Pension contributions;
15. Fines, penalties, legal fees (except to recover back wages), and bad debts;
16. Bribes, kickbacks, or other illegal payments;
17. Eligible job-hunting expenses and pre-employment expenses or initial agent's fees;
18. Residential phone service (however, specific charges for telephone calls required to be made for business purposes may be deducted); and
19. Taxpayer's with multiple federal Form W–2, where expenses are greater than the wages from one employer, are not allowed deductions against other compensation from other employers.

E. PA-40 Schedule UE, Allowable Employee Business Expenses, Preparation Including the Pennsylvania TeleFile Schedule UE

A separate PA-40 Schedules UE must be completed for each taxpayer and for each employer and occupation. This means that a separate *PA-40 Schedule UE, Allowable Employee Business Expenses* must be filed for each federal Form W–2 received by the taxpayer. Additionally, the department has the right to request a detailed breakdown of expenses for each employer or occupation. The total amount of unreimbursed expenses must be entered.

An employee cannot deduct expenses if he or she was reimbursed by the employer for the exact amount of the expenses, including a fixed mileage allowance or per diem living expense that the employer did not include in the PA Taxable Compensation in block 16 of the federal Form W–2. However, if the employer did include reimbursements for the employee's expenses in PA Taxable Compensation on the federal Form W–2, the employee may complete the PA-40 Schedule UE to deduct his or her allowable PA business expenses.

If filing by *TeleFile*, use the *UE–TeleFile*. The only expenses allowed using *TeleFile* are union dues/agency fees/initiation fees, work clothes, and small tools/supplies.

Note: *TeleFile* will not be available for personal income tax filing for 2013 and beyond; to facilitate the transition to *PA Free File*, *padirectfile* will be available to file tax year 2013 income tax returns, but the system will be retired following the 2014 income tax filing season.

Pennsylvania will not consider the stated value or fair market value of an employee's personal use of an employer's owned or leased property or the use of an employer's services at no cost or at reduced cost as Pennsylvania-taxable compensation. The type of property or service and its value or fair market value is not a consideration when determining whether it should or should not be taxable. The employee's personal use is 100 percent excludable.

When an employer rewards an employee in recognition for performance, the cash or value of the award, unless *de minimis* under federal rules, is taxable Pennsylvania compensation. However, an award out of detached generosity or in recognition for civic or humanitarian services is not taxable Pennsylvania compensation.

When an employer reimburses its employees for personal and non–business expenses, the entire reimbursement is taxable Pennsylvania compensation. The employees may take any Pennsylvania-allowable unreimbursed employee business expenses on *PA-40 Schedule UE, Allowable Employee Business Expenses*.

F. Allowance for Clothing

The department has determined that an advance or allowance for clothing is subject to tax unless it represents a reimbursement. The employee must report all reimbursements and allowances as compensation unless:

1. The expenses for which the employee is reimbursed are allowable business expenses; and

2. The employee is required to and does account for the expenses to his employer; and
3. The employee is reimbursed by his employer in the exact amount of the allowable business expenses; and

4. The employee does not report the expenses on *PA-40 Schedule UE, Allowable Employee Business Expenses.*

The costs of purchasing and maintaining uniforms and work clothing to protect you from bodily injury are allowable business expenses under Pennsylvania personal income tax law if the uniforms and clothing are both:

1. Of a type required by the employer to be purchased as a condition of continued employment; and

2. Not adaptable to general usage.

An allowance is considered taxable Pennsylvania income if the employee receiving the allowance can use it at his discretion. An allowance for work clothing is included in Pennsylvania compensation, and, thus, taxed as income. However, a reimbursement paid to the employee for amounts he expended for a particular purpose is not income. Reimbursements for the purchase of work clothing are not income and costs in excess of the reimbursement are deductible to the employee.

Compensation does not include benefits payable by an employer or labor union under a supplemental unemployment benefit plan, whether payable on a periodic basis or in the form of cash, services, or property. *Refer* to 61 Pa. Code §101.6(c)(14).

G. Examples

Example 1. The employer provides leased company cars, each with a value of $200 per month, to its employees. An employee's use of the car is 75 percent business and 25 percent personal. The personal use of the car ($50 per month) is not taxable Pennsylvania compensation to the employee.

Example 2. The employer provides dependent care for its employees in a facility it leases and pays all the costs. The value of the dependent care is not taxable Pennsylvania compensation to the employees.

Example 3. The employer allows its employees to use the company’s plane to go to its recreational property. The value of the use of the plane and the recreational facilities is not taxable Pennsylvania compensation to the employees.

Example 4. An employee leases her own vehicle for $200 per month. The employer reimburses the employee for the full value of the lease ($2,400). The employee’s use of the car is 75 percent business and 25 percent personal. The $2,400 is taxable compensation on the employee’s W–2 form. The employee may deduct $1,800 on PA-40 Schedule UE. Her personal use of the car ($600) is not deductible.

Example 5. The employer reimburses its employees $50 per month for the dependent care costs they incur. The employer must include $600 in the employees’ W–2 forms as taxable Pennsylvania compensation.

Example 6. The employer rewards the 'employee of the year' with a paid vacation. The value of the vacation is taxable Pennsylvania compensation to the employee.

Example 7. The employee can elect compensation or to receive reimbursement. The amount is taxable for the employee for Pennsylvania personal income tax.

VIII. DAMAGE AWARDS

A. Overview – Federal/Pennsylvania Differences

Federal courts have held that there are no provisions in either Title VII of the Civil Rights Act of 1964 or the ADEA that provide compensatory damages for pain and suffering or for emotional distress. Refer to Supreme Court Decision in *United States v. Burke*, 112 S.Ct. 1867, 119 L.Ed.2d 34 (1992); *Commissioner v. Schlieier*, 515 U.S. 323 (1995). For federal income tax purposes, one could not exclude the settlement proceeds unless he could demonstrate that the award represents "damages received on account of personal injury or sickness." 26 U.S.C. §104(a)(2).

For Pennsylvania personal income tax purposes, damages for personal injury or sickness are excludable from Pennsylvania compensation. This includes emotional distress as well as physical injury.

If a claim was brought under either Title VII of the Civil Rights Act of 1964 or the ADEA, the amounts received are meant to restore the worker to the wage and employment position that the worker would have occupied prior to the unlawful discrimination. Consequently, the sums received from former employers are considered a form of back wages and are taxable as compensation under Pennsylvania's Tax Reform Code.

As mentioned above, damage awards received for personal injury or sickness are not taxable for Pennsylvania personal income tax. This includes federal taxable punitive damages. Damage award for lost profits or lost capital are taxable for Pennsylvania personal income tax.

B. Summary of Pennsylvania Personal Income Tax Treatment of Specific Damage Awards

1. Personal Injury Damage Awards Received Including Punitive Damage Awards

Personal injury damage awards, including punitive damages, are not taxable under Pennsylvania personal income tax law.

2. Age Discrimination Under ADEA Damage Awards

Damage Awards received for age discrimination under ADEA are taxable as compensation.

3. Sex Discrimination and Title VII of the Civil Rights Act

Damage Awards received for sex discrimination under Title VII of the Civil Rights Act are taxable as compensation.

C. Damage Awards for Lost Profits for Pennsylvania Personal Income Tax

Damage awards for lost profits are taxable under Pennsylvania personal income tax law.

D. Damage Awards for Return of Capital for Pennsylvania Personal Income Tax

Damage awards for return of capital are taxable under Pennsylvania personal income tax law.

E. Pennsylvania Treatment of Legal Expenses

For Pennsylvania personal income tax purposes, legal fees directly associated with the receipt of a damage award or settlement award are offset against the damage award received. The offset occurs only within the class of income.

IX. GUARANTEED PAYMENTS TO A RETIRED PARTNER

A. Guaranteed Payments to a Retired Partner – Taxable Compensation

Guaranteed payments to a retired partner are taxable as compensation on the same basis as deferred compensation is taxed to former employees of a partnership if:

1. Such partner rendered no services with respect to any trade or business carried on by such partnership or its successors during the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received;

2. No obligations, whether certain in amount or contingent on a subsequent event, exist during the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received except with respect to retirement payments under such plan; and

3. Such partner's share of the capital of the partnership has been paid to him in full before the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received.

B. Guaranteed payments to a Retired Partner – Non-taxable Retirement Benefits

However, amounts received by a retiring partner pursuant to a written plan of the partnership that provides for guaranteed payments on account of retirement to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, are excludible retirement benefits if:

1. The above requirements are met; and

2. The plan otherwise constitutes a qualifying retirement benefit plan.

C. Other Payments Received in Liquidation of the Interest of a Retiring Partner

Other payments received in liquidation of the interest of a retiring partner shall be considered as:

1. A distributive share of partnership income if the amount thereof is determined with regard to the income of the partnership;

2. A guaranteed payment; or

3. A distribution made in exchange for the interest of such partner in partnership property, including, unless the partnership agreement provides otherwise, unrealized receivables of the partnership and goodwill of the partnership.

D. Federal Limitations on the Taxation of Retirement Income of Nonresident Partners

Recent federal statutory changes prohibit states from taxing some retirement income of nonresidents. *Public Law 109-264*, signed Aug. 3, 2006, amends *Section 114 of Title 4 of the U. S. Code*. The new law provides that retirement payments made under a nonqualified plan maintained by a partnership and meeting specific criteria are taxable only by a state where the retired partner is a resident or where the retired partner is domiciled at the time the payments are received. To qualify for this tax treatment, the retirement payments must meet all of the following criteria:

1. The payments must be provided for in a written plan, program, or arrangement that was in effect before the partner's retirement;

2. The payments must be in recognition of prior service performed by the partner for the partnership; and

3. The payments must be made over the life or life expectancy of the recipient or over a period of at least 10 years, must be paid at least annually, and must be paid in substantially equal periodic payments.

X. PARTNERS AND SELF-EMPLOYED RETIREMENT PLANS – SIMPLIFIED EMPLOYEE PENSION (SEP), KEOGH PLANS

A. Overview

Pennsylvania tax law concerning simplified employee plans differs from federal law. For Pennsylvania income tax purposes, employer contributions to a SEP are excludable from the compensation of an employee. However, a self-employed taxpayer cannot deduct payments to his own IRA or Keogh plan.

B. Employer Contributions

Contributions by a self-employed individual or entity which employs one or more persons for compensation to employee welfare benefit programs on behalf of such employees generally are excludable from the employee's income and are deductible as business expenses to the extent the contributions constitute reasonable compensation for services. Pennsylvania tax law makes no distinction between stockholder-employees or officers of closely held corporations and other employees.

C. Employee Contributions

When either an employee or self-employed individual invests money in a deferred payment plan, and such individual did so as a result of his unilateral choice, the courts have held that the amounts placed into the plan or forgone as cash-in-hand were either compensation or net profits reportable in the year of deferral or contribution. *Bernknopf v.* Commonwealth, 425 A.2d 880 (Pa. Cmwlth. 1981); *Amp Products Corp. V. Commonwealth,* 593 A.2d 1 (Pa. Cmwlth. 1991) *aff'd. Per curiam,* 530 Pa. 249, 608 A.2d 25 (1992); *Smith v. Commonwealth,* 684 A.2d 647 (Pa. Cmwlth. 1996), *aff'd. Per curiam,* 549 Pa. 578, 701 A.2d 1360 (1997)

D. Case Law

In *Kalodner v. Commonwealth of PA*, 150 Pa Commw 248 , 615 a2d A.2d 900 (1992), the commonwealth believed that contributions to a Keogh plan or an IRA by a self-employed individual for his or her own benefit are not ordinary expenses incurred in the conduct of a business and, thus, could not be excluded from net profits. The court stated:

> Self-employed persons who contribute to their own retirement plan are investing income they have actually received for their retirement. *Refer* to *Bernknopf v. Department of Revenue,* 57 Pa. Commonwealth Ct. 57 (1981)*.* On the other hand, in situations where an employee's retirement plan is entirely funded by his or her employer and the contributions are not made by reducing the employee's salary, the employee may not actually or constructively receive income since the receipt of benefits under such a retirement plan could be subject to substantial limitations and restrictions. *Refer* to 61 Pa. Code § 101.7. Hence, we conclude that the tax code does not offend the federal constitution or the Pennsylvania constitution because there is a rational basis supporting the distinction in the tax code between self-employed persons who make their own contributions to retirement plans and employers who contribute to a retirement plan for their own employees.

XI. GROSS NON-EMPLOYEE COMPENSATION

Taxable gross compensation is not limited to employee compensation. It also includes:

A. Honorarium

Honoraria are taxable for Pennsylvania personal income tax purposes.

B. Executor or Administrator Fees

Executor fees are taxable as compensation. This includes executor's fees paid to nonresident executors and administrators for estates in Pennsylvania. It is presumed that these fees are received for services performed in Pennsylvania by the executor and/or his or her agent (such as an attorney) and the burden of proof falls upon the taxpayer to prove otherwise. Any apportionment must be reported on *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals.*

An executor or executrix for an estate in Pennsylvania would be required to visit Pennsylvania to complete his or her duties. The fact that the executor or executrix may use an agent to do the duties does not take away the fact that they had a presence in Pennsylvania and are subject to tax on that income. The only apportionment to be done is to exclude that portion of the executor fee that represents the services performed outside of Pennsylvania for the convenience of the estate and by necessity out of Pennsylvania. An example would be an appearance in court outside of Pennsylvania involving the estate. The remainder of the fee would be taxable as compensation for Pennsylvania purposes by non-resident executors. Apportionment can only be done by the number of days required out of Pennsylvania over total days spent working on the estate, including the time of the agent. The executor or executrix may be able to get some credit on another state's return for the income taxed by both states.

C. Witness Fees

Witness fees are taxable compensation for Pennsylvania personal income tax.

D. Jury Fees

Jury fees are taxable compensation for Pennsylvania personal income tax.

E. Director Fees

Director fees are taxable compensation for Pennsylvania personal income tax. The taxpayer is entitled to claim unreimbursed employee business expenses that are directly related to that compensation on *PA-40 Schedule UE, Allowable Employee Business Expenses.*

F. Foster Care

For taxable years beginning on or after Jan. 1, 1995, remuneration received by a foster care provider for in-home care of foster children received from an agency of the commonwealth or political subdivision or an organization exempt from federal income tax under IRC Section 501(c)(3) are not compensation subject to Pennsylvania personal income tax, unless the taxpayer is in the business of providing foster care.

G. Miscellaneous Compensation

Miscellaneous Compensation includes nonemployee compensation from sources other than a federal Form W–2. Enter the payer's EIN and name, Pennsylvania-taxable compensation, Pennsylvania tax withheld, federal taxable income and one of the following codes to identify the type of income:

- Executor fee

- Jury duty pay
- Director fee
- Expert witness fee
- Honorarium
- Covenant not–to–compete
- Damages or settlement for lost wages other than personal injury
- Other nonemployee compensation; describe it on this line
- Early distribution from retirement or pension plan
- Television Game Show or "Reality" Show winnings

H. Federal Form 1099–MISC Income

Fees, commissions, rewards, golden parachute payments, damage awards, termination payments, fringe benefits or other items of non-employee compensation reported on *federal Form 1099–MISC* are taxable as compensation.

I. Pennsylvania Personal Income Tax Treatment of Household Employees

A household employee, who can include babysitters, caretakers, nannies, health aides, private nurses, housekeepers, cleaning people, drivers, and yard workers, is a person hired to do any sort of household work as long as the employer retains the right to control the details of how the work is done. This differs from house workers obtained through an agency or self-employed workers who retain control of how the work is done. Generally, a self-employed worker provides his or her own tools and offers services to the public as an independent business. These individuals must file and report their income through the appropriate business schedule.

Since household employees are not subject to federal income tax withholding (although they may be subject to Social Security withholding), they are not subject to Pennsylvania income tax withholding.

XII. NONRESIDENT – ALLOCATION OF PENNSYLVANIA COMPENSATION

A. Compensation From Sources Within Pennsylvania

If services are performed within Pennsylvania, the compensation for the services constitutes income from Pennsylvania sources, regardless of the following:

1. Whether the services were performed as an employee;

2. Whether the compensation is received in a taxable year after the year in which the services were performed; and/or

3. Whether the compensation is received by someone other than the person who performed the services.

Some items of compensation may be based upon services relating to a single transaction or piece of work while other items may be based upon multiple transactions or piecework. Some may be based upon services of a continuing nature or services that are frequently recurring; and some constitutes prepaid income. Accordingly, different rules for allocating income to Pennsylvania sources may apply. They are explained below.

B. Commissions

1. On Sales Of Real Estate

A commission payable on a sale of real estate must be allocated to Pennsylvania if it is either the place where the real estate is situated or the place where the greater proportion of the income-producing activity is performed, based upon costs of performance and hours of work.

2. On Sales Of Tangible Personal Property

A commission payable on a sale of tangible personal property must be allocated to Pennsylvania if it is either the place where the property is delivered to the purchaser, regardless of the f.o.b. point or other conditions of the sale, or the place where the greater proportion of the income producing activity is performed, based upon costs of performance and hours of work.

3. On Sales Of Intangible Personal Property

A commission payable on a sale of intangible personal property must be allocated to Pennsylvania if it is the place where the greater proportion of the income producing activity is performed, based upon costs of performance and hours of work.

C. Compensation Based Upon Years Of Continued Service

If the amount of payment is based upon years of service or the total compensation received by the payee during his years of service, the payment shall be apportioned on the basis of the aggregated total number of working days worked within Pennsylvania during such years. This rule applies where, for example, a plan participant is to receive a severance benefit of 2 percent of his final year’s compensation times the years of service performed or a plan participant is to receive a benefit of 2 percent of the total compensation received during the payee’s years of service.

D. Casual Employments; Compensation Paid On A Daily Basis

Compensation that is based upon services relating to a single transaction or piece of work must be allocated to Pennsylvania if it is the place where the greatest proportion of the income producing activity is performed, based upon costs of performance and hours of work. The same rule applies to compensation paid—or ordinarily paid—on a daily basis.

E. Compensation Paid On A Weekly, Biweekly, Semimonthly, Monthly, Quarterly, Semiannual Or Annual Basis

Compensation that is earned and paid—or is ordinarily earned and paid—on a weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual basis shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual period bears to the total number of working days during the period.

F. Miscellaneous Compensation

Miscellaneous compensation is compensation other than prepaid compensation, commissions, compensation based upon years of continued service, compensation from casual employments or compensation paid on a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual basis. If its payment accrual period is determinable, each payment of miscellaneous compensation shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the payment's payment accrual period bears to the total number of working days during the payment's payment accrual period.

If its payment accrual period is not determinable, each payment of miscellaneous compensation shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the last period of continuous employment preceding the payment bears to the total number of working days during such period.

G. Prepaid Compensation

Even when conditioned, directly or indirectly, on the future performance (or refraining from performance) of substantial services, payments for services not yet rendered are taxable to cash method taxpayers unless the possibility of forfeiture is substantial or they are repaid within the refundable period. Amounts paid exclusively to provide reasonable compensation for future services such as a covenant not to compete, however, cannot be allocated on a working days basis unless and until all services fixing the right to retain the payment have occurred. Accordingly, if the evidence shows that substantially all of the future services would have been performed in PA, then the prepayments are allocable to Pennsylvania. Otherwise, such amounts may be allocated only to the employee, director or officer place of residence at the time of payment.

Amounts that substantially exceed the reasonable value of future services or payments that are intended to provide a "stay bonus" or similar incentive, however, must be treated as compensation for prior and current services. Moreover, if there is no way to determine the portion of a payment attributable to prior or current services and the portion attributable to future services, the entire amount is allocable to prior and current services.

H. Working Day Explained

A working day is any calendar day upon which compensable work is done, regardless of how short the time. In determining the number of working days:

1. No account whatsoever may be taken of nonworking days, including Saturdays, Sundays, holidays, days of absence because of illness or personal injury, vacation days, days of leave with pay, days of leave without pay, days where a person is on call if needed or days when work could not reasonably be expected to proceed because of strikes, weather conditions or other cause;

2. The presence within a state or foreign country shall be disregarded if it is solely for the purpose of boarding a plane, ship, train or bus for travel to a destination outside such state or country or while traveling by motor, plane, or train through a state or foreign country to a destination outside such state or country; and

3. Time spent in commuting or in traveling between work sites shall be disregarded.

I. Working Days Employed Within Pennsylvania Explained

Where a worker is provided with a suitable office or other workplace within Pennsylvania or is maintaining an office-in-home or other workplace within Pennsylvania, a working day is employed within Pennsylvania if either:

1. Some of the compensable work done during the calendar day is done in Pennsylvania; or

2 All of the work done outside Pennsylvania was done there only for the worker's convenience or was not performed there of necessity in the service of the employer.

Conversely, where a worker is provided with a suitable office or workplace outside PA or is maintaining an office-in-home or other workplace outside Pennsylvania, a working day is employed within Pennsylvania only if some of the compensable work done during the calendar day is done in Pennsylvania for the convenience, and of necessity in the service, of the employer.

Time spent in performing the following services shall be disregarded in determining working days employed in Pennsylvania:

1. Services performed by a nonresident individual who performs regularly assigned duties on a railroad in more than one state as an employee of an interstate rail carrier providing transportation;

2. Services performed by a nonresident individual who performs regularly assigned duties with respect to a motor vehicle in more than one state as an employee of an interstate motor carrier or private carrier; and

3. Services performed by a nonresident individual who performs regularly assigned duties on an aircraft in more than one state as the employee of an interstate air carrier, unless one-half or more of the employee's time in the employ of the employer in the calendar year is spent in performing services in this commonwealth.

J. The Convenience-Of-The-Employer Doctrine

Pennsylvania, like many other states, follows the "*convenience-of-the-employer*" doctrine. It provides that compensation for services performed by nonresidents cannot be allocated to the services' actual places of performance if they were performed there only for the employee's convenience or if they were not performed there "of necessity in the service of the employer". In these instances, the compensation must be allocated only to the state (or among the states) where the employee is of necessity performing actual services in the service, and for the convenience, of the employer.

The only factors considered under this doctrine are:

1. Whether the services performed by an individual outside the taxing jurisdiction were performed in the service, and for the benefit, of the individual's employer; and

2. Whether such services were such that they could have been performed at an office of the employer within the taxing jurisdiction (or could have been performed at an office of the employer within the taxing jurisdiction had the employer made suitable accommodations available to the employee).

Consequently, under the "*convenience-of-the-employer*" doctrine, allocation depends upon whether the services in question are of a character required to be performed away from an office of the employer and outside the taxing jurisdiction or require highly specialized facilities not available at or near an office of the employer.

K. Payment Accrual Period Explained

A payment accrual period ends when all services fixing the right to receive, or the duty to pay, the payment have occurred. The period begins when any of the activities that is required to establish that right or duty is begun.

In determining payment accrual periods:

1. The inability to ascertain the amount of payment with reasonable accuracy or doubts as to ability to collect shall be disregarded; and

2. It is immaterial whether an immediate right to receive, or duty to pay, has arisen, whether the payment may later be repaid or whether the right to receive payment is subject to forfeiture. It is also immaterial whether the right is enforceable at law or in equity or is unenforceable or the duty is a legal or moral duty.

L. Retirement Income

A nonresident's "retirement income" as defined at 4 U.S.C. §114 is not allocable to Pennsylvania if it is part of a series of substantially equal periodic payments made not less frequently than annually for the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or a period of not less than 10 years.

XIII. DISCHARGE OF INDEBTEDNESS

A. Discharge of Indebtedness Income for Pennsylvania Personal Income Tax

Refer to the *PENNSYLVANIA PERSONAL INCOME TAX GUIDE*, *Chapter 24 CANCELLATION OF DEBT*.

1. Insolvent Individuals

Insolvent individuals not filing for bankruptcy recognize cancellation of debt as income. The reportable amount is the lesser of:

a. The amount of indebtedness forgiven or discharged; or

b. The excess over the taxpayer's net worth as computed using generally accepted accounting principles (GAAP) immediately after the cancellation.

If an insolvent individual is not rendered solvent by the cancellation of debt, no income is recognized.

2. Solvent Individuals

Solvent individuals would report the amount of indebtedness forgiven or discharged as income.

3. Individuals filing for Bankruptcy

Unless the case is dismissed, an individual bankruptcy filed under Chapter 7, 11, or 12 of the Bankruptcy Act leads to the creation of a bankruptcy estate and no income shall be considered to have been realized by reason of discharge of indebtedness under bankruptcy laws.

B. When Is It Taxable

Income from cancellation of debt is taxable in Pennsylvania in only two circumstances:

1. Under GAAP, the debt forgiven was considered a liability; and

2. Where the debt forgiven constitutes a *quid pro quo* or incentive that would be taxable under Pennsylvania personal income tax law if it had been paid to the debtor in cash or in property.

C. Class of income

If the debt forgiveness relates to rent, royalty, patent, or copyright income, it is reported in that class.

XIV. ANNUITIES

A. Employer Annuity Plan

1. Features

An employer-sponsored plan that provides benefits to employees or their beneficiaries without a trust under annuity or endowment contracts which are held by the employer until such time as the employee separates from service by retirement constitute an employer's annuity plan. Under such plans, contributions are paid toward the purchase of the contracts for the exclusive benefit of the employees or their beneficiaries, and there is a definite written arrangement between the employer and insurer that refunds of premiums, if any, will be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of annuities or endowments under the plan.

2. Premium Payments

The following rules apply to premium payments for employees' annuity or endowment plans:

(a) Amounts voluntarily paid by an employee for an insurance contract forming part of a deferred compensation plan for the exclusive benefit of plan participants and their beneficiaries are not deductible. They constitute the employee's cost of investment in the plan contract.

(b) Amounts lawfully deducted and withheld from the compensation of an employee and paid for an insurance contract forming part of a deferred compensation plan for the exclusive benefit of plan participants and their beneficiaries are received by the employee as compensation at the time the deduction is made and are treated as amounts voluntarily contributed by the employee.

(c) Premium payments made under a contributory plan by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement are received by the employee as compensation at the time the contribution is made and are treated as amounts voluntarily contributed by the employee.

(d) Employer premium payments for an insurance contract under a plan are excludible from tax if the plan participant's rights are nontransferable and subject to a substantial risk of forfeiture or penalty.

3. Distributions

(a) Distributions are excludible from tax if they constitute a qualified annuity. "Qualified annuity" is defined at 61 PA Code § 101.1 to be an arrangement under which the payee is entitled to equal, or substantially equal periodic payments, paid at least annually, for any of the following periods:

- The life of the participant, or, if applicable, the joint lives of the recipient and recipient's designated beneficiary;
- The life expectancy of the participant, or, if applicable, the joint life expectancies of the recipient and recipient's designated beneficiary; or
- A period of at least 10 years.

(b) Withdrawals of employee contributions.
Actual or constructive pre-retirement withdrawals of one's own contributions and accumulated plan earnings are taxable only to the extent allocable to the earnings. The extent to which such withdrawals are taxable as compensation shall be determined using the cost recovery method of accounting.

(c) Pre-retirement withdrawals of employer contributions.
Actual or constructive pre-retirement employee withdrawals upon severance of employment without retiring of employer premiums or earnings constitute taxable severance pay.

4. Terminated plan annuities
Annuity contracts that are purchased by an employer upon the termination of a deferred compensation plan are taxed the same as employees' annuity or endowment plans.

B. Nonqualified annuities.

An annuity that a service provider buys on his own, rather than through a qualified employer sponsored plan or individual retirement arrangement, is a non-qualified annuity. Amounts received under nonqualified annuities are not taxable as compensation. They constitute taxable interest to the extent they are includible in gross income for Federal tax purposes.

C. Non-Employee Benefit Annuities

If you invested in a retirement annuity that is not part of an employer-sponsored program or a commonly recognized retirement program, you have Pennsylvania-taxable income when you begin receiving annuity payments. You must report the difference between the amount you receive and your previously taxed investment as taxable gain on *a PA-40 Schedule D, Sale, Exchange, or Disposition of Property*. If you receive periodic payments, you use the cost-recovery method to report the taxable gain.

For taxable years beginning after Dec. 31, 2004, income from annuity contracts purchased as retirement annuities that are not from an employer sponsored retirement annuity, or are not part of an employer sponsored program, are now taxable as interest income. Any income from these types of plans that is taxable for federal income tax purposes is now taxable for Pennsylvania personal income tax purposes as interest income as a result of Act 40 of Jul. 7, 2005. Act 40 also provided that that amounts paid under contract of life insurance or endowment, which may be included in gross income for federal income tax purposes, are also subject to Pennsylvania personal income tax as interest income. Previously, the income received from an annuity that you purchased, including a retirement annuity that is not part of an employer-sponsored retirement program was reported as gain on the sale, exchange, or disposition of property. The old rules for annuities are explained in *Pennsylvania Personal Income Tax Guide*, *Chapter 8 Interest* and *Chapter 12, Net Gains (Losses) From the Sale, Exchange or Disposition of Property*.

D. Life Insurance Annuity Contracts

Act 2005–40 provides the taxability of an exchange of life insurance annuity contracts will follow the requirements of Section 1035 of the Internal Revenue Code. Therefore, do not report the gain (loss) on the sale, exchange or disposition of any insurance contracts that include:

1. An exchange of a life insurance contract for another life insurance contract, an endowment contract, or an annuity contract;

2. An exchange of an annuity contract for another annuity contract;

3. An exchange of an endowment contract for an annuity contract; or

4. An exchange of one endowment contract for another endowment contract if the dates for payments begin on or before the original contract's payment dates.

If the exchange of contracts has the effect of transferring property to a non-U.S. person, the gain or loss is not tax exempt. If cash or other boot is involved with the exchange of the contracts, the gain or loss is also not tax-exempt.

Under these rules, if there is no cash involved, the exchange will be tax-free. If the exchange involves cash, the amount of cash received will be taxable as interest income. This shall apply to taxable years beginning after Dec. 31, 2004.

XV. PLANNED DEFERRED COMPENSATION

A. Overview

1. Introduction

A plan provides for the deferral of compensation only if, under the terms of the plan and relevant facts and circumstances:

- The service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income for Federal tax purposes, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year; or

- In the case of compensation that is excludible from gross income for Federal tax purposes, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year and is neither actually reduced to possession by nor otherwise made available to the service provider during the taxable year.

A service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or the discretion to reduce or eliminate the compensation is unlikely to be exercised, a service provider will be considered to have a legally binding right to the compensation. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture. Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under IRC § 401(a), or because benefits are reduced due to actual or notional investment losses, or in a final average pay plan, subsequent decreases in compensation.

Planned deferred compensation ordinarily is paid pursuant to a written agreement between an employer and an employee whereby the employee's compensation becomes due and payable, as provided in the plan, within a stated period after one or more of the events or times set forth below transpire:

- The employee's separation from service;
- The employee's becoming disabled;
- The employee's death;
- A time or fixed schedule specified under the plan;
- The completion of a stated period of plan participation or the lapse of a fixed number of years;
- A change in the ownership or effective control of the employer or in the ownership of a substantial portion of the assets of the employer; or
- Financial hardship.

In contrast, an employee's regular compensation is the remuneration that ordinarily is paid on regular paydays designated in advance by the employer for services performed in a preceding pay period. The regular compensation earned in any pay period is due and payable within the number of days after the expiration of the pay period as is provided in the employee's written contract of employment or, if not so specified, within the standard time lapse customary in the employer's trade or business or within the number of days after the expiration of the pay period as is provided by law, whichever is earlier. A pay period may be a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual period.

2. Categories Of Planned Deferred Compensation

Almost all nondiscriminatory deferred compensation plans are designed to satisfy the requirements for a "qualified deferred compensation plan"[1] or other "eligible retirement plan"[2] for Federal income tax purposes. Consistent with the requirements of the *Employee Retirement Income Security Act*, all of such plans provide a secured benefit for plan participants and allow for a deferral of payment and tax for periods extending to the termination of the covered employment. They, however, also allow for deferrals for periods extending *beyond* the termination of the covered employment. Some plans, however:

- Provide no secured benefit for plan participants;

- Are maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees; and

[1] Defined Treasury Regulation **§** 1.402.0(b)(1).
[2] Defined 72 P.S. § 402(c)(8).

- are designed neither to provide retirement incomes to plan participants nor to result in a deferral of payment for periods extending beyond the termination of the covered employment.

Accordingly, not all planned deferred compensation constitutes excludible old age or retirement benefits.

Deferred compensation plans fall into nine separate categories:

- Short-term deferral plans;
- In-service benefit plans;
- Federally qualified defined benefit plans;
- Federally qualified defined contribution plans;
- Section 409A Supplemental Executive Retirement Plans (SERP);
- Section 409A Voluntary Deferral Plans;
- Section 401(k) Mirror Plans;
- Unfunded Section 457 plans; and
- Funded Section 457 plans.

Each category is subject to different rules. They are explained below.

B. Short-term Deferral Plans

1. Short-term deferral plans explained

Some Federally nonqualified deferred compensation plans specifically provide for every payment to be made within two-and-a-half months of the end of the taxable year in which the deferred compensation is no longer subject to a substantial risk of forfeiture (or, in the case of an employer that is a fiscal year taxpayer, within two-and-a-half months of the end of the taxable year in which the services are provided or within two-and-a-half months of the end of the calendar year in which the services are provided). Such a plan constitutes a "short-term deferral plan" for Federal and PIT purposes.

2. Taxation

Any amount payable under a short-term deferral plan becomes taxable as compensation when it is no longer subject to a substantial risk of forfeiture.[3]

Short-term planned deferred compensation, however, is not limited to payments under a short-term deferral plan. Notwithstanding that a plan document does not specifically provide for every payment by the relevant two-and-a-half month deadline, so long as a plan payment is actually made by that date, it becomes taxable as compensation when it is no longer subject to a substantial risk of forfeiture.

[3] Such plans and payments are not covered by IRC § 409A.

C. In-Service Benefit Plans

1. In-service benefit plans explained

An in-service benefit plan is any Federally nonqualified deferred compensation plan (other than a short-term deferral plan) that provides that compensation deferred under the plan may be distributed earlier than separation from service, the date the participant becomes disabled, or death and is neither designed to result nor ordinarily results in deferrals of income by employees for periods extending to or beyond the termination of covered employment. Distributions under such plans typically become due and payable to vested plan participants:

- Pursuant to timing arrangements other than the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in IRC § 3401(b); or

- Within a stated period after a time or fixed schedule specified under the plan other than the specified age or stated period of employment for separation from service by normal or early retirement.

2. Taxation

(a) Effective for taxable years beginning after December 31, 2004, the determination of when compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A as they exist as of the time of their application that apply to nonqualified deferred compensation plans.

(b) Effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC § 409A (a) (1) shall be included in compensation. This rule shall apply whether or not the distributee is retired from service at the time of distribution.

(c) Generally, if at any time during a taxable year an in-service benefit plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed. This rule shall apply whether or not the distributee is retired from service at such time.

D. Federally Qualified Defined Benefit Plans

1. Categories of defined benefit plans

For PIT purposes, federally qualified defined benefit plans fall into three categories:

- Pension benefit plans;
- Mixed-purpose plans; or
- Savings pension plans.

The tax treatment of each of these categories is explained in this section.

2. Pension benefit plans

(a) FEATURES
A pension benefit plan has two important features:

(i) The plan is established and maintained by an employer to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement; and

(ii) Since the primary purpose of a pension benefit plan is to provide for retirement benefits, the right of an employee to make withdrawals under the plan before meeting the age or service requirements for acquiring the rights immediately to separate from employment by retirement without the consent of the employer and to begin receiving retirement benefits is restricted to one or more of the following:

(A) Incidental benefits due to permanent disability;

(B) Incidental death benefits;

(C) Distributions required to be made under the minimum distribution rules of IRC § 401(a)(9); or

(D) Distributions upon termination of the plan.

(b) POST-RETIREMENT BENEFITS
Post-retirement benefits under a pension benefit plan are commonly recognized as nontaxable old age or retirement benefits.

(c) DISABILITY BENEFITS
Any benefit due to permanent disability under a pension benefit plan is

taxable deferred compensation unless paid as part of a series of substantially equal periodic payments made for the period of the disability.

(d) BENEFITS ON ACCOUNT OF DEATH
Amounts paid to the beneficiary of an employee solely by reason of the death of the employee are taxable neither to the employee nor beneficiary.

(e) OTHER BENEFITS
Pre-severance of employment distributions required to be distributed under the minimum distribution rules of IRC § 401(a)(9) or made upon termination of a plan are taxable deferred compensation.

(f) ROLLOVERS
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

3. Mixed-purpose plans

(a) FEATURES
A mixed-purpose defined benefit plan is established and maintained by an employer only in part to provide for the payment of retirement benefits. It also is established and maintained in part merely to provide a tax-advantaged deferral of income by employees for periods extending to the termination of covered employment by permitting employee withdrawals of employer contributions or the earnings thereon upon severance of employment without retiring.

(b) PRE-RETIREMENT WITHDRAWALS OF EMPLOYER CONTRIBUTIONS
Pre-retirement employee withdrawals of employer contributions or plan earnings upon severance of employment without retiring constitute taxable severance pay.

(c) POST-RETIREMENT BENEFITS
Post-retirement benefits under a mixed purpose plan are commonly recognized as nontaxable old age or retirement benefits.

(d) DISABILITY BENEFITS
Any benefit due to permanent disability under a pension benefit plan is taxable deferred compensation unless paid as part of a series of substantially equal periodic payments made for the period of the disability.

(e) BENEFITS ON ACCOUNT OF DEATH
Amounts paid to the beneficiary of an employee solely by reason of the death of the employee are taxable neither to the employee nor beneficiary.

(f) OTHER BENEFITS
Pre-severance of employment distributions required to be made under the minimum distribution rules of IRC § 401(a)(9) or made upon termination of the plan are taxable deferred compensation.

(g) ROLLOVERS
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

4. Savings pension plans

(a) FEATURES
A savings pension plan is a pension benefit plan or mixed-purpose plan that permits an employee to withdraw his own contributions to the plan, together with accumulated interest, prior to retirement or separation.

(b) WITHDRAWALS OF EMPLOYEE CONTRIBUTIONS
Withdrawals of one's own contributions and accumulated plan earnings prior to retirement or separation are taxable only to the extent allocable to the earnings. The extent to which such withdrawals are taxable as compensation shall be determined using the cost recovery method of accounting.

(c) PRE-RETIREMENT WITHDRAWALS OF EMPLOYER CONTRIBUTIONS
Pre-retirement employee withdrawals of employer contributions or plan earnings upon severance of employment without retiring constitute taxable severance pay.

(d) POST-RETIREMENT BENEFITS
Post-retirement benefits under a pension benefit plan are commonly recognized as nontaxable old age or retirement benefits.

(e) DISABILITY BENEFITS
Any benefit due to permanent disability under a pension benefit plan is taxable deferred compensation unless paid as part of a series of substantially equal periodic payments made for the period of the disability.

(f) BENEFITS ON ACCOUNT OF DEATH
Amounts paid to the beneficiary of an employee solely by reason of the death of the employee are taxable neither to the employee nor beneficiary.

(g) OTHER DISTRIBUTIONS
Pre-severance of employment distributions required to be made under the minimum distribution rules of IRC § 401(a)(9) or made upon termination of the plan are taxable deferred compensation.

(h) ROLLOVERS
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

E. Federally qualified defined contribution plans

1. Categories of qualified defined contribution plans

For PIT purposes, qualified defined contribution plans fall into three categories:

- Nondiscretionary defined contribution plans;
- Federally qualified stock bonus plans or employee stock ownership plans; and
- Discretionary defined contribution plans.

The tax treatment of each of these categories is explained in this section.

2. Nondiscretionary defined contribution plans

(a) NONDISCRETIONARY DEFINED CONTRIBUTION PLAN EXPLAINED

A nondiscretionary defined contribution plan is one of the following:

- A Federally qualified profit-sharing plan, stock bonus plan or employee stock ownership plan to which contributions (including employee contributions made as a result of a corresponding reduction in salary pursuant to a cash or deferred arrangement) can be made only to the extent of the employer's current or accumulated earnings and profits for tax accounting or financial accounting purposes, net income, surplus or other measure of employer profitability;

- A noncontributory qualified defined contribution plan where one or more of the following is applicable:

  (i) The amount of earnings on contributions (or allocations of contributions or earnings) and the amount of benefits are determined with regard to the current or accumulated profits or losses of the employer;

  (ii) The employer can contribute only in those years when it has current or accumulated profits;

  (iii) The employer's contributions can fluctuate depending on the level of its profits; and/or

(iv) The employer's contributions are made out of current or accumulated profits.

(b) TAXATION
Except as provided in (c), all actual or constructive distributions upon dismissal, termination, or severance of employment (whether by retirement or otherwise) under either subcategory of nondiscretionary defined contribution plans constitute severance pay for personal income tax purposes.

(c) ROLLOVERS
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

3. Federally qualified stock bonus plans or employee stock ownership plans

(a) TAXATION
Except as provided in (b) of this section, all distributions of cash or property upon dismissal, termination or severance of employment (whether by retirement or otherwise) under a Federally qualified stock bonus plan or employee stock ownership plan constitute severance pay for personal income tax purposes.

(b) ROLLOVERS
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

4. Discretionary defined contribution plans

(a) FEATURES
A discretionary defined contribution plan is a 401(k) plan or other Federally qualified profit-sharing plan that does not limit contributions to the amount of the employer's current or accumulated earnings and profits for tax accounting or financial accounting purposes.

(b DISTRIBUTIONS
The only distribution under a discretionary defined contribution plan that constitutes severance pay is:

(1) A distribution received by an employee before the date he attains age 59½; or

(2) A distribution received by an employee before the date on which he separated from the covered service after attainment of age 59½.

(c) ROLLOVERS
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

F. Section 409A Supplemental Executive Retirement Plans (SERP)

1. Features

A SERP is a long-term nonqualifed deferred compensation plan based solely on notional employer contributions to an account and may be designed along the lines of a Federally qualified defined contribution plan or a Federally qualified defined benefit version. In the defined contribution version, the employer funds the agreement with a pre-determined periodic notional contribution. In the defined benefit version, the business is obligated to provide a pre-determined benefit to the executive on retirement or specified date. SERPs typically include a vesting schedule to encourage executives to remain with the business.

2. Taxation of pre-retirement benefits

(a) Federal rules and rulings shall be applicable with respect to what constitutes a long-term deferral;

(b) Effective for taxable years beginning after December 31, 2004, the determination of whether or when long-term deferred compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A applicable thereto as they exist as of the time of their application;

(c) Effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC § 409A (a) (1) shall be included in taxable compensation; and

(d) Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.

3. Taxation of post-retirement benefits

(a) Equal (or substantially equal) periodic payments paid not less frequently than annually to a retired plan participant for the life or life expectancy of the plan participant, the joint lives or joint life expectancies of the plan participant's and recipient's beneficiary, or for a period of not less than 10 years are excludible from tax as old age or retirement benefits.

(b) If the plan vests a retired plan participant with the right to elect only between payments described in paragraph (a) and a lump sum cash-out or periodic payments of equivalent actuarial value in lieu thereof, such elective benefits are excludible from tax as old age or retirement benefits.

(c) Other benefits are taxable on the same basis as pre-retirement benefits.

G. Section 409A Voluntary Deferral Plans

1. Features

Voluntary Deferral Plans are long-term deferred compensation plans that are based solely on deferrals of executive compensation, and accordingly, are structured as defined contribution plans. Benefits are generally determined by using growth factors or an index to an investment asset. The executive typically is immediately vested in all his/her contributions.

2. Taxation

(a) Federal rules and rulings shall be applicable with respect to what constitutes a long-term deferral.

(b) Effective for taxable years beginning after December 31, 2004, the determination of whether or when long-term deferred compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A applicable thereto as they exist as of the time of their application.

(c) Effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC § 409A (a) (1) shall be included in taxable compensation.

(d) Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed; and

(e) Post-retirement benefits are taxable on the same basis as pre-retirement benefits.

H. Section 401(k) Mirror Plans

1. Features

401(k) Mirror Plans are hybrids of a defined contribution SERP and a Voluntary Deferral Plan, with the plan participant having the option to defer salary and bonus amounts, and the business making notional matching contributions. The Plan usually includes a vesting schedule for business contributions.

2. Taxation

(a) Effective for taxable years beginning after December 31, 2004, the determination of whether or when long-term deferred compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A applicable thereto as they exist as of the time of their application.

(b) Except as provided in (d), effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC § 409A (a) (1) shall be included in taxable compensation.

(c) Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.

(d) Notional matching contributions and the income attributable thereto are taxable or excludible on the same basis as Section 409A Supplemental Executive Retirement Plan benefits.

I. Unfunded Section 457 plans

Unfunded Section 457 plans of tax exempt organizations other than government units provide that compensation for services performed during a taxable year may be deferred at the plan participant's election on a long-term basis. The following rules apply to all such deferrals:

1. Effective for taxable years beginning after December 31, 2004, the determination of whether and when deferred compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 475 applicable thereto as they exist as of the time of their application.

2. Effective for taxable years beginning after December 31, 2002, any part of a distribution received under a section 457 plan that is attributable to an elective deferral of income or the income on any elective deferral of income shall be included in compensation. This rule shall apply whether or not the distributee is retired from service at the time of distribution.

3. Generally, if at any time during a taxable year a plan fails to meet the requirements of IRC § 457(b), or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 475(f) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.

4. If the employer makes notional matching contributions, they and the income attributable thereto are taxable or excludible on the same basis as Section 409A Supplemental Executive Retirement Plan benefits.

J. Funded Section 457 Plans

Section 457 plans of government units and tax exempt organizations that maintain set-asides for the exclusive benefit of plan participants provide that compensation for services performed during a taxable year by may be deferred at the plan participant's election on a long-term basis. The following rules apply to such plans:

1. Payments to a set-aside described in section 457(g) of the Internal Revenue Code of 1986 made by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement shall be considered to have been received by the employee or individual as compensation at the time the payment is made, whether or not such payment is subject to a substantial risk of forfeiture, whether or not the taxation of such payment is deferred under section 457 of the Internal Revenue Code, and regardless of when the election is made or the payment is received. They constitute the employee's cost of investment in the plan contract.

2. The cost-recovery rule shall be used to determine the amount of a distribution under a contributory deferred compensation plan that shall be recognized as compensation. Under the cost-recovery rule, no compensation is recognized with respect to distributions until the distributee has enjoyed a full recovery of his cost of investment in the plan contract. The amount recognized as compensation is *not* determined under IRC § 72.

3. Distributions in excess of unrecovered employee contributions shall be considered to be attributable to contributions by the employer. Such amounts are taxable or excludible on the same basis as Section 409A Supplemental Executive Retirement Plan benefits.

4. ROLLOVERS
   Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

XVI. PENNSYLVANIA ELIGIBLE RETIREMENT PLANS

A. Criteria for Retirement Plan to Qualify as an Eligible Pennsylvania Retirement Plan

Under Pennsylvania law, retirement plans are considered eligible Pennsylvania retirement plans if, at a minimum, the plan has four characteristics:

1. The plan is reduced to writing and has been communicated to the participants;

2. The plan establishes eligibility requirements for separation of service or a combination of old age or infirmity, and long-continued service;

3. The plan provides for payments to be made at regularly recurring intervals after their separation from service by retirement which continues at least until death. An option for a lump sum payments or payments does not disqualify the retirement nature of the plan as long as the other provisions are provided; and

4. The plan does not permit the distribution of program benefits to any employee until termination of employment except for incidental disability benefits or the return of the employee's previously taxed contributions and income or gains if the employee is required to contribute to the pension plan.

If the pension program is a SEP, a Keogh, a federally qualified tax sheltered annuity program or a tax deferred custodial account, then an additional provision must be included in the written provisions to be a qualified pension program.

Program benefits cannot be paid before retirement, death, disability, separation from service unforeseeable emergency or attaining the age of 59 ½ without a substantial penalty for early withdrawal.

B. Employee Contributions to a Retirement Plan

Employee contributions to any retirement plan are always taxable as wages. (As indicated below, payments received from eligible Pennsylvania retirement plans are nontaxable retirement income).

C. Distributions from an Eligible Pennsylvania Retirement Plan at or After Retirement Age or Years of Service

All amounts withdrawn from under eligible Pennsylvania retirement plans are taxable in the year received to the extent that contributions and income earned on contributions were not taxed previously, except:

1. Payments from an eligible Pennsylvania retirement plan to a retired employee by reason of his retirement; or

2 Payments paid to the estate or designated beneficiary of a participant by reason of the participant's death; or

3. Payments received from an eligible Pennsylvania retirement plan which are rolled over into another deferred payment program or IRA, where the transferred amounts are not includable in income for federal income tax purposes.

D. Treatment of Investment Earnings by an Eligible Pennsylvania Retirement Trust Fund

Investment earnings on funds deposited into an eligible Pennsylvania retirement trust fund are not taxable to the employee when earned provided that the employee has not constructively received the earnings. Investment earnings on funds held in an eligible PA retirement plan trust fund that are received at retirement age are not taxable retirement income. Investment earnings distributed from a non-qualified deferred compensation plan that is not an eligible PA retirement plan are taxable in the year distributed. *Refer* to *PIT Bulletin 2005-04 Section 457(b) Eligible Deferred Compensation Plans*.

XVII. NONQUALIFIED DEFERRED COMPENSATION PLANS

Pennsylvania has no provision for the reducing of income being placed in a deferred compensation account under a qualified cash or deferral arrangement. This "deferred" income is taxable compensation in the tax year it is earned.

Deferred compensation is subject to tax as compensation for Pennsylvania residents to the extent it was not or would not have been subject to tax. That is, it is subject to tax over and above the amount of the employee's contribution to the plan. The taxable amount is determined by the cost-recovery method.

With certain exceptions, Pennsylvania's constructive receipt rules are now the same as the federal constructive receipt rules to determine when compensation is received by a cash basis taxpayer. Following the federal constructive receipt rule, deferrals to nonqualified deferred compensation plans are not included in compensation. However, compensation now includes distributions from nonqualified deferred compensation plans attributable to an elective deferral of income, regardless of whether the distributions are paid during employment or retirement.

Also, distributions of previously taxed contributions are not taxable. If you receive distributions of previously taxed contributions, complete and include with your return the *PA-40 W-2 Reconciliation Worksheet*. Refer to PIT Bulletin 2005-03, Deferred Compensation Under Nonqualified Plans.

XVIII. NEW RULES ON NONQUALIFIED DEFERRED COMPENSATION PLANS ADD SPECIAL REQUIREMENTS FOR EMPLOYERS AND TAXPAYERS

A. General Information

Act 40 of 2005 changed the definition of constructive receipt for Pennsylvania personal income tax purposes. Specifically, the act's new definition of constructive receipt adopts many of the provisions established by the Internal Revenue Code with respect to what to include and when to include certain deferrals of compensation as income for Pennsylvania personal income tax purposes. The Act also provided that distributions from nonqualified deferred compensation plans attributable to elective deferrals and earnings thereon are taxable at the time of the distributions irrespective of retirement.

B. Employer Requirements

For Tax Years Before 2005

Employers who have nonqualified deferred compensation plans that provide for elective deferrals need to provide plan participants with a letter establishing the amount of elective contributions previously included in Pennsylvania-taxable income so that plan participants have an acceptable record of their elective deferrals. The letter should set forth (for each taxable year of elective deferral between July 1, 1971 and Dec. 31, 2004) amounts of elective deferrals of compensation to nonqualified deferred compensation plans that were not taxable for federal income tax purposes (Box 1 of the federal Form W-2), but were included in Medicare Wages (Box 5 of the federal Form W-2) and in Pennsylvania taxable wages (Box 16 of the federal Form W-2) and were subject to withholding.

For Tax Year 2005
Employers should also provide a letter to their plan participants that outlines amounts included in Box 11 of federal Form W-2 that are attributable to - 1) nonqualified deferred compensation plan deferrals that were included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture for prior year services; or 2) earnings from prior year deferrals not previously included in Medicare wages. The letter should set forth the value of each of these amounts.

For Tax Years after 2005
Employers that have nonqualified deferred compensation plans for employees and directors must use Box 14 of the federal Form W–2 to indicate additional information regarding these plans in cases where, 1) the employee had a deferred amount of nonqualified deferred compensation that was included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture (for prior year services); 2) the employee had a distribution from the nonqualified deferred compensation plan; 3) the employee had a distribution from the nonqualified deferred compensation plan when the employee had a deferral for prior year services and a distribution in the same year; or 4) the employee had earnings from prior year deferrals not previously included in Medicare wages. Employees with only a deferral of nonqualified deferred compensation that is included in Medicare wages that are not subject to a substantial risk of forfeiture for current year services are required by the IRS to have this amount shown in Box 12 of the federal Form W-2 with a code Y and do not need to complete Box 14 of the federal Form W-2.

Employees who have a deferral of compensation that is included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture (for prior year services) should have that amount shown in Box 14 of federal Form W-2 along with the code YN. Employees who have a distribution of nonqualified deferred compensation should have that amount shown in Box 14 of federal Form W-2 along with a code YT. Employees who have had a deferral for prior year services and a distribution in the same year should have both the amounts shown in Box 14 of federal Form W-2. The deferral for prior year services will have a code YN next to that amount and the distribution will have a code YT next to that amount. Employees who have earnings from prior year deferrals not previously included in Medicare wages should have these amounts shown in Box 14 of federal Form W-2 with the code ZN.

Table 7–7 New Pennsylvania Codes in W–2 Box 14 Nonqualified Deferred Compensation Plans

Code	When to use

-	Deferrals under a Nonqualified Deferred Compensation (NQDC) Plan (coded as a Y in Box 12 of federal Form W-2).
YN	Deferrals under a NQDC Plan included in social security and Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture and are for prior year services.
YT	Distributions from a NQDC plan included in Box 1 of federal Form W-2.
ZN	Earnings from prior year deferrals now included in social security and Medicare wages.

C. Withholding Requirements

When distributions exceed the amount of elective deferrals previously taxed by the commonwealth, inclusion of the amounts in PA taxable compensation and withholding on the excess is required. Employers are required to withhold Pennsylvania personal income tax from nonqualified deferred compensation plan distributions when payment is made to employees (except for distributions of deferrals for taxable years prior to Jan. 1, 2005, if the deferrals were previously included in PA taxable compensation).

D. Taxpayer Requirements

Amended returns for tax years between 2003 and 2005

Taxpayers do not have to file amended returns for tax years between 2003 and 2005. Taxpayers who paid tax on elective deferrals of nonqualified deferred compensation for such years will not be subject to tax on such deferrals when such amounts are distributed from the nonqualified deferred compensation plan. However, if a taxpayer elects to do so, amended returns can be filed to remove the elective deferrals of nonqualified deferred compensation plans previously included in Pennsylvania-taxable compensation from such taxable compensation. As a result, special processing procedures and supporting documentation are needed to establish and validate the reduction to compensation. Therefore, the department will require that taxpayers, who amend their returns and remove the deferrals from Line 1a, Gross Compensation, of the *PA-40 Individual Income Tax Return*, write the words "Deferred Compensation" across the top of the amended return. They must also provide a copy of the letter to them from their employer establishing the amount of deferrals previously included in Pennsylvania-taxable compensation for each tax year along with a copy of the original federal Form W-2 from their employer. Taxpayers with distributions and deferrals within the same tax year should also include a worksheet with their amended return reconciling the federal wages (Box 1) shown on federal Form W-2 to the Medicare wages (Box 5) on federal Form W-2 as well as to Pennsylvania wages (Box 16) on federal Form W-2 by clearly indicating on that schedule each category of compensation included in each of the three aforementioned areas. A sample of the worksheet to be provided is included at the end of this article and is available on the department's website at www.revenue.state.pa.us. Click "Forms and Publications**"** link. Under

"Choose Category to Browse or Search" click Prior Tax Year at the end of "Income Tax." Click 2005 and scroll to PA-40 W-2 Reconciliation Worksheet**.**

For tax year 2005
The *PA-40 W-2 Reconciliation Worksheet* should be included with taxpayers' returns if they have not yet filed their 2005 returns. This worksheet should indicate whether the amount is due to a distribution or as a result of the amount no longer being subject to a substantial risk of forfeiture for prior year services and/or from earnings from prior year deferrals. The worksheet will also indicate whether any distributions were previously taxed as Pennsylvania compensation. Taxpayers should also obtain a letter from their employer indicating each of these amounts as previously discussed in the employer section of this article. For taxpayers who have already filed their returns for 2005, the Department will request PA-40 W-2 Reconciliations on an as-needed-basis.

For tax years after 2005
Taxpayers whose employers do not include codes in Box 14 of federal Form W-2 may be requested to provide additional information and reconciliations of PA Gross Compensation if there is an amount reported in Box 11 of federal Form W-2 or if the department is not able to reconcile the Pennsylvania wages with Medicare and/or federal wages from federal Form W-2 forms. If an employer does not provide the new codes in Box 14 of federal Form W-2, the PA-40 W-2 Reconciliation *Worksheet* should be provided with the return.

Any taxpayer who receives distributions from their nonqualified deferred compensation plans must include the distributions from nonqualified deferred compensation plans in their Pennsylvania Gross Compensation to the extent that they have not already paid tax on their deferrals. Taxpayers who have already paid tax on any deferrals should complete the *PA-40 W-2 Reconciliation Worksheet* and include it with their return along with a copy of the letter from their employer indicating the amounts previously taxed.

E. Proof Deferrals Were Previously Taxed

In addition to the letter from their employers showing the amounts previously included in Pennsylvania compensation, taxpayers may also be requested to provide proof that the deferrals were previously taxed. Proof of tax paid may include, but may not necessarily be limited to - copies of federal Form W–2 for the tax years showing the deferrals were included in Pennsylvania compensation; copies of the tax returns for the tax years showing the amount included in the reported gross compensation for those tax years; copies of any departmental assessments showing that the compensation amount reported for the taxpayer was adjusted by the department to include the deferred amount; and copies of any amended returns including or excluding the compensation from taxation.

Important: Taxpayers and practitioners should keep the above listed tax records and all other related tax records for deferrals of compensation (or other contributions to retirement plans) indefinitely with their permanent tax records for purposes of documenting their recoverable costs and previously taxed contributions and deferrals.

For additional information regarding the taxation of Deferred Compensation, refer to PA PIT Bulletins 2005-03 and 2005-04 available on the Department's Web site at www.revenue.state.pa.us.

XIX. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

Pennsylvania does not follow federal rules on deferral. The fair market value of stock is taxable compensation when constructively received. Any additional appreciation is then taxable Schedule D income when sold. ESOPs are not eligible retirement plans for Pennsylvania personal income tax purposes; therefore, all distributions in excess of previously taxed employee contributions are taxable.

XX. PROFIT-SHARING PLANS

A. Overview

Under Pennsylvania case law, including Gosewisch v. Commonwealth, 40 Pa Commw. 565, 397 A2d 1288 (1979), profit-sharing plans are taxable as Pennsylvania compensation. In Gosewisch, a distribution was made to the taxpayer from the "Profit-sharing Trust" and was considered to be remuneration received for services rendered. Since it was a severance, not a retirement benefit, the court held that the payment was compensation as defined in the Code and the regulations.

Pursuant to the *Gosewisch* case, during 2001, the department adopted provisions in Regulation Section 1.101 which provide that "Severance Pay" under Pennsylvania personal income tax law is defined as follows:

Severance pay
A payment made upon separation from employment under a plan, including a stock bonus or profits sharing plan formed by a trust that meets the requirements for qualification described in section 401 of the IRC (26 U.S.C.A. §401) or employee stock ownership plan, with one or more of the following attributes:

a. The amount of earnings on contributions or allocations of contributions or earnings and the amount of benefits are determined with regard to the current or accumulated profits or losses of the employer;

b. The employer can contribute only in those years when it has current or accumulated profits;

c. The employer's contributions can fluctuate depending on the level of its profits;

d. The employer's contributions are made out of current or accumulated profits;

e. Distributions are paid with respect to stock of a corporation that is held by an employee stock ownership plan.

B. Employee Contributions

Employee contributions are taxable in the year of contributions or deferral.

C. Employer Contributions

Employee contributions are not taxable if held in trust and no there is constructive receipt.

D. Distributions

All distributions in excess of previously taxed employee contributions are taxable.

XXI. IRAS, ROTH IRAS, SEPS, AND DEEMED IRAS

A. Definitions

The following words, terms, and phrases shall have the meaning ascribed to them in this part:

Employer-sponsored IRA

(1) Accounts established by employers under Internal Revenue Code § 408(c).

(2) Any individual retirement plan under which all employer contributions to the account of an employee are determined under a definite written allocation formula which specifies the requirements which the employee must satisfy to share in an allocation and the manner in which the amount allocated is computed.

(3) Simple retirement accounts or SIMPLE IRAs described in IRC § 408(p).

(4) Simplified employee pensions or SEPs described in IRC § 408(k).

The term shall not include inherited IRAs or deemed IRAs described in IRC § 408(q).

Individual retirement investment account
Any individual retirement plan other than an employer-sponsored IRA.

Individual retirement plan
An individual retirement account or annuity, section 408(c) IRA, Roth IRA, SEP, SIMPLE IRA or deemed IRA.

Inherited IRA

(1) An individual retirement plan that becomes the property of a beneficiary as a result of the death of the original owner. 2

(2) An inherited IRA beneficiary distribution account or annuity.
The term shall not include a plan that became the property of the original owner's surviving spouse as a result of the death of the original owner if the surviving spouse elects to treat it as his or her own individual retirement plan.

Participant
The individual for whom an individual retirement plan is maintained or the owner thereof. The term shall not include a beneficiary or the estate of a participant.

B. Employer Contributions

An employer contribution to an individual retirement plan of an employee and the income attributable thereto shall be considered to be compensation received by the employee only when:

- Distributed (see Sections G and H for taxability of distributions);
- The plan fails to meet Federal requirements; or
- The plan is not operated in accordance with Federal requirements.

C. Other Contributions

1. Employee Contributions

An employee's receipt of income shall not be tax-deferred by reason of a contribution of that income to an individual retirement plan through payroll deduction, a cash or deferred arrangement or otherwise.

2. Contributions By Or On Behalf Of The Self-Employed

A self-employed individual's receipt of income shall not be tax-deferred by reason of a contribution of that income directly or indirectly to any individual retirement plan. A self-employed individual includes a partner in a partnership or a member of an LLC.

D. Nondeductibility Of Contributions

No deduction is allowed to a plan participant for;

- The participant's contribution of compensation, whether direct or indirect, or any other asset to an individual retirement plan; or
- Re-contributed or rolled-over amounts.

E. Income On Plan Assets

Income on assets held in an individual retirement plan is not includible in income until:

- Distributed (see Sections G and H for taxability of distributions);
- The plan fails to meet Federal requirements; or
- The plan is not operated in accordance with Federal requirements.

F. Distributions To Plan Participants Under Employer-Sponsored IRAs

All amounts distributed under an employer-sponsored IRA shall be included in compensation to the extent provided in Section H, "Cost Recovery Method," except:

- Distributions to a former employee made on or after the later of:
  - o The date the former employee attained age 59½; and
  - o The date on which the former employee separated from the service of such employer sponsor; and
- For the year of the transfer, distributions that are transferred into an individual retirement plan or qualified plan where the transferred amounts are not included in income for federal income tax purposes.

G. Distributions To Plan Participants Under Individual Retirement Investment Accounts

All amounts distributed from an individual retirement investment account shall be included in compensation to the extent provided in Section H, "Cost Recovery Method," except:

- Distributions made to a participant after the participant attains age 59½; and
- For the year of the transfer, distributions that are transferred into an individual retirement plan or qualified plan where the transferred amounts are not included in income for Federal income tax purposes.

H. Cost Recovery Method

The extent to which a distribution is taxable as compensation shall be determined using the cost recovery method of accounting. That accounting method is explained in *Personal Income Tax Bulletin 2005-5* ("*Qualified Employer Plans*").

I. Distributions To The Beneficiaries Or Estate Of A Plan Participant

1. General Rule

Except as provided in paragraphs 2 and 3, all amounts paid under an inherited

IRA to the estate, or designated beneficiary, of the plan participant after the death of the plan participant are excludible from tax, including amounts attributable to income on plan assets that accrues after the death of the plan participant.

2. Electing Surviving Spouse

The rules outlined in Section G relating to individual retirement investment accounts apply to distributions from an inherited IRA that a surviving spouse elects to treat as his or her own individual retirement plan.

3. Rollovers Into A Surviving Spouse's Own Individual Retirement Plan

Any amount rolled over into an individual's own individual retirement plan on a tax free basis from an IRA that became the property of the individual as a result of the death of the individual's spouse shall be treated as the individual's own contribution for tax accounting purposes. The fact or amount of the rollover, however, has no other effect on the taxation of the income on plan assets of, or distributions from, the surviving spouse's own plan. If the surviving spouse's plan is an employer-sponsored IRA, the rules outlined in Section F shall apply to all distributions; and if it is an individual retirement investment account, the rules outlined in Section G shall apply to all distributions.

J. Special Rules Relating To Terminations, Conversions, Directors Of Corporations, And Elections

1. Termination Of An Individual Retirement Plan

(a) Except as specifically provided in paragraph (b), distributions made upon termination of an individual retirement plan are taxable upon the same basis as other distributions.

(b) Distributions made upon termination of an arrangement that are transferred into a qualified plan or individual retirement plan are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal tax purposes.

2. Conversions

The conversion of an individual retirement plan (other than a Roth IRA) to a Roth IRA shall be treated as a distribution.

3. Directors Of Corporations

The terms "employee" and "former employee" shall include the directors and former directors of a corporation.

4. Election To Treat An Inherited Ira As A Surviving Spouse's Own Individual Retirement Plan

The Pennsylvania personal income tax rules relating to the election to treat an inherited IRA as a surviving spouse's own individual retirement plan are the same as Federal income tax rules. An election to treat an inherited IRA as a surviving spouse's own individual retirement plan shall be deemed to have been made if:

(a) The surviving spouse redesignates the account as an account in the name of the surviving spouse as owner rather than as beneficiary; or

(b) At any time, either of the following occurs:

(i) Any amount in the inherited IRA that would be required to be distributed to the surviving spouse as beneficiary is not distributed within the time period required under section IRC § 401(a)(9)(B); or

(ii) Any additional amount is contributed to the inherited IRA which is subject, or deemed to be subject, to the lifetime distribution requirements of IRC § 401(a)(9)(A).

K. Regular Individual Retirement Account

1. Treatment of Contributions

No exclusion is provided for contributions to an IRA except:

a. Direct employer contributions; and/or

b. Amounts rolled over from another IRA or from a qualifying old age or retirement benefit program where the transferred amounts are not includable as income for federal income tax purposes

2. Treatment of Distributions

Amounts withdrawn from an IRA are includable in income to the extent that contributions and income earned on such contributions were not taxed previously except:

a. Payments, including lump sum distributions, made on or after retirement and reaching the age of 59½ years;

b. Payments received at regularly recurring intervals during periods of disability by reason of disability;

c. Payments paid to the estate or designated beneficiary of the participant by reason of the plan participant's death; or

d. Payments that are rolled over into another IRA or into an eligible retirement benefit program where the transferred amounts are not includable in income for federal income tax purposes.

Note: Distribution of an IRA or any other retirement plan pursuant to a divorce is taxable to the extent it has not previously been taxed. This income is reported as compensation.

Any amount distributed from an IRA pursuant to a qualified domestic relations order is treated as though distributed to the plan participant.

3. IRA Investment Appreciation

Undistributed income on assets held is not includable in income.

L. Roth IRA

1. General Rules

Most of the Pennsylvania personal income tax rules that apply to IRAs or annuities or simplified employee pensions also apply to Roth IRAs. For example:

a. An exclusion is allowed for payments made by employers directly to Roth IRA trustees or issuers for the benefit of employees;

b. No exclusion or deduction is allowed for contributions to a Roth IRA made by, on behalf of, or attributable to, an employee or self-employed person, directly or indirectly, whether through payroll deduction, a salary reduction agreement, or otherwise;

c. Income on assets held in a Roth IRA is not taxable;

d. Distributions are includable in income to the extent that contributions were not previously included if made before the individual for whom the account is maintained obtains age 59 ½ and retires from service or if the plan makes no provision for payments at regularly recurring intervals continuing at least until the participant's death; and

e. The cost-recovery method is used to determine the portion of a distribution to be included in income.

2. Transfers to Roth IRAs

For federal tax purposes, amounts rolled over into Roth IRAs from regular IRAs are includable in income, but the income from rollovers before Jan. 1, 1999, may be spread out over four tax years beginning with the distribution year. However, for Pennsylvania personal income tax purposes, the following rules apply:

- Amounts rolled over into a Roth IRA from an individual retirement plan other than a Roth IRA are includable in income for the year of distribution to the extent that contributions were not previously included, unless the plan provides that the distributee may elect to have such distribution paid directly to another federally-qualified retirement plan maintained for his benefit and such distribution is made in the form of a direct trustee-to-trustee transfer to the Roth IRA.

- Amounts rolled over into a distributee's Roth IRA from a federally-qualified retirement plan other than an individual retirement plan are includable in income for the year of distribution to the extent that contributions were not previously included, unless the entire amount received is paid into the Roth IRA not later than the 60th day after the day on which the distributee receives the payment of distribution.

- If either of the foregoing exceptions applies, the amounts rolled over shall be excludable from federal/Pennsylvania personal income tax.

3. Converting Regular IRAs to Roth IRAs

For Pennsylvania personal income tax purposes, the conversion of an individual retirement plan (other than a Roth IRA) to a Roth IRA shall be treated as a distribution. Any portion of a distribution resulting from a conversion from an individual retirement plan (other than a Roth IRA) to a Roth IRA is exempt from tax to the extent that the distribution is transferred to a Roth IRA. Any distribution that is not transferred is not exempt from tax. For any portion of a distribution that is not transferred, such as the federal income tax withheld, the cost recovery method shall be used to determine the portion of distribution that is subject to tax. This is an exception to the general rule that IRA distributions that are transferred to other types of plans are taxable to the extent taxable for federal income tax purposes.

Inasmuch as financial service companies report only the full amount of the withdrawal on federal Form 1099R they issue to the state without breaking down the contributions that have already been taxed, the department may request proof that the tax has been paid or the IRA has been rolled over.

XXII. EMPLOYER WELFARE PLANS

A. Overview

Employee welfare benefit programs are established by employers to provide welfare benefits to employees or their beneficiaries, such as dependent care assistance; life-; accident- or health insurance coverage; local services; medical benefits; supplemental unemployment compensation (SUB); tuition reductions; disability benefits; strike benefits and dismissal pay.

B. Taxation of Certain Benefits for Pennsylvania Personal Income Tax

1. Employee Welfare Benefit Program Benefits

All welfare benefit program benefits are taxable in the year received to the extent they are attributable to contributions by the employer that were not includable in the income of the employee or were paid by the employer except:

a. Amounts received for the permanent loss or loss of use of a part or function of the body or permanent disfigurement or in reimbursement of expenses incurred for medical care;

b. Amounts which are computed with reference to the nature of a sickness or injury and without regard to the period the employee is absent from work;

c. Amounts (other than regular wages or sick-leave pay) which are computed with record to the period that the employee is absent from work due to sickness or disability;

d. Strike benefits;

e. Supplemental Unemployment Compensation (SUB). For a payment to qualify as SUB pay, it must be made periodically during the period of actual unemployment and must continue only for the period of actual unemployment. Lump sum payments are taxable;

f. Amounts paid to the beneficiaries or the estate of an employee by reason of the death of the employee; or

g. The fair market value of employer-provided dependent care facilities.

2. Plan Requirements for Qualifying as an Eligible Pennsylvania Welfare and Benefit Plan

Employers establish and maintain employee welfare benefit plans to provide miscellaneous benefits to eligible employees or their beneficiaries. Unless specifically excluded, Box 16 of federal Form W–2 includes the cost of the Pennsylvania-taxable benefits that your employer provides. Your employer must include the value of these benefits, regardless of the type of plan your employer has.

C. Employee Contributions – Taxable

Deferred-payment program or welfare benefit program contributions deducted from the compensation of an employee; voluntary employee contributions; and contributions made by an employer pursuant to a cash or deferred arrangement under which the employee may unilaterally elect to have the employer either make the payments as contributions to the profit-sharing or stock bonus plan, money purchase plan, Federal Employee's Thrift Savings Plan or 401(k) Plan or 403(b) plan or other program on behalf of the employee or to the employee directly in cash, are not excludable from the employee's Pennsylvania income.

Table 7-8 - Pennsylvania Taxation of Contributions to and Distributions from Eligible Pennsylvania Retirement Plans

Type of Compensation Employer contributions to -	Taxable Description	Nontaxable Description
1) Employer-sponsored eligible Pennsylvania retirement plans; and or	Employer contributions to plans or trust s are taxable if constructive receipt by employee	1) Employer contributions are not taxable when contributed, provided there is no constructive receipt under Pennsylvania personal income tax rules.
2) Nonqualified deferred compensation plans that are non-eligible Pennsylvania retirement plans and/or	Employer contributions to plans or trust s are taxable if constructive receipt by employee	1) Employer contributions are not taxable when contributed, provided there is no constructive receipt under the Pennsylvania personal income tax rules.
3) Federal qualified plans that are not eligible Pennsylvania retirement plans	2) Treated as a nonqualified deferred compensation plan	1) Employer contributions are not taxable when contributed, provided there is no constructive receipt under the Pennsylvania personal income tax rules
Distributions of employer contributions and investment earnings on non-eligible employer contributions from employer sponsored nonqualified deferred compensation plan.	Always taxable as compensation	
Distributions of employer contributions and investment earnings on employee contributions from employer sponsored nonqualified deferred compensation plan meeting the requirements of an eligible Pennsylvania retirement plan	Any payment of employer contribution and investment earnings prior to retirement age are taxable PA compensation	Not taxable if the amounts are received at or after retirement age.

Table 7-8 – (cont'd)

Type of Compensation Employer contributions to -	Taxable Description	Nontaxable Description
Distributions of employer contributions from employer-sponsored qualified federal retirement plan that is non-eligible Pennsylvania retirement plan (e.g., profit-sharing plan providing no option to receive an annuity or an employee stock ownership plan)	Taxable as compensation. The fact that the plan is a qualified plan for federal income taxpayers is not controlling. The plan is not an eligible Pennsylvania retirement plan. ESOPs may be qualified federal plans, but they are non-eligible Pennsylvania retirement plans.	
Distributions of employee contributions and investment earnings on employee contributions	Distributions received before retirement age	
1) Distributions of employee contributions from an eligible Pennsylvania retirement plan	1) Taxable to extent of excess determined under the cost recovery method for amounts received prior to retirement	1) After retirement age, not taxable
2) Distribution of employee contribution from a nonqualified deferred compensation plan that is not an eligible Pennsylvania retirement plan	2) Taxable to extent of excess determined under the cost recovery method	2) Not taxable - only to extent of amounts previously included in income on prior PA-40 Individual Income Tax Returns and/or amounts contributed
3) Distribution of employee contributions from a qualified federal plan which is not an eligible Pennsylvania retirement plan e.g. profit-sharing plan not providing an option for an annuity of ESOP employee stock ownership plan	3) Taxable to extent of excess determined under the cost recovery method	3) Not taxable - only to extent of amounts previously included in income on prior PA-40 Individual Income Tax Returns and/or amounts contributed

Table 7-8 – (cont'd)

Type of Compensation Employer contributions to -	Taxable Description	Nontaxable Description
	If you invested in a retirement annuity that is not part of an employer-sponsored program or a commonly recognized retirement program, you have PA-taxable income when you begin receiving annuity payments. You must report the difference between the amount you receive and your previously taxed investment as taxable gain on a *PA-40 Schedule D, Sale, Exchange, or Disposition of Property*. (If you receive periodic payments, you use the cost-recovery method to report the taxable gain.)	
Annuities (other than employer sponsored retirement plan annuities)		To the extent of previously taxed investment
Roth IRA – Federal	Contributions not deductible	Distributions are includable in income to the extent that contributions were not previously included if made before the individual for whom the account is maintained obtains age 59 ½ and retires from service or if the plan makes no provision for payments at regularly recurring intervals continuing at least until the participant's death.

Table 7-8 – (cont'd)

Type of Compensation Employer contributions to -	Taxable Description	Nontaxable Description
Traditional IRA – Federal	Contributions not deductible	Amounts withdrawn from an IRA are includable in income to the extent that contributions and income earned on such contributions were not taxed previously except -
		1) Payments, including lump sum distributions, made on or after retirement and reaching the age of 59½ years;
		2) Payments received at regularly recurring intervals during periods of disability by reason of disability;
		3) Payments paid to the estate or designated beneficiary of the participant by reason of the participant's death;
		4) Payments that are rolled over into another IRA or into a qualifying old age or retirement benefit program where the transferred amounts are not includable in income for federal income tax purposes.
Nondeductible IRA – Federal		

XXIIi. FEDERAL FORM 1099-R RECONCILIATION FOR PENNSYLVANIA PERSONAL INCOME TAX

Federal Form 1099R is used to report income received from pensions, annuities, profit sharing plans, IRAs, insurance contracts, *etc.* The 1099R designates the taxable amount for federal purposes but not for Pennsylvania. You have to apply Pennsylvania rules described in Table 7-9 Form 1099R Reconciliation for Pennsylvania Personal Income Tax to determine what portion, if any, is taxable for Pennsylvania. Pennsylvania law does not follow federal law concerning early retirement options for IRAs, IRC Section 401 plans, 403 plans, and other federally-qualified plans. To determine if the amount you received is taxable in Pennsylvania, review Boxes 1 through 3 (the amount you received or your distributions) and the Pennsylvania tax treatment of Box 7 (the codes that will help determine the taxability of your distribution). The federal codes contained in Box 7 of federal Form 1099R include:

A. Code 1 & 2 Early Distribution

This distribution is taxable for Pennsylvania purposes, unless - (1) your pension or retirement plan was an eligible plan for Pennsylvania tax purposes, and (2) you retired after meeting the age conditions of the plan or years of service conditions of the plan. If your plan was not an eligible plan, or if you have not attained the age or years of service required under the plan to retire, you must determine the Pennsylvania taxable amount of your distribution. You must use the cost recovery method to determine this amount.

Important: If you are not sure whether your plan was an eligible retirement plan under Pennsylvania tax law, ask your plan administrator.

B. Code 3 or 4 Death/Disability Distribution

This is a distribution due to death and/or disability. A distribution due to death is not taxable for Pennsylvania purposes. A distribution due to disability generally is not taxable for Pennsylvania purposes.

C. Code 7 Normal Distribution

This distribution from an eligible Pennsylvania retirement plan is not taxable if you met the plan requirements (the age and/or years of service required by the plan) for retirement, and retired after meeting those requirements.

Caution. The distributions taken from annuities are taxable for Pennsylvania tax purposes. If taking distributions from annuities for which a federal Form 1099R was received, refer to PA-40IN, Instruction Booklet (no forms included) for reporting Pennsylvania-taxable income.

The State Employees' Retirement System, the Pennsylvania School Employees' Retirement System, the Pennsylvania Municipal Employees Retirement System, and the U.S. Civil Service Commission Retirement Disability Plan are eligible Pennsylvania Retirement Plans and all distributions are exempt from Pennsylvania personal income tax.

Retired or retainer pay of a member or former member of a uniform service computed under Chapter 71 of Title 10, U.S. Code as amended is also exempt from Pennsylvania personal income tax.

D. Code G or H Rollover

This is a rollover from one qualified fund to another and is not taxable for Pennsylvania purposes. Refer to IRA Distributions below.

E. Boxes 8 or 9b

Distributions listed in these boxes are distributions from an insurance policy or annuity purchased for retirement. Such distributions are not taxable if:

1. The insurance policy or annuity was from an eligible plan for Pennsylvania tax purposes; and

2. Retired after meeting the age or years of service conditions of such eligible plan.

If these requirements are not met, the taxation of distributions must be determined under the cost recovery method. This distribution is taxable as a gain on *a PA-40 Schedule D, Sale, Exchange, or Disposition of Property*, not as compensation on Line 1a.

F. Boxes 10 and 11

If there is state withholding in Box 10 of the federal Form 1099R and the state indicated in Box 11 is Pennsylvania, please include a copy of the federal Form 1099R with the tax return.

IRA Distributions (60-day rollover rule)

If a distribution from an IRA was received before age 59 ½ and retiring, and rolled the entire distribution (100 percent) into a Roth IRA directly or within 60 days, the distribution is not taxable income for Pennsylvania purposes. If the entire distribution was not rolled into another IRA, Pennsylvania-taxable income must be reported to the extent the distribution exceeds your contributions.

Important: If 59 ½ years of age, but did not retire, IRA distributions must be reported on a cost recovery basis until retirement. If retired, but did not reach age 59 ½, distributions must be reported on a cost recovery basis until age 59 ½ is reached.

Table 7–9 Federal Form 1099-R Reconciliation for Pennsylvania Personal Income Tax

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
1	Shows the total amount you received this year. The amount may have been a direct rollover, a transfer, or conversion to a Roth IRA, a recharacterized IRA contribution; or you may have received it as periodic payments, as non-periodic payments, or as a total distribution. Unless this amount is from a Coverdell Education Savings Account, report it on Form 1040 or 1040A on the line for "IRA distributions" or "Pensions and annuities" (or the line for "Taxable amount"), and on Form 8606, whichever applies. However, if this is a lump-sum distribution, report it on federal Form 4972, Tax on Lump-Sum Distribution. If you have not reached minimum retirement age, report your disability payments on the line for "Wages, salaries, tips, etc." Also report on that line corrective distribution of excess deferrals, excess contributions, or excess aggregate contributions. If a life insurance, annuity, or endowment contract was transferred tax-free to another trustee or contract issuer, an amount will be shown in this Box and Code 6 will be shown in Box 7. Do not report this on the tax return.	Under Pennsylvania personal income tax law, this distribution is taxable for Pennsylvania purposes if: • the pension or retirement plan was NOT an eligible plan for Pennsylvania personal income tax purposes; or • you retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution. **Cost Recovery Method – Residents** The "cost recovery method" provides for tax-free distribution of all prior employee contributions (since they were previously taxed) before distribution of employer contributions and investment appreciation (which are subject to tax). **Cost Recovery Method – Non-Residents** • Persons who reside outside of Pennsylvania but have worked in Pennsylvania and receive retirement benefits from such Pennsylvania employer must use the "cost recovery method" as indicated under "Cost Recovery Method – Residents" above. • Persons who contributed to a retirement plan while a Pennsylvania resident, but have moved out of Pennsylvania, are subject to tax on the income allocable to Pennsylvania over and above their contributions. • Residents who contributed to a retirement plan while a nonresident are subject to tax only on the amount received over and above their contributions, regardless of whether tax was paid to another state on the retirement income. **Cost Recovery Method - Annuities and Insurance Contracts** To determine prior employee contributions paid on annuities or insurance contracts, consult your plan administrator as to your full cost of the annuity.

Table 7–9 (cont'd)

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
2a	This part of the distribution is generally taxable. If there is no entry in this Box, the payer may not have all the facts needed to figure the taxable amount. In that case, the first Box in Box 2b should be checked. You may want to get one of the following publications from the IRS to help you figure the taxable amount - Pub. 560, Pub. 571, Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations, Pub. 575, Pub. 590, Pub. 721, Tax Guide to U.S. Civil Service Retirement Benefits, or Pub. 939, General Rule for Pensions and Annuities. For an IRA distribution, refer to IRAs and Roth IRAs above. For a direct rollover, zero should be shown, and you must enter zero (-0-) on the "Taxable amount" line of your tax return. If this is a total distribution from a qualified plan (other than an IRA or tax-sheltered annuity) and you were born before 1936 (or you are the beneficiary of someone born before 1936), you may be eligible for the 10-year tax option. Refer to the Instructions for federal Form 4972 for more information.	Not applicable to Pennsylvania personal income tax. Refer to Pennsylvania personal income tax treatment in Box 1 above.

Table 7–9 (cont'd)

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
2b	If the first checkbox is checked, the payer was unable to determine the taxable amount, and Box 2a should be blank. However, if this is a traditional IRA, SEP, or SIMPLE distribution, then refer to IRAs above. If the second checkbox is checked, the distribution was a total distribution that closed out your account.	Not applicable to Pennsylvania personal income tax. Refer to Pennsylvania personal income tax treatment in Box 1 above.
3	If a lump-sum distribution was received from a qualified plan and the taxpayer was born before 1936 (or is a beneficiary of someone born before 1936), you may be able to elect to treat this amount as a capital gain on federal Form 4972 (not on Schedule D (federal Form 1040)). Refer to the Instructions for federal Form 4972. For a charitable gift annuity, report as a long-term capital gain on Schedule D (federal Form 1040).	Under Pennsylvania personal income tax law, a lump sum distribution is taxable if– • Your pension or retirement plan was NOT an "eligible Pennsylvania retirement plan," or • You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable under either of the two rules above, then you may use the "cost recovery method" to report the taxable portion of this distribution. For Pennsylvania personal income tax there are no provisions for capital gain. The distribution is reported as gross compensation not as sale, exchange, or disposition of property.
4	This is the amount of federal income tax withheld. Include this on your income tax return as tax withheld, and if Box 4 shows an amount (other than zero), attach Copy B to your return. Generally, if you will receive payments next year that are not eligible rollover distributions, you can change your withholding or elect not to have income tax withheld by giving the payer Form W-4P, Withholding Certificate for Pension or Annuity Payments.	Not applicable to Pennsylvania personal income tax Refer to Pennsylvania personal income tax treatment in Box 1 above

Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
5	Generally, this shows the employee's investment in contract (after-tax contributions), if any, recovered tax free this year; the part of premiums paid on commercial annuities or insurance contracts recovered tax free; or the nontaxable part of a charitable gift annuity. This Box does not show any IRA contributions.	Generally, this shows the employee's investment in an annuity contract. Refer below for after-tax contributions. if any, recovered tax free this year; the part of premiums paid on commercial annuities or insurance contracts recovered tax free; or the nontaxable part of a charitable gift annuity. This Box does not show any IRA contributions. **Cost Recovery Method of Taxation of Retirement Distributions** (if applicable) Pennsylvania personal income tax law provides for the cost recovery method of taxation of retirement distributions if such distributions are – • From a non-eligible retirement plan, and • Distributed prior to the participant meeting the - ✓ Retirement age or ✓ Years of service, requirements under the plan. The cost recovery method provides for recovery of all prior employee contributions prior to taxation of distributions. To determine prior employee contributions consult your plan administrator as to your full cost of the annuity. "After-tax contributions" employee means contributions (usually deducted from pay) that the employee makes to his or her plan, annuity, etc. Since the employee has already been subject to tax on his or her contributions, these contributions are referred to as after tax contributions.

Table 7–9 (cont'd)

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
6	If you received a lump-sum distribution from a qualified plan that includes securities of the employer's company, the net unrealized appreciation (NUA) (any increase in value of such securities while in the trust) is taxed only when you sell the securities unless you choose to include it in your gross income this year. Refer to Pub. 575 and the Instructions for federal Form 4972. If you did not receive a lump-sum distribution, the amount shown is the NUA attributable to employee contributions, which is not taxed until you sell the securities.	Under Pennsylvania personal income tax law, provided there is no constructive receipt, unrealized appreciation from securities held in trust is not taxable unless the securities are sold.

Table 7–9 (cont'd)

7	The following codes identify the distribution you received	The following codes identify the distribution you received
	1– Early distribution, no known exception (in most cases, under age 59½). Refer to federal Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. For a rollover to a traditional IRA of the entire taxable part of the distribution, do not file federal Form 5329. Refer to the federal Form 1040/1040A instructions.	**1**– Under Pennsylvania personal income tax law, this distribution is taxable for PA purposes if – • Your pension or retirement plan was not an eligible plan for Pennsylvania personal income tax purposes or • You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution. **Cost Recovery Method – Residents** The "cost recovery method" provides for tax-free distribution of all prior employee contributions (since they were previously taxed) before distribution of employer contributions and investment appreciation (which are subject to tax). **Cost Recovery Method – Non-Residents** • Persons who reside outside of Pennsylvania but have worked in Pennsylvania and receive retirement benefits from such Pennsylvania employer must use the "cost recovery method" as indicated under "Cost Recovery Method – Residents" above. • Persons who contributed to a retirement plan while a Pennsylvania resident, but have moved out of Pennsylvania, are subject to tax on the income allocable to Pennsylvania over and above their contributions. • Residents who contributed to a retirement plan while a nonresident are subject to tax only on the amount received over and above their contributions, regardless of whether tax was paid to another state on the retirement income. **Cost Recovery Method - Annuities and Insurance Contracts** To determine prior employee contributions or amounts paid on annuities or insurance contracts, consult your plan administrator as to your full cost of the annuity.

Table 7–9 (cont'd)

Federal Form 1099R Box Number	**Federal Treatment**	**Pennsylvania Personal Income Tax Treatment**
7	**The following codes identify the distribution you received**	**The following codes identify the distribution you received**
	2 – Early distribution, exception applies (under age 59 ½)	**2 –** Under Pennsylvania personal income tax law, this distribution is taxable for PA purposes if – • Your pension or retirement plan was NOT an eligible plan for Pennsylvania personal income tax purposes or • You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.
	3 – Disability	**3 –** Under Pennsylvania personal income tax law, a distribution due to disability generally is not taxable .
	4 – Death	**4 –** Under Pennsylvania personal income tax law, a distribution due to death is not taxable
	5 - Prohibited transaction	**5 –** Not applicable - Pennsylvania personal income tax has no provisions for prohibited transactions
	6 – Section 1035 exchange (a tax-free exchange of life insurance, annuity, or endowment contracts)	**6 –** For taxable years beginning after Dec. 31, 2004, Act 40 of Jul. 7, 2005 provides that exchanges of insurance contracts listed under IRC Section 1035 that are tax exempt for federal income tax purposes are also tax exempt for Pennsylvania personal income tax purposes. Therefore, do not report the gain (loss) on the sale, exchange or disposition of any insurance contracts that include • An exchange of a life insurance contract for another life insurance contract, an endowment contract, or an annuity contract; • An exchange of an annuity contract for another annuity contract; • An exchange of an endowment contract for an annuity contract; • An exchange of one endowment contract for another endowment contract if the dates for payments begin on or before the original contract's payment dates. If the exchange of contracts has the effect of transferring property to a non-US person, the gain or loss is not tax exempt. If cash or other boot is involved with the exchange of the contracts, the gain or loss is also not tax exempt. The amount of cash or other boot received will be taxable as interest income. For additional information. refer to PIT Guide, Chapter 8, Interest .

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 7–9 (cont'd)

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
7	**The following codes identify the distribution you received**	**The following codes identify the distribution you received**
	7 – Normal Distribution	**7** – Under Pennsylvania personal income tax law, a normal distribution is not taxable if an only if – • Your pension or retirement plan was an "eligible Pennsylvania retirement plan", and • You have met the retirement age or years of service requirement (as applicable) under such plan. If you or your plan does not meet the two requirements above, the taxation of this distribution is determined under the cost recovery method
	8 – Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 2002	**8 –** Under Pennsylvania personal income tax law, an excess contribution is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable
	9 – PS 58 costs (premiums paid by a trustee or custodian for current insurance protection, taxable to you currently)	**9 –** Under Pennsylvania personal income tax law, PS 58 costs are taxable
	A – May be eligible for 10-year tax option. Refer to federal Form 4972.	**A –** Under Pennsylvania personal income tax law, there is no provision for 10-year tax options
	D – Excess contributions plus earnings/excess deferrals taxable in 2000	**D –** Under Pennsylvania personal income tax law, an excess contribution is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable
	E – Excess annual additions under section 415 and certain excess amounts under section 403(b) plans. Report on federal Form 1040/1040A on the line for taxable pension or annuity income	**E –** Under Pennsylvania personal income tax law, an excess annual addition is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable
	F – Charitable gift annuity	**F –** Under Pennsylvania personal income tax law, charitable gift annuities from retirement plans are not taxable to the extent that such amounts are distributed after retirement under the retirement plan
	G – Direct rollover to IRA	**G –** Under Pennsylvania personal income tax law, direct rollovers are not taxable
	H – Direct rollover to qualified plan or tax-sheltered annuity or a transfer from a conduit IRA to a qualified plan	**H –** Under Pennsylvania personal income tax law, direct rollovers are not taxable

Table 7–9 (cont'd)

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
7	**The following codes identify the distribution you received**	**The following codes identify the distribution you received**
	J – Early distribution from a Roth IRA, no known exception (in most cases, under age 59 ½). Report on federal Forms 1040 and 8606 and refer to federal Form 5329.	**J –** Under Pennsylvania personal income tax law, the taxation of a distribution from a Roth IRA prior to reaching 59 ½ is determined under the cost recovery method.
	L – Loans treated as distributions	**L –** Under Pennsylvania personal income tax law, this distribution is taxable for Pennsylvania purposes if- • Your pension or retirement plan was not an eligible plan for Pennsylvania personal income tax purposes or • You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.
	M – Distribution from a Coverdell ESA. Report any taxable amount on federal Form 1040. If your education expenses during 2003 were not equal to or more than your distribution, part or all of your distribution may be taxable and subject to an additional 10 percent tax.	**M –** Not applicable to Pennsylvania personal income tax. Under Pennsylvania personal income tax law, there is no provision for Coverdell ESA distributions.
	N – Re-characterized IRA contribution made for 2003 and re-characterized in 2003. Report on 2003 federal Form 1040/1040A and federal Form 8606, if applicable.	**N –** Under Pennsylvania personal income tax law, employee contributions to an eligible retirement plan are always taxable
	P – Excess contributions plus earnings/excess deferrals taxable in 2002	**P –** Under Pennsylvania personal income tax law, an excess contribution is taxable if not already taxed by employer. Employee contributions to an eligible retirement plan are always taxable.
	R – Re-characterized IRA contribution made for 2002 and re-characterized in 2003. Report on 2002 federal Form 1040/1040A and federal Form 8606, if applicable.	**R –** Under Pennsylvania personal income tax law, employee contributions to an eligible retirement plan are always taxable.
	S – Early distribution from a SIMPLE IRA in first 2 years, no known exception (under age 59 ½). May be subject to an additional 25 percent tax. Refer to federal Form 5329.	**S –** Under Pennsylvania personal income tax law, an early distribution from a SIMPLE IRA is taxable under the cost recovery method.

Table 7–9 (cont'd)

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
7	**The following codes identify the distribution you received**	**The following codes identify the distribution you received**
	T – Roth IRA distribution, exception applies. Report on Forms 1040/1040A and 8606. You are either age 59 ½ or over or an exception (code 2, 3, or 4) applies	**T –** Under Pennsylvania personal income tax law a Roth IRA distribution is not taxable if you are at least 59 ½ so long as the Roth IRA is considered an "eligible retirement plan." If you are not 59 ½, the taxation of this distribution is determined under the cost recovery method.
	If the IRA/SEP/SIMPLE Box is checked, you have received a traditional IRA, SEP, or SIMPLE distribution	
8	If you received an annuity contract as part of a distribution, the value of the contract is shown. It is not taxable when you receive it and should not be included in Boxes 1 and 2a. When you receive periodic payments from the annuity contract, they are taxable at that time. If the distribution is made to more than one person, the percentage of the annuity contract distributed to you is also shown. You will need this information if you use the special 10-year tax option (Form 4972).	This is a distribution from an insurance policy or annuity purchased for your retirement. Such distributions are not taxable if- • Your insurance policy or annuity was an eligible plan for Pennsylvania personal income tax purposes, and • You retired after meeting the age or years of service conditions of the insurance policy or annuity. If you do not meet these requirements, a distribution may be taxable as a gain on Schedule D, not compensation on Line 1a. Consult you plan administrator as to your cost in the annuity.
9a	If a total distribution was made to more than one person, the percentage you received is shown.	This box is your percentage of the total distribution listed.
9b	For a life annuity from a qualified plan or from a tax-sheltered annuity (with after-tax contributions), an amount may be shown for the employee's total investment in the contract. It is used to compute the taxable part of the distribution. Refer to Pub. 575.	Under Pennsylvania personal income tax law, this distribution is taxable for PA purposes if- • Your pension or retirement plan was NOT an eligible plan for Pennsylvania personal income tax purposes; or • You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then this distribution may be taxable as a gain on Schedule D, not compensation on Line 1a. Consult you plan advisor as to your cost of the annuity.
10	State tax withheld	This box lists the amount of withholdings applicable to Pennsylvania personal income tax. This amount should be added to any other withholdings and listed on your *PA-40 Individual Income Tax Return.*

Table 7–9 (cont'd)

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
11	State/Payer's state no	Employer identification number or Revenue ID (Box number) of payee
12	State distribution	Not applicable for Pennsylvania personal income tax
13	Local tax withheld	Not applicable for Pennsylvania personal income tax
14	Name of locality	Not applicable for Pennsylvania personal income tax
15	Local distribution	Not applicable for Pennsylvania personal income tax

XXIV. PROPERTY TRANSFERRED IN CONNECTION WITH THE PERFORMANCE OF SERVICES

A. Background

The Pennsylvania personal income tax was amended in order to make, with certain exceptions, section 83 of the Internal Revenue Code of 1986 and the regulations thereunder ("Section 83") applicable for taxable years beginning after December 31, 2004, with respect to property transferred to a service provider (or beneficiary thereof) in connection with the performance of services by such service provider. Those exceptions to the applicability of Section 83 are explained in this subchapter.

B. Certain transfers upon death

For PA PIT purposes, if substantially non-vested property has been transferred in connection with the performance of services and the person who performed such services dies while the property is still substantially non-vested, any income realized on or after such death by reason of such death with respect to such property under IRC §§ 83 and 691 is excludible from tax. The personal income tax has no provisions corresponding to IRC § 691.

C. Forfeiture after substantial vesting

For Federal tax purposes, If a person is taxable under IRC § 83(a) when the property transferred becomes substantially vested and thereafter the person's beneficial interest in such property is nevertheless forfeited pursuant to a lapse restriction, any loss incurred by such person (but not by a beneficiary of such person) upon such forfeiture shall be an ordinary loss. For personal income tax purposes, the loss is reportable as a loss from the disposition of property to the extent the basis in such property has been increased as a result of the recognition of income by such person under IRC § 83(a) with respect to such property.

D. Election to include in gross income in year of transfer

1. In general

Under Treasury Regulation §1.83.2, If property is transferred (within the meaning of Section 83(a)) in connection with the performance of services, the person performing such services may elect for Federal tax purposes to include in gross income under IRC § 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in Section 4(i)) over the amount (if any) paid for such property, as compensation for services. If this election is made, the substantial vesting rules of section 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in section IRC § 83(d)(2) and the regulations thereunder (relating to the cancellation of a non-lapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, property with respect to which this election is made shall be includible in gross income as of the time of transfer, even though such property is substantially non-vested (as defined in Section 4(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested (as defined in Section 4(b)). In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under IRC § 83(b).

2. Deemed personal income tax election

An election under section 83(b) for Federal tax purposes shall be deemed an election for PA PIT purposes unless revoked with the consent of the Commissioner of the Internal Revenue Service. The PA election is made by making the Federal election. No separate filing of the election is required to be made to the Department. A copy of the election filed with the IRS need not be included with the PA personal income tax return for the person making the election for the period related to the services.

3. No separate PA election

A separate PA election is not permitted if no election is made for Federal tax purposes.

4. Forfeitures

If property for which a section 83(b) election is in effect is forfeited while substantially non-vested, such forfeiture shall be treated as a disposition of property for PA PIT purposes upon which there is realized a loss equal to the excess (if any) of:

(a) The amount paid (if any) for such property, over,

(b) The amount realized (if any) upon such forfeiture.
A sale or other disposition of the property that is in substance a forfeiture, or is made in contemplation of a forfeiture, shall be treated as a forfeiture under the immediately preceding sentence.

E. Unstated interest payments

For Federal tax purposes, the term "amount paid" refers to the value of any money or property paid for the transfer of property to which section 83 applies. Such value does not include any unstated interest payments. For PA PIT rules regarding the calculation of the amount of unstated interest payments, see Treasury Regulation §1.483-1(c).

F. Sales which may give rise to suit under section 16(b) of the Securities Exchange Act of 1934

1. In general
For Federal tax purposes, when the sale of property at a profit within six months after the purchase of the property could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, the person's rights in the property are treated as subject to a substantial risk of forfeiture and as not transferable until the earlier of (i) the expiration of such six-month period, or (ii) the first day on which the sale of such property at a profit will not subject the person to suit under section 16(b) of the Securities Exchange Act of 1934.

2. Effective date
For personal income tax purposes, this paragraph applies to property transferred after December 31, 2004.

G. Special rule for certain accounting rules

1. “Pooling-of-Interests Accounting" rules
For Federal tax purposes, property is subject to substantial risk of forfeiture and is not transferable so long as the property is subject to a restriction on transfer to comply with the "Pooling-of-Interests Accounting" rules set forth in *Accounting Series Release Numbered 130* ((10/5/72) 37 FR 20937; 17 CFR 211.130) and *Accounting Series Release Numbered 135* ((1/18/73) 38 FR 1734; 17 CFR 211.135).

2. Effective date
For personal income tax purposes, this paragraph applies to property transferred after December 31, 2004.

H. Taxation of nonqualified stock options

For PA personal income tax purposes, If, after December 31, 2004, there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option which has a readily ascertainable fair market value at the time the option is granted and to which IRC § 421 (relating generally to certain qualified and other options) does not apply, the person who performed such services realizes compensation upon such grant at the time and in the amount determined under section 83(a).

If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under section 83(a) or 83(b).

I. Applicability of Section and Transitional Rules

1. Scope of section 83

Section 83 is not applicable to employer payments described in Section 11(b)(1)(B).

2. Transitional rules

(a) In general
Except as otherwise provided in subsection (b), these rules shall apply to property transferred after December 31, 2004.

(b) Binding written contracts
These rules shall not apply to property transferred pursuant to a binding written contract entered into before January 1, 2005. For purposes of this paragraph, a binding written contract means only a written contract under which the employee or independent contractor has an enforceable right to compel the transfer of property or to obtain damages upon the breach of such contract. A contract which provides that a person's right to such property is contingent upon the happening of an event (including the passage of time) may satisfy the requirements of this paragraph. However, if the event itself, or the determination of whether the event has occurred, rests with the board of directors or any other individual or group acting on behalf of the employer (other than an arbitrator), the contract will not be treated as giving the person an enforceable right for purposes of this paragraph. The fact that the board of directors has the power (either expressly or impliedly) to terminate employment of an officer pursuant to a contract that contemplates the completion of services over a fixed or ascertainable period does not negate the existence of a binding written contract. Nor will the binding nature of the contract be negated by a provision in such contract which allows the employee or independent

contractor to terminate the contract for any year and receive cash instead of property if such election would cause a substantial penalty, such as a forfeiture of part or all of the property received in connection with the performance of services in an earlier year.

J. Statutory Stock Options

1. Statutory stock option defined

The term "statutory stock option" describes stock option arrangements with particular Federal tax benefits made available under IRC § 421. Such arrangements include the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option in respect of which the requirements of IRC § 422(a) are met. It also includes transfers pursuant to the exercise of an option under an employee stock purchase plan in respect of which the requirements of IRC § 423(a) are met.

2. PA PIT treatment

Compensation in the form of statutory stock options is taxable as personal income when:

(a) The option is exercised if the stock subject to the option is free from any restrictions having a significant effect on its market value;

(b) The restrictions lapse if the stock subject to the option is subject to restrictions having a significant effect on its market value; or

(c) Exchanged, sold or otherwise converted into cash or other property.

IRC §§ 421, 421, 422, 423 and 424 have no application for PIT purposes.

K. Secular trust arrangements

1. Secular trust defined

A secular trust is a nonqualified deferred compensation arrangement that immediately and substantially vests plan participants with a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor and/or service recipient, for example, in a trust, escrow account or other means that is treated as a grantor trust for Federal tax purposes. Accordingly, for Federal tax purposes, the amounts transferred or set aside and trust income are currently taxable to the plan participant.

2. PA PIT taxation of secular trust arrangements

(a) Amounts transferred or set aside for the benefit of employees.

(i) General rule.
For taxable years beginning after December 31, 2004, any amount transferred to or set aside in a secular trust for the benefit of a employee (or the employee's beneficiary) and any earnings allocable thereto are currently taxable to the employee as compensation.

(ii) Programs covering retirement.
Notwithstanding the rules of IRC §§ 83 and 402(b), employer payments for programs covering retirement established for the benefit of the employer's employee(s) are excludible from personal income tax until actually or constructively received by the employee. However, for taxable years beginning after December 31, 2004, the earnings on any amounts transferred to or set aside in a secular trust for the benefit of an employee are currently taxable to the employee as compensation.

(b) Amounts transferred or set aside for the benefit of independent contractors, directors, and similar service providers.

For taxable years beginning after December 31, 2004, any amount transferred or set aside for the benefit of an independent contractor, director or similar service provider and any earnings allocable thereto are currently taxable to the independent contractor, director or service provider as compensation.

(c) For purposes of this Clause:

(i) An employee is an individual from whose wages an employer is required under the Internal Revenue Code to withhold Federal income tax.

(ii) A program covers retirement if it provides a specific distribution rule in the case of an employee's retirement from service such as, for example, where the plan provides for a qualified annuity upon retirement. A program that has substantially the same distribution rules in the case of an employee's voluntary termination of employment before reaching retirement age or service does not qualify.

(iii) A qualified annuity is defined at 61 PA Code § 101.1 to be an arrangement under which the payee is entitled to equal, or substantially equal periodic payments, paid at least annually, for any of the following periods:

- The life of the participant, or, if applicable, the joint lives of the recipient and recipient's designated beneficiary;

- The life expectancy of the participant, or, 9if applicable, the joint life expectancies of the recipient and recipient's designated beneficiary; or

- A period of at least 10 years.

L Employer Annuity Plans

Employer payments for an annuity or endowment contract are taxable unless the plan constitutes an employer annuity plan. *See* Subchapter XIV ("Annuities") for an explanation of employer annuity plans.

M. Cross Reference

A qualified annuity is defined at 61 PA Code § 101.1 to be an arrangement under which the payee is entitled to equal, or substantially equal periodic payments, paid at least annually, for any of the following periods:

- The life of the participant, or, if applicable, the joint lives of the recipient and recipient's designated beneficiary;

- The life expectancy of the participant, or, 9if applicable, the joint life expectancies of the recipient and recipient's designated beneficiary; or

- A period of at least 10 years.

pennsylvania
DEPARTMENT OF REVENUE

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 8: INTEREST

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CHAPTER 8: INTEREST

I. PENNSYLVANIA INTEREST

A. Gross Income Class

Interest income is a gross taxable income class under Pennsylvania law. Consequently, Pennsylvania law does not permit the deduction of any expenses that a taxpayer incurs to realize ordinary interest income. However, income that can reasonably be classified either as interest or as another taxable class of income is to be classified into that other class of income.

Interest derived from obligations that are not statutorily free from state or local taxation under any act of the General Assembly or under the laws of the U.S. is subject to taxation under the Pennsylvania personal income tax (PA PIT) statute. Interest on obligations issued by or on behalf of the U.S. government is not subject to Pennsylvania personal income tax.

B. Nonresidents

Nonresidents are not subject to Pennsylvania personal income tax on ordinary interest income from investments from sources within Pennsylvania.

C. Interest Income - Residents versus Nonresidents

Different types of interest income are classified as taxable as interest income or not taxable for Pennsylvania residents. Generally, nonresidents do not report ordinary interest income from sources within Pennsylvania. Refer to Table 1 on Page 12.

D. Interest is Classified as Income from the Pennsylvania Class in which it was Earned

Under Pennsylvania law, income and expenses are generally classified according to the activity in which they are earned or incurred. Similarly, interest as indicated below is classified as income from the Pennsylvania class in which it is earned:

1. Interest earned from savings accounts, personal checking accounts, bank accounts, bonds, notes and other securities, and other similar type investments is classified as interest income and, as such, no deductions are permitted against such interest income.

2. Interest earned in the normal and regular operation of a business, profession or farm is classified as net income (loss) from operation of a business, profession or farm as net income or loss, not as ordinary interest income. Examples of interest

which is classified as net income or loss from the operation of a business, profession or farm are as follows:

- Interest earned on accounts receivable;
- Interest earned on a business checking account; and
- Interest earned from investment of business working capital.

Likewise, expenses directly related to the production of this type of "business" interest are deductible against net income (loss) from the operation of a business, profession or farm. Examples of deductible expenses against net income (loss) from the operation of a business, profession or farm are as follows:

- Interest expense incurred with respect to accounts payable;
- Expense directly related to generating interest for working capital, *i.e.* bank fees; and
- Expense on business loans.

Refer to Pennsylvania Personal Income Tax Guide, Chapter 11, Net Income (Loss) From The Operation of a Business, Profession Or Farm Part I, Section C and Part III, Section B.

3. Interest derived by the seller from the sale of property on an installment basis is classified as net gain (loss) from the sale, disposition or exchange of property. Likewise, expenses incurred in holding a mortgage on a property sold by the seller on an installment basis are deductible.

   Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains (Losses) From the Sale, Exchange, or Disposition of Property and Chapter 30, Pennsylvania Department Of Revenue Personal Income Tax Policy Guidance.

4. Interest earned on the deposit of rents (i.e. tenant security deposits) is classified as interest income unless the interest earned is used to operate or maintain the rental property and is not returnable with the return of escrow funds. If the interest earned is actually used to operate or maintain the rental property, then such interest is classified as net income (loss) from rents, royalties, copyrights

and patents. Likewise, expenses incurred to operate or maintain a rental property are classified as net income (loss) from rents, royalties, copyrights and patents. Refer to Pennsylvania Personal Income Tax Guide, Chapter 13, Net Income or Loss From Rents, Royalties, Copyrights and Patents.

II. INDIVIDUALS

A. Interest Income

An individual taxpayer classifies ordinary interest earned from savings accounts, personal checking accounts, bank accounts and other investments as interest income.

B. Expenses Incurred to Generate Interest Income

Pennsylvania law does not permit the deduction of any expenses that an individual taxpayer incurs to realize ordinary interest income.

C. Uniform Gifts to Minors Act

Interest, dividends or any other income earned by accounts set up under the Uniform Gifts to Minors Act must be reported on the tax return of the child.

D. Other Income Taxable As Interest

Other income taxable as interest includes:

- Distributions from IRC Section 529 Qualified Tuition Programs for non-educational purposes;
- Distributions from Health/Medical Savings Accounts included in federal taxable income;
- Interest income from PA S corporations and partnership(s), from PA Schedule(s) RK-1.

III. INVESTMENT

A. General

Interest generated by investments of an individual such as interest income received during the taxable year from savings and loan associations, credit unions, bank deposits, bonds, certificates of deposit, interest-bearing checking accounts, tax refunds, mortgages or other obligations is classified as interest income. No deductions are permitted against income classified as interest income. Generally, federal Form 1099-INT, issued by financial institutions, will indicate the amount of interest received or credited from or by such institutions.

B. Burial Fund Earnings

Burial fund earnings are taxable income for Pennsylvania residents when the funeral home holds the account in the name of the taxpayer to pay the future funeral expenses of the taxpayer. Irrevocable burial funds are not taxable to the taxpayer. The funeral home reports the income as the custodian of the account on the *PA-41, Fiduciary Income Tax* return.

C. Insurance Companies

Interest income on dividends from insurance companies, whether disbursed or not, is taxable as interest income.

D. IRA, Keogh Accounts, or Pension Trusts

Undistributed unearned income accruing in IRA, Keogh Accounts or Pension Trusts is not taxable as interest income.

E. Amounts Paid Under Contract of Life Insurance, Endowment or Annuity

For taxable years beginning after Dec. 31, 2004, income from annuity contracts purchased as retirement annuities that are not from an employer-sponsored retirement annuity or are not part of an employer-sponsored program, are now taxable as interest income. Any income from these types of plans that is taxable for federal income tax purposes is now taxable for Pennsylvania personal income tax purposes as interest income as a result of Act 40 of July 7, 2005. Act 40 also provides that amounts paid under contract of life insurance or endowment, which may be included in gross income for federal income tax purposes, are also subject to Pennsylvania personal income tax as interest income. Previously, the income received from an annuity that you purchased, including a retirement annuity that is not part of an employer-sponsored retirement program was reported as gain on the sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains (Losses) From the Sale, Exchange or Disposition of Property for the old rules for annuities.

F. Charitable Gift Annuities

Income received from a charitable gift annuity contract for which the annuity was entered into or given for tax years beginning after Dec. 31, 2004 or from which the first payment from such contract to the taxpayer is received in a tax year beginning after Dec. 31, 2004, is calculated in the same manner as it is for federal income tax purposes and reported as interest income for Pennsylvania personal income tax purposes. Income received from charitable gift annuity contracts entered into prior to Jan. 1, 2005, is taxable in the same manner as gain on sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains (Losses) From the Sale, Exchange, or Disposition of Property.

IV. INTEREST GENERATED FROM RENTS, ROYALTIES, PATENTS AND COPYRIGHTS

A taxpayer classifies interest earned on the deposit of rents (i.e. tenant security deposits) as interest income unless the interest earned is used to operate or maintain the rental property. If the interest earned is actually used to operate or maintain the rental property, then such interest is classified as net income (loss) from rents, royalties, patents and copyrights. Refer to Pennsylvania Personal Income Tax Guide, Chapter 13, Net Income or Loss From Rents, Royalties, Copyrights and Patents.

V. INTEREST FROM INSTALLMENT SALE OF PROPERTY

A taxpayer classifies interest that he or she realizes from the sale of property on an installment basis as net gain (loss) on the sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains (Losses) From the Sale, Exchange or Disposition of Property.

VI. IMPUTED INTEREST AND ORIGINAL ISSUE DISCOUNT (OID)

Imputed interest is taxable under Pennsylvania personal income tax law. Imputed interest is the implied interest on an obligation where the instrument does not provide for interest or the interest rate is below the applicable federal rate (AFR). For example, on an original issue discount bond (OID), a stripped bond, or a certificate of deposit (CD) maturing in several years where interest is received at maturity, the imputed or accrued interest (discount on original issue discount bond) is reported each year for Pennsylvania personal income tax purposes.

Pennsylvania and federal rules for imputed and accrued interest are the same. Under Pennsylvania law (Act 68 of 1993) for tax years beginning on or after Jan. 1, 1993, original issue discount is calculated in the same manner as it is calculated for federal income tax purposes. For the purpose of determining taxable gain or income from the sale, exchange or disposition of original issue discount bonds, a holder's adjusted basis is increased by the amount of original issue discount bond accrued with respect to such bonds and is adjusted downward, but not below zero, by the amount of payments under the original issue discount bond, other than payments of stated interest.

The applicable Pennsylvania regulations require that unstated or imputed interest be calculated in the same manner as it is calculated for federal income tax purposes. The Pennsylvania Department of Revenue's policy is to look at federal rules regarding the transactions that result in or that are exempt from unstated or imputed interest, how unstated or imputed interest is to be calculated and when it is realized. Consequently, any amount of unstated or imputed interest that includable in gross income for federal income tax purposes is subject to Pennsylvania personal income tax as interest income.

VII. INTEREST FROM REFUNDS OF TAX OVERPAYMENTS

Interest paid to taxpayers on tax overpayments by the Pennsylvania Department of Revenue, the Internal Revenue Service or by local taxing authorities, is no different than any other taxable interest payments. Such interest is derived from "open accounts," not obligations that are statutorily free from state taxation. Therefore, interest paid to taxpayers on tax overpayments by the Internal Revenue Service, Pennsylvania Department of Revenue or any applicable state is taxable interest income in Pennsylvania.

VIII. TAX-EXEMPT INTEREST

Interest is not taxable income if received from direct obligations of the Commonwealth of Pennsylvania, its political subdivisions and authorities or the U.S. government and should not be reported on the *PA-40, Individual Income Tax* return. Likewise, interest from Series E, F, G, H, EE and HH bonds and federal treasury bills and notes are not taxable.

A. Obligations of Federal Agencies, Instrumentalities and Territories Exempt from Pennsylvania Personal Income Tax:

- Banks for Cooperatives, 12 USC §2134
- Federal District Banks for Cooperatives, 12 USC §2121
- Central Banks for Cooperatives, 12 USC §2121
- Commodity Credit Corporation, 15 USC §713a-5
- Farm Credit System Capital Corporation: Consolidated Obligations, 12 USC §2278a-11 (replaces 12 USC §2216k)
- Farm Credit System Joint Stock Banks, 12 USC §2023 (12 USC §931 replaced by 12 USC §2055, replaced by 12 USC §2023)
- Farm Credit System Land Banks and Land Bank Associations, 12 USC §2023
- Federal Crop Insurance Corporation, 7 USC §1511
- Federal Deposit Insurance Corporation, 12 USC §1825
- Federal Farm Credit Banks (merger of Federal District Intermediate Credit Banks and Federal Land Banks, 12 USC §2011), 12 USC §2023
- Federal Financing Bank, 12 USC §2290(b)
- Federal Home Loan Banks, 12 USC §1433
- Federal Land Bank Associations, 12 USC §2098
- Financing Corporation, 12 USC §1441(e)(8)
- General Insurance Fund, issued under Armed Services Mortgage Insurance, 12 USC §1748(b)(f) National Defense Housing Insurance, 12 USC §1750c(d) Rehabilitation and Neighborhood Conservation Housing Insurance, 12 USC §1715k(h)(7) Rental Housing Insurance Fund, 12 USC §1747 Rental Housing Insurance Fund Mortgage Insurance, 12 USC §1713(i) War Housing Insurance law, 12 USC

§§1739(d) and 1744(e) Insurance of Loans for Manufacture of Houses, 12 USC §1739 Mortgage Insurance Benefits, 12 USC §1750c
- Government of the Northern Mariana Islands, 48 USC §1801, and Covenant to Establish a Commonwealth of the Northern Mariana Islands in a Political Union with the U.S. States Article IV 607(a)
- Government of Puerto Rico, 48 USC §745
- Government of Virgin Islands, 48 USC §§1403, 1574(b)(iii)(A)
- Government of Guam, 48 U.S.C. §1423a
- Public Building Trust Participation Certificates, 31 USC §3124(e)
- Mutual Mortgage Insurance Fund, 12 USC §1710(d)
- National Credit Union Administration Central Liquidity Facility, 12 USC §1795k(b)
- Production Credit Associations, 12 USC §2077
- Public Housing Agencies, 42 USC §§1437i, 1437c(g)
- Resolution Funding Corporation (REFCORP), 12 USC §1441b(f)(7)
- Student Loan Marketing Association, 20 USC §1087-2(l)
- Tennessee Valley Authority, 16 USC §831n-4(d)
- U.S. Postal Service, 39 USC §2005(d)(4)
- U.S. Treasury Bonds, Notes, Bills, Certificates, and Savings Bonds, 31 USC §§3124, 3102-3106, 3109

B. Obligations of Federal Agencies, Instrumentalities and Territories <u>Not</u> Exempt from Pennsylvania Personal Income Tax

Unless they are issued to the Secretary of the Treasury and all purchases and sales by the Secretary of the Treasury of such obligations is treated as public debt transactions of the U.S., the following obligations of federal agencies, instrumentalities or territories are not exempt from taxation on interest or gain under the Pennsylvania Personal Income Tax Act:

- Agricultural Credit Insurance Fund (Agricultural Credit), 7 USC §1929(c)
- Pacific Northwest Transmission (Bonneville Power Administration), 16 USC §838k(c)
- Electric and Hybrid Vehicle Development Fund, 15 USC §2509(e)(3)(c)
- Export-Import Banks, 12 USC §635b
- Federal Financing Bank, 12 USC §2288
- Federal Home Loan Mortgage Corporation, 12 USC §1455(g)
- Federal National Mortgage Association, 12 USC §§1719(e), see 1723a(c) (Fannie Mae)
- Federal Ship Financing Fund (Merchant Marine Act), 46 USC §1275(d)
- Geothermal Resources Development Fund (Geothermal Research), 30 USC §1144
- Government National Mortgage Association, 12 USC §§1723(c); see 1723a(c) (Ginnie Mae)

- Merchant Marine Obligations (Maritime Administration), 46 USC §1271
- U.S. Housing Authority, Low-rent Housing, 42 USC §1437b
- Pension Benefit Guarantee Corporation, 29 USC §1305(c)
- Rural Development Insurance Fund, 7 USC §1929a(d)
- Rural Housing Insurance Fund, 42 USC §1487(h)
- Rural Telephone Bank, 7 USC §947(b)
- Securities Investor Protection Corporation (Securities Investor Production Fund), 15 USC §78ddd(h)
- Small Business Administration, 15 USC §633(c)(5)(A)
- Synthetic Fuels Corporation, 42 USC §8795(c)
- U.S. States Railway Association, 45 USC §720(e)

C. STRIPS, CATS, ETRS, LIONS, FICOS and Other Stripped-Exempt Bonds

The federal-taxable income or gain derived from exempt bonds that are issued with interest coupons where there is a separation in ownership between the bond and any coupon that has not yet become payable is taxable as follows:

1. The tax-exempt portion of the original issue discount with respect to the stripped coupon or stripped bond is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield on the maturity as of the purchase date (of the stripped coupon or stripped bond) equal to the lower of the coupon rate of the tax-exempt obligation from which the coupons were separated or the yield to maturity on the basis of the purchase price of the stripped coupon or stripped bond.

2, The remaining portion of the discount is treated as original issue discount with respect to an obligation that is not tax-exempt and as imputed interest.

D. Example

A tax-exempt obligation with a face amount of $100 due Jan. 1, 1990 and with a coupon rate of 10 percent compounded semi-annually is issued for $100 on Jan. 1, 1987 and is stripped on Jan. 1, 1989. The right to receive the principal amount is sold for $79.21, reflecting a yield to maturity at the time of the strip of 12 percent compounded semi-annually. The tax-exempt portion of discount on the stripped bond is limited to $17.73, the difference between the stated redemption price of $100 and the issue price that would produce a yield to maturity of 10 percent ($82.27). This portion of the discount on the stripped bond in excess of the tax-exempt portion is $3.06, equal to the excess of total discount ($20.79) over the tax-exempt portion. This portion of the discount is treated as original issue discount bond with respect to an obligation that is not tax-exempt.

E. Gain (Loss) from the Sale, Exchange or Disposition of Tax-Exempt Obligations

Gain (loss) on the sale, exchange or disposition of tax-exempt obligations issued by the Commonwealth, a public authority, commission, board or other agency created by the Commonwealth, a political subdivision or obligations exempt from state taxation under the laws of the U.S. only with respect to obligations issued on or after Feb. 1, 1994, is taxable in Pennsylvania.

The tax-exempt portion of the original issue discount bond with respect to a stripped coupon or stripped bond is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield to maturity as of the purchase date equal to the lower of (1) the coupon rate of the tax-exempt obligation from which the coupons were separated, or (2) the yield to maturity (on the basis of the purchase price) of the stripped coupon or stripped bond. The taxpayer can elect to use the original yield to maturity instead of the coupon rate for these purposes.

For Pennsylvania personal income tax purposes, a premium paid on a bond is deemed to be an investment in the bond to obtain the higher bond interest rate. Further, each interest payment on the bond is deemed to be a partial interest payment and a partial return of the bondholder’s investment.

Consequently, the basis of a bond (whether the bond interest is taxable or exempt from Pennsylvania personal income tax) includes any premium paid on the bond. For each interest payment, the owner of the bond must amortize the bond premium according to the accepted accounting principles and practices consistently used by the taxpayer (such as straight-line, effective interest rate method, constant yield method, etc.) Further, the taxpayer must allocate the amortized amount to each interest payment to reflect the return of bond premium. The taxable bond interest is the difference between the total interest payment and the allocated bond premium amount. Because the allocated bond premium amount is a return of the bond owner’s investment, the owner must also reduce his basis in the bond by the amount of the allocated bond premium. The owner must reduce his basis regardless of whether the reduction in the interest payment results in a reduction of tax (in the case of a taxable bond) or does not result in a reduction in tax (in the case of a tax-exempt bond).

F. Other States

Interest on obligations of other states, territories and their political subdivisions, and instrumentalities is taxable for Pennsylvania personal income tax purposes.

G. Repurchase Agreements

Interest earned from repurchase agreements (“REPOS”) is not tax-exempt interest income; and interest received on obligations, which are only guaranteed by the federal government, is subject to tax.

IX. DISTRIBUTIONS FROM MONEY MARKET FUNDS, MUTUAL FUNDS AND OTHER INVESTMENT COMPANIES

Taxable distributions from the earnings and profits of money market or mutual funds, investment trusts and investment companies must be reported as dividend income not interest income. This rule applies even if the company is a fixed portfolio investment trust, separate portfolio trust and other entity whose governing instrument prevents varying the portfolio investments except to:

1. Eliminate unsafe investments and investments not consistent with the preservation of the capital or the tax status of the investments of the fund;
2. Honor redemption orders, meet anticipated redemption requirements, and negate gains from discount purchases;
3. Maintain a constant net asset value per unit pursuant to, and in compliance with, an order or rule of the U.S. Securities and Exchange Commission;
4. Reinvest the earnings from securities in like securities, or;
5. Defray normal administrative expenses.

X. FORFEITED INTEREST PENALTY

Pennsylvania considers the premature redemption of a certificate of deposit or a time savings account to be a disposition of property. Any forfeited interest penalty incurred may be used to offset the interest accounts from only the certificate or account that was redeemed (that is, the forfeited interest penalty may not be offset against other interest income). If the penalty exceeds unpaid interest accrued from the certificate or deposit, the excess should be reported on *PA-40 Schedule D Sale, Exchange or Disposition of Property* as a loss from the disposition of property. This loss may be used to offset other gains, if any. If the interest paid exceeds the penalty, the excess is reportable as interest income.

XI. TRUST OTHER THAN A BUSINESS TRUST

For Pennsylvania personal income tax purposes, if a trust other than a business trust invests in U.S. government obligations, then all the income from such obligations will retain their exempt status when passed through to the owners of the trust.

XII. PA-40 SCHEDULE A – PENNSYLVANIA-TAXABLE INTEREST INCOME

A. Interest Reported on PA-40 Individual Income Tax Return

All interest income must be reported on the *PA-40 Individual Income Tax* return.

B. PA-40 Schedule A - Required if Interest Exceeds $2,500

If a taxpayer receives interest income of more than $2,500, a *PA-40 Schedule A, PA Taxable Interest Income* must be completed and filed.

C. Report All Interest Received

Taxpayers should include all interest income received during the taxable year from savings and loan associations, credit unions, bank deposits, bonds, certificates of deposit, interest-bearing checking accounts, tax refunds, mortgages or other obligations. Generally, federal Form 1099-INT, issued by financial institutions, will indicate the amount of interest received or credited from or by such institutions. Interest received on obligations, which are only guaranteed by the federal government, is subject to tax.

XIII. TABLE 1 INTEREST INCOME - RESIDENTS VS. NONRESIENTS

Interest Income: Residents vs. Nonresidents		
Type of Interest	**Pennsylvania Resident**	**Pennsylvania Nonresident**
Saving or other bank deposits	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Coupon bonds	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Open accounts	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Promissory notes	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Mortgages	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Corporate bonds	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Debentures	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Interest on legacies or life insurance proceeds	Taxable as interest income	Not reportable for Pennsylvania personal income tax

Table 1 (con'd)

Interest Income: Residents vs. Nonresidents		
Type of Interest	**Pennsylvania Resident**	**Pennsylvania Nonresident**
Interest on legacies or life insurance proceeds* Refer to Act 40–2005 changes discussed in Part III C. above.	Taxable if taxable for federal; however for Pennsylvania personal income tax, taxed as interest income	Not reportable for Pennsylvania personal income tax
Interest on tax refunds	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax
Interest on U.S. obligations – Direct ownership	Not taxable	Not reportable for Pennsylvania Personal Income Tax
Interest on other states' obligations or political subdivisions	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax
Unstated or imputed interest, including government obligations (original issue discount)	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax
GNMA	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax
FNMA	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax

pennsylvania
DEPARTMENT OF REVENUE

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 9: DIVIDENDS

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PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 9: DIVIDENDS

I. OVERVIEW

A. Gross Income Class

Dividend income is a gross taxable income class under Pennsylvania law. Consequently, Pennsylvania law does not permit the deduction of any expenses that a taxpayer incurs to realize dividend income. However, income that can reasonably be classified either as dividend income or as another taxable class of income is to be classified into that other class of income. For instance, dividends earned from the short-term investment of working capital funds would be classified as net income (loss) from the operation of a business, profession or farm. Refer to Pennsylvania Personal Income Tax Guide, Chapter 11, Net Income or Loss from the Operation of a Business, Profession, or Farm.

B. Dividends Defined

Dividends are defined under Pennsylvania personal income tax law as any distribution in cash or property made by a corporation, association, investment company, or business trust: (1) out of accumulated earnings and profits, or (2) out of earnings and profits of the year in which such dividend is paid. The term dividends specifically excludes stock dividends which are pro-rata distributions of additional shares issued to existing shareholders of a corporation on account of a shareholder's shares. The term also excludes certain constructive dividends.

C. Nonresidents

Nonresidents are not subject to Pennsylvania income tax on dividend income from investments from sources within Pennsylvania.

D. Dividend Income - Residents and Nonresidents – Table 9-1

Table 9-1

Dividend Income - Residents and Nonresidents		
Type of Dividend	**Pennsylvania Residents**	**Pennsylvania Nonresidents**
Distributions made by an investment company out of earnings and profits derived from nontaxable interest in Pennsylvania state and local government obligations	Not taxable	Not taxable
Distributions made by an investment company out of earnings and profits derived from nontaxable interest in U.S. government obligations	Not taxable	Not taxable

Table 9-1

Dividend Income - Resident and Nonresident		
Type of Dividend	**Pennsylvania Resident**	**Pennsylvania Nonresident**
Distributions by a public utility corporation that are treated as a return of capital	Not taxable[1]	Not taxable
Paid in property	Taxable at fair market value of property	Not reportable for Pennsylvania personal income tax
Stock dividends and stock rights	Not taxable	Not taxable
Distributions in lieu of money (TR Reg. §1.305-2)	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Disproportionate distribution (TR Reg. §1.305-3)	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Convertible preferred stock (TR Reg. §1.305-3)	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Distribution of common and preferred stock (TR Reg. §1.305-6)	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Capital gain distribution from regulated investment company	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Dividend income not reported as working capital in arriving at net profits for a business, profession, or farm	Taxable as a dividend	Not taxable as a dividend, however, taxable as net profits
Dividend income allocated to net profits from a business, profession or farm	Taxable as a dividend	Not reportable for Pennsylvania personal income tax

[1] Distributions after the basis in the stock has been reduced to zero are taxable on PA-40 Schedule D as net gain(loss) from the sale, exchange or disposition of property.

II. INDIVIDUALS

A. Dividend Income

An individual taxpayer classifies dividends earned from investments as dividend income.

B. Expenses Incurred to Generate Dividend Income

Pennsylvania law does not permit the deduction of any expenses that an individual taxpayer incurs to realize dividend income.

C. Uniform Gifts to Minors Act

Interest, dividends, or any other income earned by accounts set up under the Uniform Gifts to Minors Act must be reported on the tax return of the child.

III. CAPITAL GAIN DISTRIBUTIONS

Capital gain distributions received from mutual funds or other regulated investment companies are taxable as dividend income. Generally, capital gain distributions are listed on a federal Form 1099B which a taxpayer receives from his or her broker or mutual fund manager.

IV. RETURN OF CAPITAL DISTRIBUTIONS

A. Return of Capital Distribution – Resident

A return of capital distribution is any distribution that is not made or credited by a business corporation or association out of its earnings and profits. A resident shareholder must report as taxable gain for the tax year in which it was received or credited, the excess of the fair market value (FMV) of any return of capital distribution over the adjusted basis of the stock on the *PA-40 Schedule D,* Sale, Exchange or Disposition of Property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains or Losses From the Sale, Exchange or Disposition of Property.

B. Distributions Designated as Return of Capital by Utility Companies or Other Corporations

Distributions designated as return of capital by utility companies or other corporations serve to reduce the basis of stock in the utility company or other corporation. Once a taxpayer's basis is reduced to zero, any further distributions are taxed as net gain (loss) from the sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains or Losses From the Sale, Exchange or Disposition of Property.

C. Basis

The basis of stock shares held by a shareholder is not decreased by any distribution that is a dividend. The basis of stock shares held by a resident shareholder is decreased (but not below zero) by any distribution that is not a taxable dividend. Once the basis of the stock shares is reduced to zero, any further distributions are taxed as net gain (loss) from the sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains or Losses From the Sale, Exchange or Disposition of Property.

V. NONTAXABLE OR PARTIALLY TAXABLE DIVIDENDS

A. Exempt-Interest Dividend Funds

An exempt-interest dividend paid after Jan. 1, 1993 is not taxable under Pennsylvania personal income tax law. Taxpayers should exclude that portion of the total dividend designated as being from exempt Pennsylvania and federal obligations. Any amount designated as capital gain is fully taxable as dividend income for Pennsylvania purposes.

An ordinary dividend paid by a fund and designated as being an exempt-interest dividend for Pennsylvania purposes is not considered to be interest under Pennsylvania personal income tax law. Such income is dividend income but is not taxable. Taxpayers must determine what percentage of the dividends is from Pennsylvania-exempt obligations using the statements the fund provides.

If a fund invests 100 percent in Pennsylvania-exempt obligations, none of the exempt-interest dividend income is taxable for Pennsylvania purposes. However, the amount designated as capital gains is fully taxable as dividend income for Pennsylvania personal income tax purposes. Refer to Pennsylvania Personal Income Tax Guide, Chapter 8, Interest.

B. Stock Dividends

A stock dividend is not taxable for Pennsylvania personal income tax purposes. A stock dividend is a *pro rata* distribution by a corporation to its stockholders in the form of stock if the distribution is not treated as income for federal income tax purposes. If the stock distribution is not taxable, the tax basis of the old stock is adjusted to reflect the additional shares.

It should also be noted that any gain derived from the sale, exchange or disposition of the underlying shares in the fund or trust will be a taxable gain for Pennsylvania personal income tax purposes. Any loss incurred from the sale, exchange or disposition of the underlying shares is recognized but may only be offset against a shareholder's taxable gain for the taxable year.

Under a stock dividend reinvestment plan (DRIP), a shareholder elects to receive dividends in the form of stock, rather than cash or other property. A taxpayer must report the stock's fair market value as taxable dividend income as of the date paid. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains or Losses From the Sale, Exchange or Disposition of Property.

C. Money Market or Mutual Funds and Investment Trusts

Taxable distributions from the earnings and profits of money market or mutual funds and investment trusts and companies must be reported as dividend income, not interest income.

D. Mutual Insurance Companies

Dividends paid by mutual insurance companies are a return of premium only and cannot be reported as taxable. Dividends paid by other than mutual insurance companies are taxable dividends.

E. Savings and Loan Associations, Mutual Savings Banks, Cooperative Banks, and Credit Unions

Do not report as taxable any dividends paid by savings and loan associations, mutual savings banks, cooperative banks, and credit unions on deposits or withdrawals from accounts. They must be reported as interest income. Refer to Pennsylvania Personal Income Tax Guide, Chapter 8, Interest.

F. Regulated Investment Company

Do not report any dividends from undistributed capital gains made by a regulated investment company.

G. Insurance Companies

Interest income on dividends from insurance companies, whether disbursed or not, is taxable as interest income. Refer to Pennsylvania Personal Income Tax Guide, Chapter 8, Interest.

H. Constructive Dividends

Constructive dividends such as a corporate expenditure incurred for the personal benefit of the shareholder or the personal use of corporate property or corporation-provided services are excluded from tax. However, a corporate loan to a shareholder where there is no intent to create a bona fide creditor-debtor relationship, a sale of property by a corporation to its shareholders for less than fair market value, or excessive payments made by the corporation on purchasing or leasing a shareholder's property, are taxable as dividends, even if a distribution to shareholders has not been formally declared by the corporation.

I. Charitable Gift Annuity

Dividends distributed under a charitable gift annuity are not taxable. However, after a taxpayer recovers the amount donated, further distributions must be reported as taxable gains on *PA-40 Schedule D*, Sale, Exchange or Disposition of Property.

VI. TAXABLE DIVIDENDS

A. Distributions to Shareholders Out Of Earnings And Profits Made By Personal Holding Companies Or Subchapter S Corporations That Are Not PA S Corporations

These distributions are taxable as dividends. A Pennsylvania resident shareholder in another state's Subchapter S corporation that has elected not to be treated as a PA S corporation must include the cash or property actually received out of the corporation's earnings and profits. Distributions in excess of the corporation's earnings and profits are reported on *PA-40 Schedule D*, Sale, Exchange or Disposition of Property. Do not report the amount of distributable income, and do not submit the federal Schedule K-1.

A shareholder may not claim a credit for income tax paid to another state by an S corporation that elected not to be treated as a PA S corporation. If the entity does business entirely within another state, then the entity is also required to file a *PA-20S/PA-65,* PA S Corporation/Partnership Information Return as a result of having a Pennsylvania resident shareholder.

B. Excessive Salaries Paid To a Shareholder

Excessive salaries paid to a shareholder are taxable as dividends rather than compensation.

VII. PA-40 SCHEDULE B

A. Dividends Reported On PA-40 Individual Income Tax Return

All dividend income must be reported on the *PA-40, Individual Income Tax Return.* The substitution of a federal Schedule B for PA-40 Schedule B is not allowed.

B. PA-40 Schedule B Required If Dividend Income Exceeds $2,500

When dividend income exceeds $2,500, a *PA-40 Schedule B*, PA-Taxable Dividend and *Capital Gains Distributions Income* must be completed and filed.

C. Report All Dividends Received

All dividend income is reported on PA-40 Schedule B, Line 3. A resident shareholder must report as taxable dividend income for the taxable year in which it is received or credited, any distribution by a business corporation or business association out of its earnings and profits without regard to the manner in which the business derived the income. For Pennsylvania tax purposes, a business association is an unincorporated business enterprise that is organized in a manner similar to a business corporation. Business corporations or business associations include business trusts, agricultural cooperatives, electric cooperatives, federally-qualified real estate investment companies, mutual funds and other federally-regulated investment companies. A business entity is required to file a *PA-20S/PA-65,* PA S Corporation/Partnership Information Return as a result of having a Pennsylvania resident shareholder or engaging in business activity in Pennsylvania. The entity should provide PA Schedules RK-1 or NRK-1 to each resident or nonresident shareholder.

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X. SAMPLE FILLED IN FORMS.

A. Facts.

1. Employer - PMI. Pennsylvania Molding, Inc. ("PMI") is a Pennsylvania employer with operations in Philadelphia and Pittsburgh. For a comprehensive analysis of PMI's operations and Pennsylvania tax reporting see Chapter XVIII.

2. Individual Employees of PMI. PMI employs or employed Kevin, Tom, Mary and Debra. The specific circumstances of each of these employees are described below. In the next section, all of the Pennsylvania tax implications for each of these employees are described in detail.

a. Kevin – Example 1. [Issues: Receipt of Retirement Income (Lump Sum) if Retired AFTER Retirement Date – Form W-2 and PA Schedule UE.]

Kevin has worked for PMI since 1954. Kevin is 55, a Pennsylvania resident and retired during 2002. He had a balance in his 401(k) plan of $600,000 of which he previously contributed $225,000, PMI contributed $100,000 and interest was earned of $275,000. The 401(k) plan provides that participants may retire on or after they attain the age of 55 years old. Under PMI's retirement plan, Kevin has the option to receive a life annuity, however, Kevin instead elected to take a lump sum distribution.

After his retirement, Kevin decided to work on a part time basis at a local bookstore. Kevin received a 2002 Form W-2 from the local bookstore indicating Pennsylvania compensation received of $17,000 per year. He has the following expenses related to his bookstore employment:

- Steel tipped boots to protect from falling inventory - $55.00
- Travel to/from home/work - 780 total miles
- Travel to other bookstores as part of work – 250 total miles
- Lunches - $540.00

Kevin retained all of the applicable documentation to substantiate each of the above expenses and his employer did not reimburse him for any of the above expenses.

b. <u>Tom – Example 2</u>. [<u>Issues</u>: Receipt of Retirement Income (Annuity) if Retired BEFORE Retirement Date – Cost Recovery Method Explained - Same facts except receipt of lump sum before retirement date - No Netting Between Trade or Businesses of Spouses – Receipt of lump sum before if retired before retirement date.]

Tom turned 52 on January 1, 2000 and retired on that same date. Tom is also a Pennsylvania resident. The 401(k) plan provides that participants may retire on or after they attain the age of 55 years old. Accordingly, Tom retired before the date specified in the plan.

Tom elected to receive his 401(k) benefits in the form of a qualified joint and survivor annuity. Tom contributed $156,000 to the plan through payroll reductions, PMI contributed $64,000 and interest of $180,000 accrued on the invested balance. The balance in Tom's 401(k) plan upon retirement was $500,000.

In addition, Tom received a 2002 Form 1099 for $14,000 from consulting services provided to a local firm after he retired from PMI. Tom had no expenses associated with the consulting services with the exception of his time. Tom also received the proceeds of $5,150 from a certificate of deposit which he held in his name. The proceeds consisted of $5,000 return of original contribution and $150 of interest.

Tom's wife operates a trade or business of selling basket weaving products. She regularly sells to the general public and during 2002 had gross sales of $12,000, interest of $125 earned on her business checking account and expenses (including cost of goods sold of $10,000) of $14,000.

c. Same facts except receipt of lump sum distribution BEFORE retirement age

d. <u>Mary – Example 3</u>. [<u>Issues</u>: Nonresident Reciprocity - Nonresident – Not Taxed on Interest.]

Mary received a Form W-2 from PMI and is a NJ resident. Mary received a Form 1099-INT indicating interest income of $1,200 from a savings account in a bank located in Pennsylvania.

Mary also owns a small store which is located in a Pennsylvania . She had gross receipts of $22,000 and expenses of $18,500 (including cost of goods sold of $16,000).

e. Debra – Example 4. [Issues: Taxation of Disability - Pennsylvania Lottery vs. Other State Lottery - Estate Pass Through - Income in Respect of Decedent - Deferred Compensation Plan – May not be "Eligible Plan" for Pennsylvania.]

Debra, a Pennsylvania resident, was injured in the Pittsburgh plant on January 1, 2001, and is now receiving disability from a third party provider. Debra is no longer employed by PMI.

Debra has no other earned income however, she won $2,000 in the Pennsylvania lottery and $2,500 in the Maryland state lottery. Debra plays the lottery often and during 2002 spent $2,500 on Pennsylvania lottery tickets and $500 on Maryland lottery tickets. Additionally, Debra spent $100 on Powerball lottery tickets and won $5,000.

Debra's mother unfortunately passed away during 2002 and the estate was properly probated. Debra 's mother was entitled to receive proceeds from a deferred compensation account from her previous employer of $10,000 per year until 2005. The deferred compensation account plan document provided that the proceeds were payable in a ten equal payments beginning five years from the termination of employment regardless of age of the employee. The terms of the deferred compensation account are such that, upon his mother's death, Debra will receive the deferred compensation benefits in lieu of her mother.

Debra received a PA Schedule L indicating $1,000 of resident taxable income was earned by her mother's estate during 2002.

B. Analysis of PA Taxation of Specific Items.

1. Retirement Plan Income.

a. Receipt of Retirement Income (Lump Sum) if Retired AFTER Retirement Date – Kevin. Kevin has consulted his PMI 401(k) plan administrator and was informed that PMI's 401(k) plan is an eligible Pennsylvania retirement plan. Kevin retired from PMI in 2002 after attaining the age of 55. Since PMI's 401(k) plan is an eligible Pennsylvania retirement plan and Kevin retired on or after the date specified in the plan, all distributions from the plan are tax free to Kevin. Although Kevin has the option to take an annuity for life from his 401(k) plan, he has chosen to receive a lump sum comprised of the following:

Kevin's previously taxed contributions	$225,000
PMI matching contributions	100,000
Interest earned	275,000
Total	$600,000

Kevin will receive a Form 1099R indicating a distribution of $600,000 to Kevin.

Kevin's previous contributions of $225,000 were subtracted from his pay and listed on his pay stub as an employee contribution to his 401(k) plan. Those amounts were taxed by Pennsylvania upon contribution by Kevin to the plan. PMI's matching contribution is known as an employer's matching contribution.

In Kevin's case, PMI's matching contributions totaled $100,000. Finally, Kevin's 401(k) plan account earned interest of $275,000 on both his employer contributions and on PMI's employer matching contributions. No Pennsylvania Personal Income Tax has been paid on either the interest earned or the employee matching contributions. because the amounts were held in trust. Since Kevin retires after meeting the retirement age specified in the plan of 55 years old, the distribution of Kevin's contributions, the employee matching contribution, and the interest generated are tax free to Kevin for PA PIT purposes.

For more information see the following PA Guide Sections:

Section VII, I	PA Taxation of Employee Contribution and Elective Deferrals to PA Eligible Retirement Plans
Section VII, O	Retirement Income for PA PIT - Determination of Eligible Pennsylvania Retirement Plan
Section VII, R	Section 401(k) Plans
Section VII, O, 2, d	Requirement for annuity provision in plan

b. Receipt of Retirement Income (Annuity) if Retired BEFORE Retirement Date – Receipt of Lump Sum Before Retirement Date - Tom. Tom has consulted his PMI 401(k) plan administrator and was informed that the PMI 401(k) plan is an eligible Pennsylvania retirement plan. Tom retired on his birthday on January 1, 2000 at 52 (three years before the retirement date specified in the 401(k) plan). A taxpayer that withdraws from the retirement fund before meeting the requirements for retirement must report the withdrawal as taxable compensation to the extent the amount received exceeds his or her contributions to the retirement fund. Since Tom retired before the date specified in the plan, distributions to Tom are subject to tax under the "cost recovery method."

The "cost recovery method" permits tax free recovery of previously tax contributions to a retirement plan to be distributed before taxable distributions. "Previously taxed contributions" are comprised of the employee's contributions to a retirement plan. Under the cost recovery method, "taxable distributions" are comprised of the employer matching contribution and any accumulated earnings on all contributions; these distributions are taxable under the cost recovery method because the taxpayer has not paid any Pennsylvania personal income tax on either of (1) the employer matching contributions, or (2) on accumulated earnings on all contributions.

Under the cost recovery method, previously taxed contributions are distributed tax free to the taxpayer, and then taxable distributions are distributed to the taxpayer. The taxable distributions are only taxable to under the Pennsylvania Persona Income Tax statute if they are actually distributed before the taxpayer reaches the age specified for retirement under the eligible retirement plan.

As related to Tom's situation, this means that the first distributions from his 401(k) account, up to $156,000, are nontaxable. Distributions in excess of $156,000 (ie. Distributions of the employee matching contributions and interest earned) would be taxable for PA PIT purposes until Tom attained the age of 55. Distributions after Tom becomes 55 are tax free. Since Tom has chosen to receive an annuity for his estimated life expectancy, under the cost recovery method all distributions to Tom will be tax free up to $156,000. All distributions received by Tom after $156,000 has been received and before he attains the age of 55, will be taxable under PA PIT. All distributions received by Tom after he attains the age of 55 will be tax free.

For instance, lets assume Tom receives distributions of $3,000 per month from his 401(k) plan. If Tom retired and turned 52 on January 1, 2000, then during each year from 2000 through 2003, Tom would have received $36,000 for a total of $108,000 ($36,000 x 3) of distributions from his 401(k). Each year Tom would receive a Form 1099R indicating distributions of $36,000 from his retirement plan. A summary of Tom's 401(k) distributions for 2000 through 2002 are as follows:

	Tom's Distributions	
	PA Taxable	PA Nontaxable
2000 Distributions		$36,000
2001 Distributions		36,000
2002 Distributions	0	36,000
Total	$0	$108,000

Since Tom received $108,000 of distributions from his annuity prior to attaining the age of 55 (as required under the plan), these distributions would be taxable under the cost recovery method. However, since these distributions do not exceed Tom's previously taxed contributions of $156,000, the $108,000 of distributions is tax free to Tom. Please see Tom's filled in PA 40. If Tom received distributions in excess of $156,000 prior to turning 55, then such excess would be subject to PA PIT. All distributions that Tom receives <u>after</u> he turns 55 on January 1, 2003 are tax free under Pennsylvania Personal Income Tax policy.

c.

<u>Same facts except that retirement distribution received as a **lump sum BEFORE** participant reaches normal retirement age under the plan</u>:

If Tom had received a **lump sum distribution** of his $500,000 401(k) retirement benefit **when he retired at 52**, the lump sum would be **taxable** for PA PIT purposes, as follows:

Lump sum distribution received	$500,000
Tom's previously taxed contributions	<u>156,000</u>
Amount of **lump sum** subject to PA PIT	$<u>344,000</u>
PA PIT Tax	$<u>9,632</u>

The tax treatment of Tom's receipt, **BEFORE** he reaches 55, of a 401(k) **lump sum benefit** in c (employer contributions and earnings are taxable to Tom) should be contrasted with Kevin's receipt, **ON or AFTER** he reaches 55, of a 401(k) lump sum benefit (entirely nontaxable for PA PIT).

<u>For more information see the following PA Guide Sections</u>:

Section VII, I	PA Taxation of Employee Contribution and Elective Deferrals to PA Eligible Retirement Plans
Section VII, O	Retirement Income for PA PIT - Determination of Eligible Pennsylvania Retirement Plan
Section VII, R	Section 401(k) Plans
Section VII, O, 2, g	Premature distributions from eligible retirement plans

2. <u>Nonresident Reciprocity – Mary</u>. Mary is a New Jersey resident who works at PMI's Philadelphia, Pennsylvania plant.

Under Pennsylvania's reciprocity agreement with New Jersey, Pennsylvania will not tax a resident of New Jersey on compensation that is subject to employer withholding (i.e. W-2 withholding). The reciprocity agreement with New Jersey, as with all reciprocity agreements which Pennsylvania has signed, applies <u>only</u> to employee compensation (i.e. W-2 income only).

PMI should withhold only New Jersey taxes. If Mary's only income from Pennsylvania sources is her wages from PMI, she would be not be required to file a 2002 Form PA-40. However, if PMI mistakenly withheld Pennsylvania taxes on Mary's income, then Mary would be required to file a Pennsylvania Form PA-40 to request a refund of the Pennsylvania taxes withheld.

In fact, in addition to her W-2 income from PMI, Mary also has income from the PA Schedule C (small store) that she owns which sells goods in a Pennsylvania . The reciprocity agreement which Pennsylvania has executed with surrounding states, including New Jersey, applies only to W-2 earnings. Accordingly, since the reciprocity agreement between Pennsylvania and New Jersey does not apply to income from the operation of a business enterprise, Mary must file a Form PA-40 with an attached PA Schedule C which will include her earnings or loss from the small store. Mary should not include her W-2 income on the PA-40 that she files since it is nontaxable by Pennsylvania.

For more information see the following PA Guide Sections:
Section VII, B, 4 Reciprocity Agreements

3. Disability - Debra. Debra was injured at the Pittsburgh plant during 2001. She is no longer employed by PMI and is receiving monthly disability payments from a third party insurer which are equal to 100% of her previous salary at PMI.

A plan payment that is attributable to the plan participant's becoming sick or injured and is part of a series of substantially equal periodic payments made for the entire period of disability of the participant, or for the life of the participant, or the joint lives of such participant and his designated beneficiary, is not taxable.

Accordingly, even though the bimonthly payment to Debra equals 100% of her final salary with PMI, since such amount is being paid by a third party insurer, such amount is not taxable in Pennsylvania.

For more information see the following PA Guide Sections:
Section VII, C, 7 Sick Pay
Section VII, C, 8 Commercial Accident and Health Insurance and Self Insured Accident and Health Plan Coverage and Benefits
Section VII, C, 9 Disability

4. <u>Form W-2 and PA Schedule UE - Kevin</u>. Kevin received a 2002 Form W-2 from his part time job at a local bookstore indicating Pennsylvania compensation received of $17,000 per year. He has the following expenses related to his bookstore employment:

- Steel tipped boots to protect from falling inventory - $55.00
- Travel to/from home/work - 780 total miles
- Travel to other bookstores as part of work – 250 total miles
- Lunches - $540.00

Kevin has kept all of the applicable documentation to substantiate each of the above expenses and his employer did not reimburse him for any of the above expenses.

An allowable PA employee business expense must be:

a. Ordinary – customary and accepted in the industry or occupation in which you work; and
b. Actual – paid while performing the duties of your employment; and
c. Reasonable – in amount and not excessive; and
d. Necessary – to enable you to properly perform the duties of your employment; and
e. Directly related – to performing the duties of your occupation or employment.

Each of Kevin's expenses must be analyzed under the five criteria above:

- Steel tipped boots to protect from falling inventory - $55.00; an expense for protective clothing or shoes is an allowable employee business expense.
- Travel to/from home/work - 780 total miles; travel to or from home to work is a personal expense and is not deductible.
- Travel to other bookstores as part of work – 250 total miles; travel required by work is deductible at the same rate used for federal purposes.
- Lunches - $540.00; lunches, unless away from home overnight, are not an allowable employee business expense.

<u>For more information see the following PA Guide Sections</u>:
Section VII, G Employee expenses for PA

5. <u>No Netting Between Trade or Businesses of Spouses - Tom</u>. Tom received a Form 1099 for $14,000 from consulting services provided to a local firm. Tom had no expenses associated with his

consulting firm with the exception of his time. Tom also received the proceeds of $5,150 from a certificate of deposit which he held in his name. The proceeds consisted of $5,000 return of original contribution and $150 of interest.

Tom's spouse operates a trade or business of selling basket weaving products. She sells to the general public and during 2002 had gross sales of $12,000, interest of $125 earned on her business checking account and expenses (including cost of goods sold of $10,000) of $14,000.

Tom and his spouse must each file a separate PA Schedule C. Tom will file a PA Schedule C showing other income of $14,000 on line 4. Tom's spouse will file a separate PA Schedule C showing $12,000 of gross receipts on line 1, $10,000 of cost of goods sold on line 2, $150 interest income on line 4 and $4,000 of expenses under the proper categories under Part II; line 35 on Tom's spouse's PA Schedule C will show a total loss of ($1,850). The couple's Form PA-40 will show total income from the operation of a business, profession or farm of $14,000. Tom's spouse's loss may not be netted against Tom's business income. Additionally, the Form PA-40 will show $150 of interest income on PA Schedule B, since the interest earned by Tom's spouse's business account is considered working capital interest, and included with her PA Schedule C calculation.

<u>For more information see the following PA Guide Sections</u>:

Section XI, D, 5	Net Income from the Operation of a Business, Profession or Farm – married filing jointly

6. <u>Nonresident – Not Taxed on Interest – Mary</u>. Mary received a 2002 Form 1099-INT indicating interest income of $1,200 from a savings account in a bank that is located across the street from the PMI plant. Interest and dividends are not taxable to Pennsylvania nonresidents. Since Mary is not a resident of Pennsylvania, the interest she earns, regardless of the source of such interest, is not taxable by Pennsylvania.

   <u>For more information see the following PA Guide Sections</u>:

Section VII, B, 6	Nonresident Pennsylvania Compensation
Section VII, A, 2	Interest – Nonresidents
Section VIII, A, 2	Dividends - Nonresidents

7. <u>Lottery – Pennsylvania Lottery vs. Other State Lottery - Debra</u>. Debra won $2,000 in the Pennsylvania lottery and $2,500 in the

Maryland state lottery. Debra plays the lottery often and during 2002 spent $2,500 on Pennsylvania lottery tickets and $500 on Maryland lottery tickets. Additionally, Debra spent $100 on Powerball lottery tickets and won $5,000.

Gambling and lottery income is a gross income class in Pennsylvania, therefore deductions are not permitted in this gross income class. Additionally, Pennsylvania lottery winnings are not taxable. Powerball lottery is now considered a Pennsylvania lottery, therefore Powerball lottery winnings are not taxable.

Debra must report only the $2,500 she won from the Maryland lottery on her Form PA-40. She may not deduct the cost of the PA lottery and Powerball lottery tickets she purchased; however, she may deduct the $500 cost of tickets she purchased for the Maryland lottery from the Maryland lottery winnings.

<u>For more information see the following PA Guide Sections</u>:
Section XV Gambling and Lottery

8. <u>Estate Pass Through - Debra</u>. Debra's mother unfortunately passed away during 2002 and the estate was properly probated. Debra received a PA Schedule L indicating $1,000 of resident taxable income was earned by her mother's estate during 2002.

All income passes through to the beneficiaries of an estate or trust as "estate or trust income". Income passed through to a beneficiary of and estate or trust does not pass through in the same class as it was earned by the estate or trust.

Debra must report the $1,000 on her Form PA-40 as estate or trust income.

<u>For more information see the following PA Guide Sections</u>:
Section XIV Estates and Trusts

9. <u>Income in Respect of Decedent - Debra</u>. Debra's mother unfortunately passed away during 2002. Debra's mother was entitled to receive proceeds from a deferred compensation account from her previous employer of $10,000 per year until 2005. The terms of the deferred compensation account are such that, upon her mother's death, Debra, in lieu of her mother, would receive the deferred compensation benefits of $10,000 per year until 2005.

Pennsylvania has no "income in respect of a decedent" rule similar to that of the Federal income tax. Since Debra's mother used the cash basis of accounting before her death, her final return would include only income actually or constructively received through her date of death. Items of income that are not taxable to the decedent on the decedent's final Form PA-40 are not taxable.

Prior to her death, Debra's mother had not actually or constructively received the deferred compensation plan benefits for 2003, 2004 or 2005. The amounts to be received from the deferred compensation plan in 2003 through 2005 are not taxable to Debra's mother, nor will they be taxable to Debra when Debra receives them.

The fact that Pennsylvania does not have an income in respect of decedent rule should not be confused with the Pennsylvania inheritance tax. In the above example, Debra's mother would be required to report the present value of the entire deferred compensation plan on the inheritance tax return because Debra's mother had control of how the payments were made.

<u>For more information see the following PA Guide Sections</u>:

Section XIV, B, 2, a	Estates and Trusts – Federal Rules for Income in Respect of Decedent not Controlling

10. <u>Deferred Compensation Plan – May not be "Eligible Plan" for Pennsylvania - Debra</u>. Debra 's mother was entitled to receive proceeds from a deferred compensation account from her previous employer of $10,000 per year until 2005. The deferred compensation account plan document provided that the proceeds were payable in a ten equal payments beginning five years from the termination of employment regardless of age of the employee.

    For any plan to be an "eligible Pennsylvania retirement plan", the plan must meet all of the requirements listed in PA PIT Guide Section O.2. These requirements include: (1) the plan must make provisions for payments to be made at regularly recurring intervals after a participant's separation from service by retirement which continues at least until death, and (2) the plan must provide that the basis for retirement is old age, infirmity, long continued service, or a combination.

    Debra's mother's deferred compensation plan provided that the proceeds were payable in a ten equal payments beginning five years from the termination of employment regardless of age of the employee. Neither of the requirements in the previous paragraph have been met. The plan does not provide for regularly recurring intervals after a participant's separation from service by retirement which continue until death and the plan does not provide that the basis for retirement is old age, infirmity, long continued service, or a combination. Instead the plan provides for ten equal annual payments (i.e. an annuity for life is not provided) which begin upon termination of employment (i.e. basis for distribution is not retirement). The plan is a severance plan not a retirement plan.

For more information see the following PA Guide Sections:

Section VII, S	Nonqualified Deferred Compensation Plans – Generally Taxable as PA compensation

11. Schedule G. [Reserved]

C. Sample Filled-In Forms.

1. Kevin - Example Taxpayer 1. [Issues: Receipt of Retirement Income (Lump Sum) if Retired AFTER Retirement Date – Form W-2 and PA Schedule UE.]

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 11: NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM

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CHAPTER 11: NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM

I. DIFFERENCES BETWEEN PENNSYLVANIA PERSONAL INCOME TAX AND FEDERAL INCOME TAXATION

A. Commercial Enterprise Test

Under Pennsylvania personal income tax (PA PIT), taxpayers are permitted to deduct ordinary, necessary and reasonable expenses currently paid or incurred during the taxable year which are directly related to and necessary for the production and marketing of their products, goods and services in the marketplace. The requirement that goods or services must be offered to others in a marketplace is referred to as the "commercial enterprise test" under Pennsylvania personal income tax.

B. IRC Section 183 - Hobby Losses

The "hobby loss" rule of IRC section 183 limits the deductions of individuals and certain other taxpayers from activities that are not engaged in for profit. In effect, for federal purposes, a taxpayer may deduct expenses subject to IRC section 183 only to the extent the taxpayer has gross income from the activity during the taxable year.

Pennsylvania personal income tax applies the "commercial enterprise test" which shows whether a taxpayer markets goods or services to others in a marketplace. Although Pennsylvania personal income tax does not strictly follow IRC section 183, Pennsylvania personal income tax does recognize a presumption that if profits occur during at least two years of the last five years the activity will be presumed to be pursued ordinarily for profit.

C. Allocation of Noncommercial Interest, Noncommercial Dividends and Gain to Net Income (Loss) from the Operation of a Business, Profession or Farm

1. Working Capital

a. Overview

Interest earned on deposits, balances, or accounts receivable that are derived in the ordinary course of business or are derived through temporary investment of working capital funds are considered to be part of business income.

b. Definition of the Term "Working Capital"

Accounting Research Bulletin 43 (ARB 43) of the American Institute of Certified Public Accountants (AICPA) states: that "working capital" is "the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business."

The American Institute of Certified Public Accountants has defined the term "current assets" as cash and other assets or resources commonly identified as "those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." For convenience, the American Institute of Certified Public Accountants lumps together all assets that are expected to be used or reduced to cash within one year even though "there are several operating cycles occurring within a year."

The primary issue in accounting and reporting for debt and equity investments is the appropriate use of market value. Generally accepted accounting principles (GAAP) require that investments in equity securities that have readily determinable fair market values and all investments in debt securities be classified in three categories (held-to-maturity, trading securities, and available for sale) and be given specific accounting treatments.

See the following chart for examples of debt and equity securities.

Debt Securities	**Equity Securities**
U.S. treasury securities	Common stock
U.S. government agency securities	Preferred stock
Municipal securities	Warrants
Corporate bonds	Rights
Convertible debt	Call options
Commercial paper	Put options
Collateralized mortgage obligations	
Preferred stock that must be redeemed	
Real estate mortgage investment conduits	
Interest-only and principal-only strips	

Per the American Institute of Certified Public Accountants held-to-maturity securities should be classified as non-current assets until they are within one year of maturity; at that time, they should be classified as current. Trading securities should always be classified as current assets. Available-for-sale securities are classified as current or non-current, as appropriate.

The American Institute of Certified Public Accountants provides for the exclusion of the following from current assets:

- Cash and claims to cash, which are restricted as to withdrawal or use for other than current operations, are designated for the purchase or construction of non-current assets or are segregated for the liquidation of long-term debts;
- Investments in securities, marketable or not, or advances which have been made for the purposes of control, affiliation, or other continuing business advantage;
- Receivables arising from unusual transactions (such as the sale of capital assets or loans or advances to affiliates, officers, or employees) which are not deemed collectible within a year;
- Cash surrender value of life insurance policies;
- Land and other natural resources;
- Depreciable assets; and
- Long-term prepayments which can be charged fairly to several years' operations or deferred charges such as un-amortized debt discount and expense, bonus payments under a long-term lease, costs of rearrangement of factory layout or removal to a new location, and certain research and development costs.

The American Institute of Certified Public Accountants has defined the term "current liabilities" as follows:

The term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. As a balance sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services; and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities or long-term obligations, amounts required to be expended within one year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons.

2. Operating Cycle of a Business

The operating cycle of a business is described by the American Institute of Certified Public Accountants as follows:

The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, finished products, operating supplies, labor and other factory services and such expenditures are accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an operating cycle.

Because a firm must consider its current assets and particularly its monetary ones - cash, marketable securities, and account receivables - for debt-paying ability over the short-term, these relationships are among the most widely used measures of current financial liquidity. Low or declining current and quick ratios may indicate an insufficient margin of safety between the assets that presumably are or will be available to liquidate claims and the obligations to be paid. On the other hand, an extremely high ratio may indicate the presence of excessive or unproductive inventories and receivables.

The current and quick ratios measure the size of the short-term liquidity buffer. A satisfactory ratio means a low risk that the existing short-term creditors could not be paid even if current assets were to shrink in value. As static measures, both the current ratio and the quick ratio must be interpreted in relation to the character of the business and its industry. In industries or firms in which the flow of funds from operations is relatively stable, acceptable liquidity ratios will be lower than in situations characterized by greater uncertainty.

3. Long-Term Investments

Interest, dividends, rents and royalty income not derived in the ordinary course of business also are not reportable as net income (loss) from the operation of a business, profession or farm, and expenses that are attributable to such income are not deductible business expenses.

For Pennsylvania personal income tax purposes, generally accepted accounting principles and practices govern regarding allocation of working capital. See Section C for calculation of net income (loss) from operations.

D. Investment Activities

Section 301(c) of the Tax Reform Code of 1971 defines "business" as an enterprise, activity, profession, vocation, trade, joint venture, commerce, or any other undertaking of any nature when engaged in as commercial enterprise and conducted for profit or ordinarily conducted for profit, whether by an individual, partnership, association, or other unincorporated entity.

A "business, profession, or other activity" must be "engaged in as a commercial enterprise" in order for the income derived from it to be taxable as net profits. The term "commercial enterprise" means the rendering of goods or services to others in a market place.

If a Pennsylvania personal income tax taxpayer has gross taxable classes of income such as interest and dividends, the taxpayer cannot deduct expenses incurred for the production or collection of interest and dividends or for the management of stock and securities, unless the taxpayer employs the stock or securities in a commercial enterprise either as working capital or stock in trade, or the interest is derived from accounts or notes receivable from sales of products or services sold in the ordinary course of business operations. Only then would the interest and dividends be net taxable as net profits from the operation of a commercial enterprise.

Moreover, even with respect to the net taxable classes, not every cost or expense incurred by a Pennsylvania personal income tax taxpayer, other than taxes based on income, would be deductible in determining the taxpayer's personal income. For a cost or expense to be deductible, it must fall into one of the following categories:

1. Ordinary and necessary expense incurred in the conduct of a commercial enterprise;

2. Ordinary and necessary expense incurred in the production or collection of rents or royalties;

3. Ordinary and necessary expense incurred in order to dispose of property;

4. Ordinary and necessary expense incurred for the management, conservation, or maintenance of rents, royalties, patents, copyrights, or like property held for the production of personal net taxable income;

5. Allowances for exhaustion, wear, tear, and obsolescence of tangible property (net profits and rents and royalties); or

6. Amortizable costs (net profits and rents and royalties).

Investment interest expense may only be deducted if the Pennsylvania personal income tax taxpayer advertises and/or markets their investing services and uses this service to invest for the public as a business and not for themselves.

E. Trading In Securities

For Pennsylvania personal income tax purposes, investing, re-investing, or trading in securities does not cease to be an investment activity solely because of the volume, regularity, and continuity of transactions. A Pennsylvania personal income tax taxpayer's investing, re-investing, or trading in securities constitutes the operation of a business for Pennsylvania personal income tax purposes only if the taxpayer:

1. Maintains or provides a marketplace or facilities and charges a negotiated commission for executing transactions and does not take title to the particular positions he buys or sells;

2. Acts as his customers' agent and charges a negotiated commission for executing transactions and does not take title to the particular positions he buys or sells;

3. Devotes managerial attention to the financial investment products holdings of others or employs other persons to assist him in that management in the capacity of a licensed investment dealer; or

4. Is a qualifying licensed dealer or underwriter.

II. DEFINING NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM

A. What is a Business or Profession

1. Features of a Business or Profession

Not every income-producing activity constitutes a business or profession. A business or profession has certain features, as follows:

a. Commercial Enterprise

A business or profession requires the offering of goods or services to others in the marketplace. For example, income from personal investment activities is not considered business or professional income.

b. Regularity and Continuity

The taxpayer regularly and continuously must conduct his or her commercial activities.

c. **Sales are Not Limited or Restricted**
The taxpayer does not limit or restrict his or her commercial activities to certain related or unrelated customers.

2. **Example**
Charles invests in stock for his personal financial benefit. He does not offer his investment services to others for hire. He derives a substantial income from his investment activities in the form of gains from the sale of stock, dividends, or interest. Charles' income is not net profits from a business or profession. He must report his income as gain from the sale of property, dividend or interest income.

B. What is Not a Business or Profession

The following activities do not constitute the operation of a business, profession or farm and are, therefore, reportable in other classes of Pennsylvania income:

1. A sale, discontinuation, or abandonment of a business or segment thereof;

2. An isolated or nonrecurring transaction which is not a normal or routine business activity;

3. The ownership or disposition of assets which are held for long-term investment purposes;

4. Trading in or hedging securities for personal purposes; and

5. A non-operating interest in coal, oil, gas, or minerals in place unless they serve an operational function in the operation of the owner's business.

III. CALCULATION OF NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM

A. Income (Loss) from the Operation of a Business, Profession or Farm

1. **Overview**
Net income (loss) is computed solely from those items of revenue, cost, expense, or liability that the taxpayer receives from or incurs in:

a. The ordinary course and operation of the taxpayer’s business, profession, or farm activities; or

b. Securities employed as working capital in the ordinary operation of the taxpayer’s business, profession or farm; or

c. Accounts and notes receivable from the sales of products and/or services in the ordinary operation of the taxpayer's business, profession or farm; or

d. Assets that serve an operational function in the ordinary operation of the taxpayer's business, profession or farm.

2. Crop Damage Insurance/Drought Relief Grants

Drought relief grants from Pennsylvania and the federal government are part of gross income from operations of a business, profession or farm. The same applies to crop damage insurance as it replaces the gross receipts of the farmer.

3. Forgiveness of Indebtedness Income

Generally, business debt forgiven pursuant to an obligation to provide payment is taxable business income. Refer to Pennsylvania Personal Income Tax Guide, Chapter 24, Cancellation of Debt. Also, refer to Pennsylvania Personal Income Tax Bulletins 2005-02, 2009-03, 2009-04 and 2009-05 on the department's website.

B. Commercial Income Generated by Investment of Working Capital

Interest earned on deposits, balances, or accounts receivable that are derived in the ordinary course of business or are derived through temporary investment of working capital funds are considered to be part of business income. Generally interest and dividends associated with current assets are net profits from a business, profession or farm. If there are excess current assets, attach a computation of the operating cycle of the business showing the percentage allocation of interest and dividends to net profits from a business, profession or farm. Interest and dividends associated with investment in noncurrent assets are classified as respective amounts of interest and dividends and not as net profits from a business, profession or farm.

C. Commercial Income which is not Generated from the Operation of a Business, Profession or Farm

1. Income Generated by Long-Term Investments

Interest, dividends, rents, and royalty income not derived in the ordinary course of business also are not reportable as profits from a business, profession or farm, and expenses, which are attributable to such income, are not deductible business expenses.

2. Other

A taxpayer computes net income (loss) from the operation of a business, profession, or farm without reference to any items he or she derives or incurs in connection with or attributable to:

a. Rendering of services as an employee;

b. The ownership or disposition of assets that he or she holds for long-term investment purposes or which serve an investment function;

c. Trading in securities on an established security market for personal purposes and not for the accounts of customers;

d. A sale, discontinuation, or abandonment of a business or segment thereof;

e. A non-operating interest in coal, oil, gas, or minerals;

f. Any event or transaction of a type that would not reasonably be expected to recur in the foreseeable future, and which also possess a high degree of abnormality; or

g. Any tax imposed on, or measured by, gross or net earned or unearned income.

D. Allowable Expenses Attributable to the Operation of a Business, Profession or Farm

1. Ordinary, Necessary and Reasonable

Allowable expenses must be those ordinary, necessary, and reasonable expenses currently paid or incurred during the taxable year which are directly related to and necessary for the production and marketing of the taxpayer's products, goods, and services.

2. Personal Expenses

Only business expenses are allowable. Personal expenses are not deductible. If some of the expenses incurred in the taxpayer's business are part business and part personal, the taxpayer may deduct only the business portion. For example, if only half of a sole proprietor's car usage is for business, he can deduct only half of the car's operating cost.

3. Depreciation

a. MACRS

Deductions allowable under the Federal Modified Accelerated Cost-Recovery System (MACRS), including the IRC section 179 deduction, in effect on Jan. 1, 1986, additional first-year depreciation allowance for small businesses, are acceptable depreciation deductions for Pennsylvania purposes.

b. Thirty Percent or Fifty Percent Or Other Additional First-Year Depreciation is Not Allowed

For federal purposes, Congress enacted legislation during 2002, 2003, 2005 and later that contained provisions providing for additional first-year depreciation on purchases of certain tangible personal property, computer software, and certain leasehold improvements. Pennsylvania personal income tax does not follow these federal provisions. Accordingly, neither the 30 percent additional first-year depreciation deduction for 2002 nor the 50 percent additional first-year depreciation deduction for 2003 and 2005 and later are permitted against net income (loss) from the operation of a business, profession, or farm for Pennsylvania personal income tax purposes. If a taxpayer took the bonus depreciation allowable under federal law for any tax year, they must file an amended *PA-40 Individual Income Tax* return.

c. IRC Section 179

For Pennsylvania personal income tax purposes, IRC section 179 qualifying property is tangible property that is:

- Of a character subject to the allowance of depreciation under IRC section 167 or cost recovery deductions under IRC section 168;
- Either personal property or other property described in IRC section 1245(a)(3);
- Acquired by purchase for use in the active conduct of a trade or business.

The term does not include air conditioning or heating pumps or any other property described in IRC section 50(b).

A taxpayer may elect to treat the cost of any IRC section 179 property as a current expense rather than as an expense that is not chargeable to a capital account.

d. Limitations

- Dollar limitation
  The aggregate cost that may be taken into account for any taxable year shall not exceed the following applicable amount:

If the taxable year begins:	The applicable amount:
1983 through 1986	$ 5,000

1987 through 1992	$10,000
1993 through 1996	$17,500
1997	$18,000
1998	$18,500
1999	$19,000
2000	$20,000
2001	$24,000
2002 and thereafter	$25,000

- The limitation under (a) for any taxable year shall be reduced (but not below zero) by the amount by which the cost of IRC section 179 qualifying property placed into service during such taxable year exceeds $200,000.

- The amount allowed as a deduction for any taxable year (determined after the application of paragraphs a and b) shall not exceed the aggregate amount of federally taxable income (computed without regard to the deduction allowable for the cost of IRC section 179 qualifying property) of the taxpayer for such taxable year that is derived from the active conduct by the taxpayer of any trade or business during such taxable year.

- Carryover of disallowed deduction. The amount allowed under section III.D.(3)(b) above for any taxable year shall be increased for the aggregate amount allowable as a carryover of disallowed deductions for federal income tax purposes for such taxable year. A taxpayer may elect to treat the cost of any IRC section 179 qualifying property as a current expense rather than as an expense that is not chargeable to a capital account.

- (5) If the taxpayer elects to expense IRC section 179 qualifying property, the limitation of a total IRC section 179 deduction is $25,000 (or the applicable limit for the year the property was acquired) regardless of the number of the taxpayer’s business enterprises and income-producing properties. The IRC section 179 property costs may be deducted on the PA-40 Schedule C, Profit (Loss) from Business or Profession or PA-40 Schedule E, Rents and Royalty Income (Loss) but the total of all IRC section 179 expenses on all Pennsylvania schedules may not exceed $25,000 or the applicable limit.

- (6) Married taxpayers are limited to $25,000 (or the applicable limit) regardless of ownership interests. If married taxpayers are joint owners, they have a $25,000 deduction limitation. Pennsylvania personal income tax limitation is based on applicable federal rules.

- Estates or trusts may not elect to currently expense IRC section 179 property costs.

- Beneficiaries of estates or trusts may not elect to currently expense IRC section 179 property costs in respect of estates or trusts.

- Pass through entities. In the case of a partnership, limitations shall apply with respect to the partnership and with respect to each partner. The same rule shall apply in the case of a PA S corporation and each shareholder.

If a partnership elects to expense certain costs under these rules:

- The above limitations apply with respect to the partnership.

- A partner's adjusted basis in his partnership interest is reduced by the entire amount of his distributive share of the IRC section 179 expense, regardless of whether a portion of the partner's deduction is disallowed in the current year by the application of the above limitations.

  Refer to the Bureau of National Affairs No. 714, A-9.

e. American Jobs Creation Act of 2004

Many provisions of the federal American Jobs Creation Act of 2004 were not adopted for Pennsylvania personal income tax purposes. Specifically, Pennsylvania personal income tax law does not conform to the following federal provisions–

- **Title I, Section 102, Deductions Relating to Income Attributable to Domestic Production Activities, IRC Section 199**
  This is a new expense/deduction allowed on qualifying domestic production activities income for taxable years beginning in 2005. Pennsylvania personal income tax law has no such provision and this expense/deduction must be added back into income reported by any individual, partnership or PA S corporation. This amount may not be deducted in calculating Pennsylvania-taxable income by an individual, partnership or PA S corporation.

- **Title II, Subtitle A, Section 201, Two-Year Extension of Increased Expensing for Small Business, IRC Section 179**
  Certain provisions of IRC section 179 expensing were extended to 2008. Pennsylvania personal income tax law continues to allow a maximum of $25,000, as previously discussed.

- **Title VIII, Subtitle D, Section 902, Consistent Amortization of Periods for Intangibles**
  Allows for the immediate expensing of intangible costs for start-up expenses, organizational expenses and syndication fees of an amount up to $5,000, reduces the amount of $5,000 for amounts over $50,000, and establishes a 180 months period for amortizing amounts over $5,000. Pennsylvania personal income tax law has no such immediate expensing provisions. However, amortization is an allowable expense according to accepted accounting principles. Therefore, the Pennsylvania Department of Revenue has adopted a rule for administrative convenience. Intangible costs for start-up expenses, organizational expenses and syndication fees must be amortized ratably over a 180-month period.

4. Taxes

A taxpayer may deduct all state, local and federal taxes other than taxes based on income that can be deducted as expenses from gross income to arrive at the taxpayer's adjusted gross income for federal tax purposes. However, the taxpayer may not deduct the one-half of self-employment tax (which the IRS allows) for Pennsylvania purposes. The taxpayer also may deduct the amount of sales tax paid on acquired property, which for federal tax purposes must be treated as part of the cost of the acquired property for depreciation purposes.

5. Nondeductible Contributions to Retirement Plans by Partners and Other Self-Employed Individuals

Contributions made by a self-employed individual to his own pension plan such as an IRA or Keogh or welfare benefit program, are not deductible as a business expense in determining the self-employed individual's net income (loss) from the operation of a business or profession; nor are such contributions otherwise excludable from taxable income. Contributions made by a self-employed individual to his employees' retirement plans and welfare benefit programs are deductible as an ordinary, necessary business expense in determining the self-employed individual's net profits from operation of a business or profession. Contributions by partners or made on behalf of partners to their retirement plans are not deductible. Contributions by shareholders of PA S corporations or on behalf of such shareholders to their retirement plans are not deductible for Pennsylvania purposes unless the shareholder is an employee of the PA S corporation.

6. Federal Labor Hired Deduction or Federal Wage Deduction

For federal income tax purposes, a taxpayer's federal labor-hired deduction and federal wage deduction must be reduced by the amount of his or her federal jobs credit. That reduction is not applicable for Pennsylvania tax purposes. However, if you are involved in Pennsylvania's Employment Incentive Payment Program, wages for which an employment incentive payment (EIP) credit is claimed cannot be claimed as an expense.

7. Meals and Entertainment

The 50 percent federal limit on the deductibility of meals and entertainment expenses does not apply for Pennsylvania purposes. However, the taxpayer must be able to show that the expenses claimed are ordinary, actual, reasonable and necessary.

8. Donations to Charitable Organizations

Payments to charitable organizations made from business funds for business purposes are allowable expenses for Pennsylvania to the extent the payment is for an ordinary, necessary, and reasonable expense currently paid or incurred during the taxable year and to the extent the payment is directly related to and necessary for the production and marketing of the taxpayer's products, goods, and services.

For federal income tax purposes, if a taxpayer receives or expects to receive a financial or economic benefit as a result of making a contribution to a qualified organization, the taxpayer cannot deduct the part of the contribution that represents the value of the benefit received.

Therefore, to the extent taxpayer makes a donation to a qualified organization and claims any portion of the donation as a federal income tax charitable deduction, the taxpayer has taken the position for federal income tax purposes that taxpayer received no financial or economic benefit for the payment.

A taxpayer is required to maintain a consistent position for both federal income tax and Pennsylvania personal income tax purposes. If a taxpayer has taken the position for federal income tax purposes that the taxpayer received no financial or economic benefit for a payment to a qualified organization, then for Pennsylvania personal income tax purposes the payment is not an ordinary, necessary, and reasonable expense and the taxpayer may not claim an expense deduction against net profits for the payment.

Following are examples that illustrate application of this standard:

a. Taxpayer operates a restaurant. A local charity asks a taxpayer to purchase a block of advertising space in a flyer it intends to distribute at an upcoming charity function. The taxpayer purchases advertising space and the taxpayer's restaurant is featured in the flyer. The taxpayer does not take a charitable deduction for Federal income tax purposes for any of the amount paid to purchase advertising space. Taxpayer may deduct the payment to the charity against net profits for Pennsylvania personal income tax purposes to the extent the payment for the advertising space is reasonable in amount.

b. Taxpayer operates a transportation business and owns a fleet of small vans that he uses in the business. A local charity is in need of a small van for use in operation of the charity, and solicits donations from the public. The taxpayer donates one of the new vans used in the business to the local charity. In return, the local charity mentions the taxpayer's name and transportation business in an annual newsletter mailed to the public. The taxpayer deducts the entire amount of the donation as a charitable contribution on taxpayer's Federal income tax return, and does not report any portion of the donation as a contribution from which taxpayer's business benefited. Taxpayer may not deduct any portion of the donation of the van as a business expense for Pennsylvania personal income tax purposes.

E. Gain (Loss) on the Sale, Exchange or Disposition of Property Used in the Production of Net Income (Loss) from the Operation of a Business, Profession or Farm

Table 11

Sale of Property – Business, Profession or Farm

Basis – The basis of any property, real or personal, tangible or intangible, acquired on or after June 1, 1971, is determined on the date of acquisition. The basis of property, acquired before June 1, 1971, is adjusted to reflect its value as of that date. The basis as of June 1, 1971, for purposes of determining gain is the greater of (1) its cost or other basis, as adjusted, or (2) its fair market value on June 1, 1971. The basis as of June 1, 1971, for purposes of determining loss is its cost or other basis, as adjusted, without reference to its fair market value as of June 1, 1971.

Type of Gain	Allocation of Gain	
	Net Income (Loss) from a Business, Profession or Farm	PA-40 Schedule D
Proceeds from the sale of intangible personal property used in the trade or business, including goodwill contractually sold with a business and allocated by the parties as to value in the sales agreement. Refer to Personal Income Tax Bulletin 2005-02 Gain (Loss) Derived From the Disposition Of a Going Concern, and Classification between Net Profits and Schedule D Gains and Losses in PA PIT Guide Chapter 12.	If Proceeds from sale are reinvested in a similar business unit, then the gain is business income. Pennsylvania Resident – Taxable on all income of the business entity. See PA-40 Line 4. Nonresident – taxable based upon proportion to the average of the property, payroll, and sales percentages of the trade or business as determined under 61 PA Code § 109.5(c) for the 365-day period preceding the disposition.	If Proceeds from the sale of a business unit are not reinvested in a similar business unit, then the gain is reported as Taxable PA-40 Schedule D.

Table 11 (con'd)

Sale of Property – Business, Profession or Farm		
Basis – The basis of any property, real or personal, tangible or intangible, acquired on or after June 1, 1971, is determined on the date of acquisition. The basis of property, acquired before June 1, 1971, is adjusted to reflect its value as of that date. The basis as of June 1, 1971, for purposes of determining gain is the greater of (1) its cost or other basis, as adjusted, or (2) its fair market value on June 1, 1971. The basis as of June 1, 1971, for purposes of determining loss is its cost or other basis, as adjusted, without reference to its fair market value as of June 1, 1971.		
Type of Gain	**Allocation of Gain**	
	Net Income (Loss) from a Business, Profession or Farm	**PA-40 Schedule D**
Proceeds from the sale of intangible personal property not used in the business, including goodwill contractually sold with a business and not allocated by the parties as to value in the sales agreement. Refer to Personal Income Tax Bulletin 2005-02 Gain (Loss) Derived From the Disposition Of a Going Concern in PA PIT Guide Chapter 30.		Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable
Proceeds from the sale of tangible personal property used in the business, profession or farm and the proceeds reinvested and used to acquire like-kind property used in the same business, profession, or farm.	If used in determining the net income (loss) of the business, profession, or farm as part of working capital.	
Proceeds from the sale of tangible personal property used in the business, profession or farm and the proceeds not reinvested and used to acquire like-kind property used in the same business, profession or farm. (For property located in Pennsylvania.)		Pennsylvania Resident and Nonresident - Taxable PA-40 Schedule D
Proceeds from the sale of tangible personal property used in the business, profession or farm and the proceeds not reinvested and used to acquire like-kind property used in the same business, profession, or farm. (For property not located in Pennsylvania.)		Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable

Table 11 (con'd)

Sale of Property – Business, Profession or Farm

Basis – The basis of any property, real or personal, tangible or intangible, acquired on or after June 1, 1971, is determined on the date of acquisition. The basis of property, acquired before June 1, 1971, is adjusted to reflect its value as of that date. The basis as of June 1, 1971, for purposes of determining gain is the greater of (1) its cost or other basis, as adjusted, or (2) its fair market value on June 1, 1971. The basis as of June 1, 1971, for purposes of determining loss is its cost or other basis, as adjusted, without reference to its fair market value as of June 1, 1971.

Type of Gain	Allocation of Gain	
	Net Income (Loss) from a Business, Profession or Farm	**PA-40 Schedule D**
Proceeds from the sale of inventory	If used in determining the net income (loss) of the business, profession or farm.	
Proceeds from the sale of stock in trade	If used in determining the net income (loss) of the business, profession or farm.	
Proceeds from the sale of other current assets	Generally if used in determining the net income (loss) of the business, profession or farm.	
Proceeds from the sale of non-current assets		Pennsylvania Resident and Nonresident - Taxable PA-40 Schedule D
Proceeds from the sale of land and buildings constituting the abandonment of a business or business segment. For property located in Pennsylvania. (i.e., sale of a division or line of business where that division or business activity is not continued by the seller.)		Pennsylvania Resident and Nonresident - Taxable PA-40 Schedule D
Proceeds from the sale of land and buildings constituting the abandonment of business or business segment. For property not located in Pennsylvania. (i.e., sale of a division or line of business where that division or business activity is not continued by the seller.)		Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable

Table 11 (con'd)

Sale of Property – Business, Profession or Farm		
Basis – The basis of any property, real or personal, tangible or intangible, acquired on or after June 1, 1971, is determined on the date of acquisition. The basis of property, acquired before June 1, 1971, is adjusted to reflect its value as of that date. The basis as of June 1, 1971, for purposes of determining gain is the greater of (1) its cost or other basis, as adjusted, or (2) its fair market value on June 1, 1971. The basis as of June 1, 1971, for purposes of determining loss is its cost or other basis, as adjusted, without reference to its fair market value as of June 1, 1971.		
Type of Gain	**Allocation of Gain**	
	Net Income (Loss) from a Business, Profession or Farm	**PA-40 Schedule D**
Proceeds from the sale of land and building used as a facility in the operation of the business, profession, or farm for reinvestment in a like-kind facility used in the same business, profession or farm.	Used in determining the net income (loss) of the business, profession or farm.	
Proceeds from the sale of land and/or buildings held for investment regardless of reinvestment of proceeds. Property located in Pennsylvania.		Pennsylvania Resident and Nonresident - Taxable PA-40 Schedule D
Proceeds from the sale of land and/or buildings held for investment regardless of reinvestment of proceeds. Property not located in Pennsylvania.		Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable
Proceeds from the sale of stocks and bonds other than federal obligations or Pennsylvania obligations used in the operating cycle of the business activity (generally current assets).	Used in determining the net income (loss) of the business profession or taken as part of working capital.	
Sale of stocks and bonds other than federal obligations or Pennsylvania obligations not used in the operating cycle of the business activity (generally long-term assets).		Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable

Table 11 (con'd)

Sale of Property – Business, Profession or Farm		
Basis – The basis of any property, real or personal, tangible or intangible, acquired on or after June 1, 1971, is determined on the date of acquisition. The basis of property, acquired before June 1, 1971, is adjusted to reflect its value as of that date. The basis as of June 1, 1971, for purposes of determining gain is the greater of (1) its cost or other basis, as adjusted, or (2) its fair market value on June 1, 1971. The basis as of June 1, 1971, for purposes of determining loss is its cost or other basis, as adjusted, without reference to its fair market value as of June 1, 1971.		
Type of Gain	**Allocation of Gain**	
	Net Income (Loss) from a Business, Profession or Farm	**PA-40 Schedule D**
Sale of ownership interests in partnerships and business enterprises. Refer to Personal Income Tax Bulletin 2005-02 Gain (Loss) Derived From the Disposition Of a Going Concern in PA PIT Guide Chapter 30.		Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable

IV. REPORTING

A. PA-40 Schedule C - Profit (Loss) From Business or Profession

Sole proprietors having net income (loss) from the operation of a business or profession other than a farm must file *PA-40 Schedule C*. If a taxpayer had more than one business or if a taxpayer and spouse each had separate businesses, submit a separate PA-40 Schedule C for each business.

B. PA-40 Schedule F - Farm Income and Expenses

Sole proprietors having net income (loss) from a farm must file *PA-40 Schedule F*. If a taxpayer had more than one farm or if a taxpayer and *spouse each had separate farms, submit a separate PA-40 Schedule F for each farm.*

C. Federal Schedule C or Federal Schedule F

1. When Can Federal Schedules C or F be Used

Federal Schedules C or F may be used with the following exceptions:

- Taxpayer is a nonresident or part-year resident, or
- Taxpayer and spouse filed jointly for federal and separately for Pennsylvania.

2. Taxpayer Must Adjust Federal Schedules for Pennsylvania Personal Income Tax Rules

Taxpayer must adjust for the differences between the federal Schedules C or F and Pennsylvania personal income tax Schedules C or F for the following items:

a. Business Meals and Entertainment Expenses

Pennsylvania allows 100 percent of customary and reasonable amounts expensed on business meals and entertainment as opposed to the federal limit of 50 percent.

b. Sales Tax on Acquired Property

Sales tax on acquired property may be expensed currently rather than added to the basis of the property as required by the IRS. If sales tax is expensed, the basis of that property will differ from the federal basis. If sales tax is expensed for Pennsylvania purposes, depreciation must be adjusted accordingly. The taxpayer cannot expense sales tax and still take depreciation on the sales tax.

c. Charitable Contributions

Charitable contributions made from business funds for business purposes and publicly acknowledged by the charity are allowable expenses for Pennsylvania.

d. Amortization

Any generally acceptable amortization method may be used.

e. Depreciation

Any depreciation method may be used as long as it is generally accepted and consistently used. Taxpayer must use straight-line depreciation if the federal basis is different from Pennsylvania personal income tax basis.

f. IRC Section 179

Pennsylvania law allows IRC section 179 expenses, in effect on Jan. 1, 1986, up to a maximum of $25,000. The federal limitation does not apply for Pennsylvania personal income tax purposes. Taxpayer may use any acceptable method of depreciation if the federal basis and Pennsylvania personal income tax basis are the same.

See the instructions for Depreciation above.

g. Intangible Drilling Costs

Current expensing of intangible drilling costs associated with the creation of wells, as permitted in IRC section 59(e)(2), is not allowable or deductible. As long as the taxpayer or entity is engaged in the active conduct of a business and business activities have begun (beyond the exploration stage), and the drilling costs are reasonable in amount, the direct expenses may be amortized over the life of the wells.

h. Depletion

With the exception of start-up expenses, depletion is an allowable deduction against income.

Refer to Personal Income Tax Statement of Policy 2004-01 Depletion as published in Section 125 of Title 61 of the Pennsylvania Code.

Also refer to Pennsylvania Personal Income Tax Guide, Chapter 23, Natural Resource and Chapter 30, Pennsylvania Department of Revenue Personal Income Tax Policy Guidance.

i. Bonus Depreciation elections enacted by the U.S. Congress in 2002, 2003, 2005, and later

The federal elections for 30 percent and 50 percent bonus depreciation do not apply for Pennsylvania personal income tax purposes.

j. Federal Jobs Credits

Federal jobs credits should not be deducted from Pennsylvania wages.

k. Employment Incentive Payment/Jobs Creation Tax Credit

The total Pennsylvania wages must be reduced by the amount of employment incentive payment (EIP) and/or credit to the Jobs Creation Tax Credit that the taxpayer is entitled.

l. Pension and Profit-Sharing Plans

The taxpayer, if he or she is a sole proprietor or partner, cannot deduct his or her own contributions to such plans; only that portion contributed for the employees is deductible.

m. Taxes

A taxpayer may not deduct taxes based on net income. A taxpayer may not deduct taxes paid to other states or foreign countries based on income. A taxpayer may not deduct estate taxes and inheritance, legacy, succession and gift taxes. Assessments for betterment and improvements are not allowable.

The **Philadelphia Business Privilege Tax** includes two components:

- Gross receipts tax based on revenue; and
- Net income tax based on net income.

Pennsylvania personal income tax law does not allow deductions for taxes based on net income. Only the gross receipts portion of the Philadelphia Business Privilege tax is deductible for Pennsylvania personal income taxes. You may not take a deduction for the net income tax portion.

A single-member limited liability company (SMLLC) that files as a sole proprietor, a limited liability company that files as a partnership or PA S corporation may deduct the Pennsylvania capital stock/franchise tax paid. Other federal, state and local taxes are allowable deductions.

n. Contributions to Benefit Plans

Contributions to benefit plans established for sole proprietors and partners cannot be deducted.

o. Pennsylvania Research and Development Credit

Expenses for Pennsylvania research and development tax credit must be reduced by expenses incurred that qualify the claim for the credit.

p. Other Adjustments

Other adjustments for differences between Pennsylvania and federal expenses should be itemized and explained in detail on the *PA-40, Individual Income Tax* return.

See instructions for PA-40 Schedules C or F as to required increases in income to arrive at Pennsylvania personal income tax. Rental losses are disallowed. IRC section 1031 and 1033 exchanges are taxable for Pennsylvania personal income tax. Defined income for advance payments of goods and services are taxable. The entire IRC section 481(a) adjustment in the year of change is taxable.

The Pennsylvania Department of Revenue does not follow the federal tax benefit rule. For tax benefit rules, Pennsylvania law requires depreciation to be computed under the straight-line method even if the depreciation did not provide any tax benefit. If a taxpayer does not utilize the loss from the PA-40 Schedules C or F, then the assets of the business must be depreciated using straight-line depreciation. There are no carryovers of losses.

D. Married Filing Jointly

If the taxpayers are married and they elect to file a joint return, each spouse must separately determine his or her own net income (loss).

E. Nonresidents

Nonresidents reporting net income (loss) from the operation of a business, profession, or farm must allocate business activity.

1. **Allocation of Net Profits**

Nonresidents reporting net income (loss) from the operation of a business, profession, or farm must allocate business activity in accordance with the following rules:

a. **Operation Wholly Within Pennsylvania**

The operation of a business, profession or farm is wholly within Pennsylvania if during the entire taxable year the taxpayer or the taxpayer's representative:

- Maintained or operated a commercial establishment (office, shop, store, warehouse, farm, factory, agency, etc.) within Pennsylvania where the business was systematically and regularly conducted or managed; and

- Did not maintain and operate a commercial establishment outside Pennsylvania where the business was systematically and regularly conducted or managed.

  If the taxpayer's representative operated as an independent contractor, the business activity will not be taken into account.

b. **Operation Wholly Outside Pennsylvania**

The operation of a business, profession, or farm is wholly outside Pennsylvania if during the taxable year the taxpayer or the taxpayer's representative:

- In the ordinary course of business, did not transact any business in Pennsylvania or only transacted business in Pennsylvania on a sporadic or temporary basis; or

- In the ordinary course of business, the only business transacted with any permanency or continuity was either or both of the following:

  (1) Soliciting orders for, or sales of, property or services when such orders were sent outside Pennsylvania for approval or rejection and, if approved, are filled by shipment or delivery of goods or services from a point outside Pennsylvania; or

  (2) Soliciting orders in Pennsylvania in the name of, or for the benefit of, a prospective customer when the orders resulting from such solicitation enable your customer to fill orders of the type described in paragraph (1) above.

c. **Operation Partly Within Pennsylvania**

If a taxpayer's business, profession, or farm is not wholly within or outside Pennsylvania as described above, allocation shall be made by separate accounting if:

- The business, profession or farm operation within and outside Pennsylvania constitutes independent profit centers (*i.e.* there are no transfers of finished goods, raw materials, supplies, services or operational assets *inter se* and each is free to buy outside, and because of geographical location, neither is in competition with the other); and

- The taxpayer's books are kept so as to properly disclose the amounts of revenues, costs, expenses and liabilities attributable to Pennsylvania operations.

2. Three-Factor Allocation

If the taxpayer does not allocate as indicated in the previous section, then the taxpayer must allocate using a three-factor (property, sales and payroll) formula. Use *PA-40 Schedule NRH* for this purpose.

F. Records Maintained

All amounts reported on PA-40, Individual Income Tax returns and accompanying schedules are subject to verification and audit by the Pennsylvania Department of Revenue. Books and records must be maintained to verify all information reported. These records should be retained for at least four years after filing.

G. Reporting Investment Income

1. Income from the Operation of a Business, Profession or Farm

Interest earned on deposits, balances, or accounts receivable would be part of business income as well as gain (loss) on sale of business assets and trade-ins and would be reported on *PA-40 Schedule C*.

2. Income which is not Generated from Operation of a Business, Profession or Farm

Income such as earnings on investments held or other income (loss) not derived in the ordinary course of business must be recorded on the appropriate schedules, such as in the following examples:

Type of Income:	**Reported on:**
Gain (Loss) on Sale or Disposition of the Business or a Portion thereof	PA-40 Schedule D
Rent or Royalty Income (Loss)	PA-40 Schedule E
Interest/Dividends	PA-40 Schedules A/B

3. Pass Through from Partnerships and PA S Corporations

For further information about partnerships and PA S corporations, refer to Pennsylvania Personal Income Tax Guide, Chapter 16, Pass Through Entities.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 12: NET GAINS (LOSSES) FROM THE SALE, EXCHANGE OR DISPOSITION OF PROPERTY

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PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 12: NET GAINS OR LOSSES FROM THE SALE, EXCHANGE, OR DISPOSITION OF PROPERTY

I. OVERVIEW

A sale, exchange or disposition of property is:

a. The transfer of property for money;
b. The transfer of property for a promise to pay money;
c. The transfer of property for other property;
d. The charging off a worthless debt;
e. A distribution of money or property, other than a dividend to a shareholder with respect to the stock, or in a partial or complete liquidation of a corporation;
f. A redemption of stock;
g. A grant of an option to purchase property;
h. A lessee receiving amounts to cancel a lease;
i. A distributor of goods receiving amounts for cancellation of a distributor's agreement;
j. The retirement of a debt instrument;
k. Any transfer of property where another party assumes a liability of the transferor as part of the consideration;
l. The transfer of property for the satisfaction of a claim;
m. A transfer of a franchise, trademark, or trade name;
n. A surrender, cancellation, termination, rescission, release or other extinguishment of any right under a contract or lease;
o. The collection of a previously written off account receivable;
p. A partition of a single parcel of property between or among its owners;
q. The destruction of property in whole or in part by fire, flood or other casualty;
r. A theft or embezzlement;
s. The condemnation, confiscation or expropriation of property;
t. The foreclosure or other collections of claims;
u. A voluntary reconveyance of property to a purchase money mortgagee;
v. The abandonment of property including intangible drilling costs for dry-hole wells in oil and gas exploration;
w. The retirement of recovery property to personal use;
x. Other transactions or occurrences wherein or whereby the rights in, or relationship with, the property is converted into money or other property or terminates, is reduced or becomes worthless.

Gains from the sale, exchange or other disposition of any kind of property are taxable under the Pennsylvania personal income tax (PA PIT) law. This includes gain from the sale or disposition of real estate, tangible personal property, intangible personal property and investments, such as stock or other ownership interests in business enterprises, bonds, annuities, and contracts of insurance with refundable accumulated reserves payable upon lapse or surrender.

Pennsylvania makes no provision for capital gains. There are no provisions for long-term and short-term gains. A gain from the sale of property is either business income or gain on the sale, exchange or disposition of property.

Losses are recognized only in the year in which some identifiable event closes and completes the transaction and fixes the amount of loss so there is no possibility of any recovery. Losses are only recognized on transactions entered into for profit, such as investments, business property, and real estate. Losses are not recognized on the sale of property that was not acquired as an investment or for profit such as personal use property. Pennsylvania also has no provisions for the carryover of losses from one tax year to another year. Furthermore, Pennsylvania does not allow an offset of loss against gain from one class of income to another or between two taxpayers (i.e., spouses).

Generally, gain (loss) on sales or other dispositions of property is computed by subtracting the adjusted basis of a property from the value of cash and property realized on its sale or disposition. Special tax provisions, however, apply with respect to the calculation of gain on property acquired before June 1, 1971. Refer to Sale of Property Acquired Before June 1, 1971 in Section VI of this chapter for additional information.

Ordinarily, your adjusted basis for property for Pennsylvania income tax purposes is the same as your adjusted basis for federal income tax purposes. It is the original (unadjusted) cost for the property (plus allowable expenses of acquisition):

1. Adjusted upward by the cost of capital improvements to the property, contributions of capital, and gain incurred, made or recognized during your entire holding period; and

2. Adjusted downward by the annual deductions for depreciation, amortization, obsolescence or cost depletion (but not percentage depletion) allowed or allowable and recoveries of capital (such as property damage awards, casualty insurance proceeds, corporate "return of capital" distributions) received during your entire holding period, allowable losses during your entire holding period and other federal and state tax differences. Refer to Depreciation and Basis Adjustment in Section VIII of this chapter for additional information.

Adjusted basis for business property or the adjusted basis for investments in partnerships and S corporations are often different for federal and Pennsylvania personal income tax purposes as a result of items 1 and 2 as previously noted. It is recommended that separate Pennsylvania basis calculations be determined annually for these types of investments.

Resident taxpayers must report all gains and losses on the sale, exchange or disposition of property regardless of where the disposition occurred. Therefore, all transactions displaying net gains and losses are reported on PA Schedule D. If a taxpayer has a loss on personal use property or other property where a loss is not permitted, the transaction must still be reported. However, in such situations, the transaction will show the sales price and basis as the same amount for Pennsylvania personal income tax purposes.

Nonresident taxpayers are only taxed on their Pennsylvania-source income. Therefore, only transactions displaying net gains and losses on tangible property located within Pennsylvania are required to be reported on PA Schedule D. Any gain reported on a PA-20S/PA-65 Schedule NRK-1 should be and is presumed to be Pennsylvania-source income. Examples of dispositions of property required to be reported by a nonresident include, but are not limited to: sales of rental property located in Pennsylvania; sales of business or rental tangible personal property located in Pennsylvania; and sales of land and/or buildings located in Pennsylvania held as investment property. Refer to Personal Income Tax Bulletin 2005-02, Gain or Loss Derived from the Disposition of a Going Concern, for additional information regarding the taxability of goodwill for nonresidents.

II. DIFFERENCES BETWEEN FEDERAL AND PENNSYLVANIA PERSONAL INCOME TAX

There are many differences between the federal tax law treatment and Pennsylvania's treatment of the gain or loss on the sale, exchange or disposition of property. Many of those differences are discussed in this chapter. Some of the differences include, but are not limited to: sales of business assets; IRC Section 338(h)(10) transactions; like-kind exchanges; wash sales; capital gains distributions; bona fide sales to related parties; tax benefit rules; and transactions related to fraudulent investment schemes. The following pages discuss Pennsylvania's treatment of these transactions as well as many others.

III. PENNSYLVANIA TAXATION OF SPECIFIC TRANSACTIONS

A. Annuities

For taxable years beginning after Dec. 31, 2004, Act 40 of July 7, 2005 provides that income from a life insurance or endowment contract or annuities such as a charitable gift annuity or an annuity contract purchased as retirement annuity that is not from an employer sponsored retirement annuity, or are not part of an employer sponsored program, are interest income. Any income from these types of investments that is taxable for federal income tax purposes is taxable for Pennsylvania personal income tax purposes as interest income. If a court awards damages in the form of an annuity, the annuity payments are taxable to the beneficiary as interest income as stated above. Refer to the PA Personal Income Tax Guide, Chapter 8, Interest, for additional information.

The sale of an annuity contract is taxable as a disposition of property (Schedule D). The assignment of annuity payments is also taxable as a disposition of property if the taxpayer gives up his or her rights to the payments. The mere assignment of annuity payments to another payee is not taxable as Schedule D gain. Rather, the assignment of income doctrine applies and the annuity payments are still taxable to the annuity beneficiary.

The assignment of a PA Lottery prize (including assignments under 72 P.S. § 3761-306) is taxable as Schedule D gain. The basis in the prize is the amount the taxpayer paid for the winning ticket/chance in the PA Lottery game that awarded the prize.

For Pennsylvania personal income tax purposes prior to Jan. 1, 2005, the entire cash surrender value of an insurance policy or annuity less premiums paid (other than the premiums on the coverage on the person's life under the insurance contract) was taxed in the income class "net gains or income from disposition of property", rather than as interest.

B. Exchange of Insurance Contracts Under IRC Section 1035

For taxable years beginning after Dec. 31, 2004, Act 40 of July 7, 2005 provides that exchanges of insurance contracts under IRC Section 1035 that are tax exempt for federal income tax purposes are also tax exempt for Pennsylvania personal income tax purposes. Therefore, do not report the gain (loss) on the sale, exchange or disposition of any insurance contracts that include:

1. An exchange of a life insurance contract for another life insurance contract, an endowment contract, or an annuity contract;
2. An exchange of an annuity contract for another annuity contract;
3. An exchange of an endowment contract for an annuity contract;
4. An exchange of one endowment contract for another endowment contract if the dates for payments begin on or before the original contract's payment dates.

If the exchange of contracts has the effect of transferring property to a non-US person, the gain or loss is not tax exempt. If cash or other boot is involved with the exchange of the contracts, the gain or loss is also not tax exempt. The amount of cash or other boot received will be taxable as interest income. Refer to PA Personal Income Tax Guide, Chapter 8, Interest, for additional information.

C. Gain on Distributions of Long-Term Care Policies

If the long-term care (LTC) insurance contract has a cash surrender value and there is an exchange of one LTC insurance contract for another, any gain on exchange of the contracts must be reported on PA Schedule D.

D. Withdrawals from Tuition Account Plans (TAP)

For taxable years beginning after Dec. 31, 2005, contributions to any qualified tuition program, including those offered by other states, will be deductible from taxable income. The amount deducted for each designated beneficiary cannot exceed the annual limitation on gifts permitted by the IRC for purposes of federal estate and gift tax. The deduction cannot result in taxable income being less than zero.

Withdrawals or distributions for taxable years beginning after Dec. 31, 2005 used for qualified higher education expenses, as well as undistributed earnings in the accounts, will not be taxable. Federally qualified rollovers between accounts and beneficiary changes will also not be taxable events for Pennsylvania personal income tax purposes. Distributions of contributions made after Dec. 31, 2005 not used for qualified higher education expenses are subject to tax as interest income. Distributions of contributions made prior to Jan. 1 2006 not used for qualified education purposes are subject to tax to the extent the distributions exceed contributions using the cost-recovery method on a first-in-first-out basis of contributions distribution. Refer to Personal Income Tax Bulletin 2006-04, Qualified Tuition Programs, for additional information.

For tax years beginning prior to Jan. 1, 2006, withdrawals from a Pennsylvania TAP account established under Section 529 of the Internal Revenue Code (IRC) used for tuition are not reportable as income under Pennsylvania personal income tax law. Withdrawals from a Pennsylvania TAP account used for other than tuition purposes, however, are taxable to the extent the withdrawals exceed contributions. These taxable withdrawals are reported as interest income. A distribution from an education savings program in another state, whether used for education or not, is taxable as gain on sale of property to the extent the withdrawals exceed contributions. Pennsylvania law only provided exclusion for Pennsylvania TAP withdrawals used for education.

E. Medical Savings Account /Archer (MSA) Distributions

Refer to PA Personal Income Tax Guide Chapter 8, Interest, and refer to Personal Income Tax Bulletin 2006-05, Archer Medical Savings Accounts, for additional information.

F. Health Savings Account/HSA Distributions

Refer to PA Personal Income Tax Guide Chapter 8, Interest, and refer to Personal Income Tax Bulletin 2006-06, Health Savings Accounts, for additional information.

G. Condemnations

Gain from a condemnation of property is a taxable disposition of property for Pennsylvania purposes. The disposition occurs when the condemnation is filed with the prothonotary's office. Only the actual compensation for the value of the property itself is taxable for Pennsylvania purposes. The compensation would be the gross sales price and the cost would be the adjusted basis of the property. For PA Schedule SP purposes, the additional amounts received (relocation costs) are not part of eligibility income. However, if the property is income producing, all monies received are included in the gross sales price on the sale of property.

H. Federal Emergency Management Agency (FEMA)

Generally, FEMA money is not taxable. However, if the monies were not fully reinvested into the damaged property, the excess would be taxable on PA-40 Schedule D. To the extent FEMA money was not used to restore the property, it would be offset by a basis reduction.

I. Class-Action Life Insurance

Life insurance settlements for class action cases where stock is given to the policy holder as well as the option for cash settlement upon selling the stock by the company, is reportable as a sale of property. The sale of the policy (if canceled) uses the cost-recovery method to determine the gain/loss. If the policy is not sold or canceled, the payments received would adjust the basis of the policy. The stock received would have a basis of zero so that when it is sold, the net sales price is the reportable gain.

J. Conversion of Mutual Insurance

Demutualization is the conversion of a mutual insurance company to a stock insurance company. By virtue of owning a policy from a mutual insurance company, the policyholder is a part owner of that entity. The policyholder is entitled to receive consideration for giving up membership interests under their policy with the mutual insurance company. Upon conversion to a stock insurance company, the policyholder exchanged his or her ownership in the mutual insurance company for stock or the cash equivalent. The policy itself is not changed by the demutualization.

Where the cash equivalent is received, the policyholder has a disposition of intangible personal property reportable on a PA-40 Schedule D. The gross amount received is the sales price and the cost basis is zero.

For tax years beginning after Dec. 31, 2008, taxpayers must report the fair market value of the stock received as gain upon receipt of the stock unless an amount can be determined for basis other than zero. Refer to Personal Income Tax Bulletin 2009-01, Treatment of Demutualization for Pennsylvania Personal Income Tax (PA PIT) Purposes for additional information regarding the reporting of the transaction and basis determination at time of receipt of the stock. When the sale of stock occurs, the basis is the fair market value of the stock reported as gain in the year of receipt. Gain or loss on any subsequent sale of the stock is computed on the difference between the sales price and the basis. If stock in a demutualization was received in a tax year beginning prior to Jan. 1, 2009, no gain was required to be included when the stock was received. However, when a subsequent sale of the stock received in the demutualization occurred, the taxpayer's basis of such stock would be zero. The sales price less any commissions paid for selling the stock would result in only a gain being reported for such transactions.

K. Gain from Easements and Right-of-Ways

Easements and right-of-ways represent a transfer of property and, therefore, are reportable on PA-40 Schedule D. The seller must establish the original value of the ceded property in determining the basis. In such cases, the square footage of the easement and the total square footage of the property are used to allocate the cost or adjusted basis. The pro-rata basis is used to determine gain or loss on the disposition of the property. The square footage method for allocating the cost or adjusted basis may only be used if the property is all of a like kind or of equal value.

In the case of a negative easement, where property is transferred but the use of such property is restricted (such as an agreement not to develop said property but maintain it for agricultural purposes), the monies received represent an adjustment to the basis and are taxable as gains to the extent they exceed the basis of the property.

L. Holocaust Settlements

Awards or settlements received in reparation for the seizure, theft, requisition, or involuntary conversion of the income of victims of Nazi persecution constitute proceeds from the disposition of property and are taxable as gains to the extent they exceed the basis of the property. Refer to 61 Pa. Code § 125.41-125.43 for further information.

M. Farmland Preservation

Income received from placement of farmland into the Farmland Preservation Program, as established by Act 146 of 1988, should be used as an adjustment to the basis of the property. In the event remuneration exceeds the basis, the excess proceeds are reported as a gain on the sale, exchange or disposition of property.

N. Timber Sales

For a discussion concerning the proper reporting of gain or loss on timber sales, reference should be made to Private Letter Ruling PIT-08-003 (a copy of which is available on the Department's website).

O. Repossession of Property

A repossession of property occurs when there is a transfer of property under a deferred payment contract and there is a default under the contract. Many times, the deferred payment contract may span more than one tax year. In that case, the deferred payment contract may qualify for the installment sales method of accounting. In the case of intangible property, the sale will not qualify for the installment sale method of accounting but may qualify for the cost recovery method of reporting the gain on the sale.

1. Tax Treatment of Repossession for Buyer/Debtor

When property is sold under a deferred payment contract and the seller/creditor repossesses the property upon default of the buyer/debtor, the buyer/debtor experiences a disposition of the property for Pennsylvania Personal Income Tax purposes. The gain or loss to the buyer/debtor is measured by the difference between the amount of indebtedness discharged by the transfer of the repossessed property, and the basis of the transferred property.

For example, a buyer purchases a widget from seller for $12,000.00, and the buyer agrees to pay the seller $500.00 per month until the purchase price is paid (i.e., $500/month for two years). The buyer has a cost basis in the widget of $12,000.00 because of his obligation to pay the seller. Six months after the sale, the buyer has made 6 payments totaling $3,000.00. The buyer's remaining debt to the seller is $9,000.00. At that point, the buyer can no longer afford to repay the seller and the seller repossesses the widget in exchange for a discharge of the remaining debt. In this case, the buyer has a disposition of the widget and experiences a loss of $3,000.00 ($9,000.00 discharge of debt - $12,000.00 basis).

Assume the same facts as above except that deferred payment contract calls for interest to accrue on the principal balance. At the time of the repossession $4,000 of interest has accrued. The seller takes the widget and discharges the buyer from the principal balance of $9,000.00 and the accrued interest balance of $4,000.00. As a result, the buyer experiences a $1,000.00 gain from the repossession ($13,000.00 discharge of debt - $12,000.00 basis.)

Refer to PA Personal Income Tax Guide, Chapter 24, Cancellation of Debt, for additional information.

2. Tax Treatment of Repossession for Seller/Creditor

When property is sold under a deferred payment contract, the seller may incur a bad debt if the buyer/debtor fails to make payments under the contract. Bad debts are recognized when the account becomes uncollectible. The seller/creditor uses either the "direct write-off method" or "allowance method" to account for bad debts.

If the seller/creditor repossesses the property upon default of the buyer/debtor, the seller/creditor will report gain or loss for Pennsylvania Personal Income Tax purposes. In effect, the seller/creditor is exchanging the rights to receive payments from buyer/debtor under the deferred payment contract in exchange for the property. The calculation of the gain or loss depends upon whether the seller/creditor reported the sale on the accrual method of accounting or on the cash basis or installment sales method of accounting.

a. Accrual Method

If the accrual method was used then the seller/creditor reported the entire gain/loss from the sale in the year of the sale. Consequently, the gain or loss on the repossession is calculated as follows:

Gain/Loss = the FMV of repossessed property less the seller/creditor's basis in the contract (basis=the contract's full face value less all payments of principal received under the contract. If only part of the payment obligation under the contract is discharged by the repossession, figure the basis using only that amount instead of the full face value of the contract.). If the seller/creditor experiences a gain to the extent that the FMV is greater than the basis or a loss to the extent the FMV is less than the basis.

b. Cash Basis or Installment Sales Method

If the cash basis or installment sales method was used, then the seller/creditor has reported only a portion of the gain or loss at the time of the repossession. Consequently, the gain or loss on the repossession is calculated as follows:

Gain/Loss = the FMV of repossessed property less the seller/creditor's remaining basis in the contract (basis=accounts receivable balance less unrealized gross profit. If only part of the payment obligation under the contract is discharged by the repossession, figure the basis using only that amount instead of the full face value of the contract.). The seller/creditor experiences a gain to the extent that the FMV is greater than the basis or a loss to the extent the FMV is less than the basis.

P. Capital Gain Distributions from Mutual Funds or Regulated Investment Companies

Capital gain distributions received from mutual funds or other regulated investment companies are taxable as dividends. Refer to PA Personal Income Tax Guide Chapter 9, Dividends, for additional information.

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Q. Tax-Exempt Obligations

Net gains from the sale or disposition (not redemption) of the following obligations are taxable to the extent these obligations include:

1. Direct obligations of the U.S. government such as federal treasury bills and treasury notes originally issued on or after Feb. 1, 1994;

2. Direct obligations of certain agencies, instrumentalities, or territories of the federal government originally issued on or after Feb. 1, 1994; and

3. Direct obligations of the Commonwealth of Pennsylvania and its political subdivisions or authorities originally issued on or after Feb. 1, 1994.

Losses incurred from the disposition of the above obligations may be used to reduce other gains.

Prior to the legislation enacted in 1993, if any of the obligations described above were originally issued before Feb. 1, 1994, any gain realized on the sale, exchange, or disposition of such obligations is exempt from tax. Losses incurred from the disposition of obligations issued before Feb. 1, 1994 may not be used to reduce other gains.

Net gain or income from the sale of obligations of other states or foreign countries is subject to tax regardless of the issue date of such obligations.

R. Like-Kind Exchanges

A like-kind exchange refers to property that has been exchanged for similar property. For example: a taxpayer exchanged land in Pennsylvania for land in Florida. Under the Internal Revenue Code (IRC) a gain (loss) is not recognized and is deferred until the like-kind property is sold. Pennsylvania tax law contains no such provision, the difference between the basis of the old property and the current market value of the property received in exchange is the taxable gain and must be reported. Definitions of like-kind properties can be found in IRC Section 1031.

S. Involuntary Conversions

Pennsylvania PIT law follows the provisions of IRC Section 1033 for property subject to involuntary conversion (destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) after September 11, 2016.

Pennsylvania personal income tax includes a taxable gain from an involuntary conversion of property that occurs prior to September 12, 2016. A loss can occur for property obtained and held for gain, profit or income but is unallowable for personal use property (tangible or intangible).

The basis of property acquired/purchased to replace involuntarily converted property is its cost.

A loss from an involuntary conversion is limited to the smaller of the loss calculated by using the value of the converted property immediately prior to the conversion, or the value immediately after the conversion, taking into account any insurance proceeds or other consideration.

T. Wash Sales

The federal wash sale provisions do not apply for Pennsylvania personal income tax purposes. For Pennsylvania purposes, every transaction is considered separate and independent of any subsequent transaction.

U. Bona Fide Sales to Related Parties

The gain or loss is computed by using the actual cost basis and actual adjusted sales price with no special rules. Pennsylvania personal income tax does not have a provision for related party transactions. Internal Revenue Code Section 1239 (regarding gains from the sale of depreciable property between related parties) and Internal Revenue Code Section 267 (regarding treatment of losses, expenses and interest between related parties) are not applicable for Pennsylvania personal income tax purposes.

V. Bartering

Bartering is a type of sale involving the exchange of property. Gain from bartering is taxable for Pennsylvania personal income tax purposes. Gain from bartering is the difference between the adjusted basis of the relinquished property and the fair market value of the property received. The cost basis in the property received is the fair market value.

W. Fraudulent Investment Schemes

Investors in fraudulent investment schemes, commonly known as "Ponzi schemes", should refer to Personal Income Tax Bulletin 2010-02, Guidance for Investors in Fraudulent Investment Schemes, for detailed information about how to report losses on any investments in such schemes.

X. Distributions from C Corporations

A shareholder in a C corporation who receives a distribution other than a dividend must decrease the basis of the C corporation stock or shares, but not below zero, by any such distribution. Any distribution greater than basis is reported as a PA Schedule D Gain.

Y. Gain or Loss on the Sale of a Partnership or S Corporation Ownership Interest

Pennsylvania resident taxpayers with investment in partnerships (including limited liability companies reporting as partnerships on federal Form 1065) and S corporations that sell or exchange their interest or shares in those entities are required to report the gain or loss on those sales on PA Schedule D. Pennsylvania basis in these investments is often different than it is for federal income tax purposes. Refer to PA Personal Income Tax Guide, Chapter 16, Pass Through Entities, for additional information on the basis calculations for these entities.

Z. IRC § 338(h)(10) Sale of Stock Treated as a Sale of Assets

There are no provisions within Pennsylvania personal income tax law that permit the gain on the sale of stock to be treated as a gain on the sale of the assets of the corporation. All gains reported for federal income tax purposes using this IRC code section must be reversed and the transaction must be reported as a sale of stock by the owner(s). As a result, the corporation must keep separate Pennsylvania books and records from the date of the purchase going forward for all assets held at the time of the purchase to keep the proper basis in the corporation and to calculate the allowable depreciation expense for the entity for Pennsylvania purposes.

AA. Federal Tax Benefit Rule

Pennsylvania Personal Income Tax law does not incorporate the Federal tax benefit rule. See generally IRC § 111 (where the federal tax benefit rule was codified). Consequently, Pennsylvania does not follow the "inclusionary" prong of the rule that requires taxable income to include the recovery of an item deducted in a prior tax year. Because Pennsylvania does not follow the inclusionary prong, it also does not follow the corollary "exclusionary" prong of the rule that limits the taxable income by the extent to which the prior deduction resulted in a tax benefit in the year deducted.

Sometimes confused with the tax benefit rule is Pennsylvania tax benefit provisions related to basis adjustments for depreciation. Refer to Depreciation and Basis Adjustment in Section VIII of this chapter for additional information.

BB. Investments in Stocks and Bonds

Any gain or loss on the sale, exchange or disposition of stocks or bonds is reportable for Pennsylvania personal income tax purposes. A taxpayer may report each transaction or use summary information from brokerage accounts or a worksheet to report any net gain or loss amounts if the stocks and bonds are listed on any major exchange.

CC. IRC § 1256 Mark-to-Market Gains and Losses

Mark-to-market gains and losses reported under IRC §1256 gains and losses are reported as Schedule D transactions for Pennsylvania personal income tax purposes.

DD. IRC §§ 987 and 988 Foreign Exchange Gains and Losses

Gains and losses from foreign currency exchange transactions are reported as Schedule D transactions for Pennsylvania personal income tax purposes.

EE. Other Income from Investment Partnerships

Gains and losses (short-term capital gains, long-term capital gains, IRC § 987, IRC § 988, IRC § 1256 and swaps) reported as other income for federal income tax purposes in Box 11 of federal Form 1065 Schedule K-1 are Schedule D gains and losses for Pennsylvania personal income tax purposes.

FF. Sales of Business or Rental Property

Net gains and losses on the sales of tangible and intangible personal property, including the sale of rights, royalties, patents and copyrights, used in a trade or business or that are part of a rental property or royalty business, are required to be reported as gains or losses on PA Schedule D if property of a similar nature is not purchased or obtained to replace the disposed property. In cases where the federal reporting of such transactions also includes an ordinary income component of the gain, the ordinary income reported for federal purposes on such sales must be reclassified as gains from the sale exchange or disposition of property. If the property sold or exchanged for a business (not rental property) is replaced with similar property, the net gain or loss may be classified as business income for Pennsylvania personal income tax purposes. Refer to Classification of Gains (Losses) in Section IV of this chapter for additional information.

GG. Sales of Land or Buildings Held for Investment

Gain or loss on the sale, exchange or disposition of property such as land or buildings held for investment with the intention of earning a profit is required to be reported on PA Schedule D.

HH. Sales and/or Abandonment of Oil and Gas Wells

Federal sales and/or abandonments of oil and gas wells require the immediate recovery of intangible drilling costs as ordinary business income. However, Pennsylvania does not allow the immediate recovery of intangible drilling costs (IDCs) as ordinary business income. If a well is sold or abandoned for lack of production or insufficient production, the sale and/or abandonment are considered dispositions of property reportable on PA Schedule D. All IDCs not expensed or amortized through the date of disposition are included in the basis of the well being disposed of for purposes of calculating gain/loss. Refer to Personal Income Tax Informational Notice Tax 2013-04, Intangible Drilling and Development Costs, for additional information.

II. Sales of Property Converted from Business or Rental Property to Personal Use Property

Gain from the sale of property that has been converted from business or rental property (i.e., income producing property) to personal use property (i.e., non-income producing property) is reported on PA Schedule D. Because the property is personal use when sold, any loss from the sale cannot be claimed for PA personal income tax purposes.

JJ. Distributions of Stock from Employee Stock Ownership Plans (ESOPs) and Subsequent Sales

If a participant in an employee stock ownership plan (ESOP) receives a distribution from the ESOP, the distribution is reported as compensation to the extent that the distribution is greater than the participant's basis (previously taxed employee contributions). If the employee receives a distribution of stock from the plan, the value of the stock that is taxable as compensation is the fair market value of the stock at the time of the distribution (less the participant's basis). After the distribution, the participant's basis in the stock is increased to the fair market value of the stock. If the participant later sells the stock back to the ESOP or to another party, the gain or loss from the sale is reported on PA Schedule D. Refer to PA Personal Income Tax Guide Chapter 7, Gross Compensation, for additional information.

IV. CLASSIFICATION OF GAINS (LOSSES)

The following table describes various types of gains or losses and the classification of the gain or loss as well as whether the income is taxable for a resident or nonresident taxpayer.

TABLE CLASSIFICATION OF GAINS (LOSSES)

TYPE OF GAIN(LOSS)	CLASSIFICATION
Proceeds from the sale of intangible personal property used in the trade or business, including goodwill contractually sold with a business and allocated by the parties as to value in the sales agreement.	PA resident – taxable Nonresident – taxable if PA source Used to determine the net income (loss) of the business, profession or farm if the proceeds are reinvested back into the business. Report on Schedule C **or** Page 1 of the PA-20S/PA-65. If the proceeds are not reinvested back into the business, report on Schedule D. Refer to Personal Income Tax Bulletin 2005-02, Gain or Loss Derived from the Disposition of a Going Concern.
Proceeds from the sale of intangible personal property **not** used in a business.	PA resident – taxable Report on Schedule D. Nonresident – not taxable Refer to Personal Income Tax Bulletin 2005-02, Gain or Loss Derived from the Disposition of a Going Concern.
Proceeds from the sale of tangible personal property used in the business, profession, or farm and the proceeds reinvested and used to acquire like-kind property used in the same business, profession or farm.	PA resident - taxable Nonresident – taxable if PA source Used to determine the net income (loss) of the business, profession or farm. Report on Schedule C **or** Page 1 of the PA-20S/PA-65.

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TABLE CLASSIFICATION OF GAINS (LOSSES)

TYPE OF GAIN(LOSS)	CLASSIFICATION
Proceeds from the sale of inventory/stock-in-trade.	PA resident/nonresident – taxable Used to determine the net income (loss) of the business, profession or farm. Report on Schedule C **or** Page 1 of the PA-20S/PA-65.
Proceeds from the sale of tangible assets held for investment.	PA resident - taxable Nonresident – taxable if PA source Report on Schedule D
Proceeds from the sale of intangible assets held for investment.	PA resident – taxable. Report on Schedule D. Nonresident – not taxable
Proceeds from the sale of land and/or building constituting the abandonment of a business or business segment. ***Example.*** Sale of a division or line of business where that division or business activity is not continued by the seller.	PA resident - taxable Nonresident – taxable if PA source Report on Schedule D.
Proceeds from the sale of land and/or building used as a facility in the operation of the business, profession, or farm for reinvestment in a like-kind facility used in the same business, profession or farm.	PA resident – taxable Nonresident – taxable if PA source Report on Schedule D.
Proceeds from the sale of land and/or building used to generate rental income.	PA resident– taxable Nonresident – taxable if PA source Report on Schedule D.
Proceeds from the sale of land and/or buildings held for investment regardless of reinvestment of proceeds.	PA resident – taxable Nonresident – taxable if PA source Report on Schedule D.

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TABLE CLASSIFICATION OF GAINS (LOSSES)

TYPE OF GAIN(LOSS)	CLASSIFICATION
Sale of stocks and bonds other than federal obligations or Pennsylvania obligations **not** used in the operating cycle of the business activity.	PA resident – taxable Report on Schedule D. Nonresident – not taxable
Sale of ownership interest in partnerships and business enterprises.	PA resident – taxable Report on Schedule D. Nonresident – not taxable Refer to Personal Income Tax Bulletin 2005-02, Gain or Loss Derived from the Disposition of a Going Concern.

V. SALE OF PRINCIPAL RESIDENCE

Generally, the gain on the sale of a principal residence occurring on or after Jan. 1, 1998 is exempt from Pennsylvania personal income tax. Likewise, no loss may be taken because such a transaction is not entered into for profit or gain. There is no requirement for any schedule to be filed for informational purposes on an exempt sale of a principal residence. However, if any portion of the gain is taxable due to nonresidential (business/rental) use of the property, the worksheet included with PA Schedule 19 must be included with the return.

A residence is a house, lodging, or other place of habitation, including a trailer or condominium that has independent or self-contained cooking, sleeping, and sanitation facilities.

A principal residence, in order to qualify for exclusion, must meet all of the following conditions:

1. Was sold on or after Jan. 1, 1998; and

2. Owned for two of the last five years prior to the date of sale; and

3. Physically occupied and personally used the most during two of the last five years prior to the date of sale. Moving furniture and personal belongings into a residence does not qualify as use. Even if the taxpayer's family physically occupied the residence, it is not the taxpayer's principal residence if he or she did not occupy it; and

4. If the taxpayer has sold a principal residence and claimed the exemption within two years of the date of sale of a second principal residence, the second sale must be reported unless the sale is the result of a change in personal circumstances beyond one's control, such as a change in employment or health.

If a principal residence includes business or rental premises, the exemption does not apply to the portion of the property used for business or rental purposes. Examples include a sole proprietor's residence above the sole proprietor's store, an office in home and a duplex where one unit is rented. A principal residence used for rental purposes while the owner is attempting to sell the property is subject to a depreciation deduction, whether taken or not, whether taken or not, and is therefore, not eligible for the exclusion.

The *PA-19, Sale of Principal Residence* worksheet and instructions should be used in order to properly apportion the percentage of a mixed-use property not eligible for the exclusion.

If the property is jointly owned and only one spouse fulfills the qualifications and a joint return is filed, the entire transaction is exempt. However, if the husband and wife file separately, only that spouse that fulfills all the qualifications may claim the exemption. The other spouse would be subject to tax on his or her half of the gain.

This exclusion also applies to installment sales.

If the owner has died, the exclusion may not be claimed unless the decedent closed the sale before death. However, a surviving spouse may claim the exclusion if the decedent satisfied both the ownership and use conditions before his or her death and the spouse has not remarried. The exclusion may not be taken on a PA-41, Fiduciary Income Tax Return by the estate.

However, the fact that the residence was rented for a couple of months does not necessarily disqualify the residence from the exclusion. For example, rent paid by the buyer to live in the seller's home prior to the disposition, does not in itself, violate any of the requirements for excluding the gain from the disposition of a principal residence.

The gain (loss) on any residence or portion of a residence not eligible for the exclusion is reported on PA-40 Schedule D. The gain (loss) on any residence not eligible for total or partial exclusion is reported on line 1 of Schedule D. The gain excluded from taxation for any principal residence or the partial gain excluded from taxation on any principal residence is included in eligibility income on Line 8 of PA Schedule SP.

VI. GAIN OR LOSS ON PROPERTY ACQUIRED PRIOR TO JUNE 1, 1971

A. GENERAL INFORMATION

Gain on property acquired before June 1, 1971 is calculated by subtracting the adjusted basis of the property or the alternative basis of the property, whichever is greater, from the value of cash or property received. Also, no gain (loss) is realized on the sale or disposition of property acquired prior to June 1, 1971 if the value of the cash or property received is greater than the property's adjusted basis, but less than its alternative basis.

These special rules also apply if the property sold was acquired by gift, and the donor acquired the property before June 1, 1971.

B. ADJUSTED BASIS

Ordinarily, the adjusted basis for property for Pennsylvania income tax purposes is the same as the adjusted basis for federal income tax purposes. It is the original (unadjusted) purchase price for the property (plus allowable expenses of acquisition):

1. Adjusted upward by the cost of capital improvements to the property, contributions of capital, and gain incurred, made or recognized during the entire holding period; and

2. Adjusted downward by the annual deductions for depreciation, amortization, obsolescence or cost depletion (but not percentage depletion) allowed or allowable and recoveries of capital (such as property damage awards, casualty insurance proceeds and corporate "return of capital" distributions) received during the entire holding period.

C. ALTERNATIVE BASIS

The alternative basis for property is calculated in the same manner as adjusted basis is calculated, except for the following important differences:

1. Use the property's fair market value as of June 1, 1971 as the original (unadjusted) basis of the property rather than its original cost or other original basis used to calculate adjusted basis for the property.

2. Adjust upward only for the cost of capital improvements to the property, contributions of capital, and gain incurred, made or recognized after May 31, 1971.

3. Adjust downward only for the annual deductions for depreciation, amortization, obsolescence or cost depletion (but not percentage depletion) allowed or allowable and recoveries of capital received after May 31, 1971.

D. DETERMINATION OF FAIR MARKET VALUE AS OF JUNE 1, 1971

The starting point for computing the alternative basis for property is its fair market value as of June 1, 1971. There are four ways to determine fair market value as of June 1, 1971:

1. Listed Security Method;

2. Appraisal Method;

3. Proration Method; and

4. Deemed Value Method.

An explanation of each of these methods follows.

1. Listed Security

If the property was acquired prior to June 1, 1971 and it was listed on an established market or exchange on June 1, 1971 or the week preceding June 1, 1971, the listed security method must be used. If the property was listed, its fair market value on June 1, 1971 is:

a. The opening price on Tuesday, June 1, 1971; or

b. The price of the last sale during the preceding week, if not traded on Tuesday, June 1, 1971;

c. The average of the high and low price or the average of the bid and asked quotations on Tuesday, June 1, 1971, whichever is appropriate, if not traded on June 1, 1971 and during the week preceding June 1, 1971; or

d. If the stock of a privately held corporation was acquired six months prior to June 1, 1971 and the corporation merged with a public corporation under a tax-free organization, the basis of the stock is the June 1, 1971 value of the public stock for Pennsylvania purposes.

2. Appraisal

Taxpayers may use either an appraisal of current fair market value made on or about June 1, 1971 or a subsequent appraisal of fair market value as of June 1, 1971, if the following conditions are met:

a. A copy of the appraisal is attached to the return.

b. The appraisal specifically excludes the value of any improvements made after May 31, 1971.

c. The appraisal is a bona fide, independent, written appraisal by a competent appraiser of recognized standing and ability.

3. Proration Method

a. Property Formula

If no adjustment to original basis is required to determine the property's adjusted basis for Pennsylvania income tax purposes, the fair market value of an asset as of June 1, 1971 may be determined in accordance with the following property value formula:

Property's Value as of June 1, 1971 = Current Fair Market Value of Property x A + Historic Cost of Property x B.

- Where "A" is a fraction. The numerator is the number of full calendar months the property was held prior to June 1, 1971 and the denominator of which is the number of full calendar months in the taxpayer's entire holding period for the property; and

- Where B is a fraction, the numerator of which is the number of full calendar months the property was held after May 31, 1971 and the denominator of which is the number of full calendar months in the taxpayer's entire holding period for the property; and

- Where the historic cost of the property is its purchase price if acquired by purchase or its fair market value on the date of death of the decedent if acquired by inheritance.

Note. For all calculations involving any proration method observe the following rules:

- Round all decimals to four digits.

- For purposes of determining holding periods, a calendar month begins on the first day of the month and ends on the last day of the month. If purchase or acquisition occurs on any day other than the first day of the month, the holding period begins on the first day of the following month. If disposition occurs on any day other than the last day of the month, the holding period ends on the last day of the preceding month.

Example 1
Allen purchased land for \$1,000 on April 1, 1964. On Dec. 31, 1987, Allen sold the land for \$15,000. Allen held the land for 285 full calendar months. 86 months were before June 1, 1971 and 199 months were after May 31, 1971. Using the formula above, the June 1, 1971 Property Value is \$5,224, calculated as follows:

$$(\$15{,}000 \times \frac{86 \text{ mos.}}{285 \text{ mos.}} = \$4{,}526) +$$

$$(\$1{,}000 \times \frac{199 \text{ mos.}}{285 \text{ mos.}} = \$698)$$

$$\$4{,}526 + \$698 = \$5{,}224$$

Property Formula Adjustments
If adjustments to original basis are required to determine the property's adjusted basis for Pennsylvania purposes, an additional adjustment may also be required to be made to the current fair market value and historic cost data before using the property value formula:

- **Capital Improvements**
  If the only required adjustment to original basis to determine the property's adjusted basis for Pennsylvania purposes is for the cost of capital improvements to the property, an adjustment to the current fair market value data is needed before using it in the property value formula. A calculation of the 6/1/71 value of improvements made before June 1, 1971 using the improvement value formula is also needed. Use the following steps to make the adjustments and computations:

  Step 1. The historic cost, holding period, and current fair market value of each improvement to property made during the holding period must be separately determined.

  Step 2. For each improvement to property made before June 1, 1971, use the following improvement value formula to compute its fair market value as of June 1, 1971:

  Improvement's Value as of June 1, 1971= Current Fair Market Value of Improvement x C + Historic Cost of Improvement x D

  - Where C is a fraction. The numerator is the number of full calendar months from the date of the improvement to June 1, 1971 and the denominator is the number of full calendar months in the taxpayer's entire holding period for the improvement.

  - Where D is a fraction. The numerator is the number of full calendar months the improvement was held after May 31, 1971 and the denominator is the number of full calendar months in the taxpayer's entire holding period for the improvement.

  Step 3. Subtract the total fair market value of all improvements to property (including improvements made after May 31, 1971) from the current fair market value of the property to determine its fair market value (less improvements) before computing its June 1, 1971 value using the property value formula.

  Step 4. Total the amounts computed in Steps 2 and 3. This total is the property's fair market value as of June 1, 1971.

Example 2
Karen purchased land for $1,000 on April 1, 1964. Karen built storage facilities on the land on July 1, 1968, at a cost of $12,000. On Sept. 1, 1983, Karen built additional storage facilities at a cost of $36,000. On Dec. 31, 1987, Karen sold the entire property (land and buildings) for

$160,000. The current fair market value of the pre-1971 storage facilities is $58,000; the other storage facilities, $60,000. The June 1, 1971 value of the pre-1971 improvements is $18,800, calculated as follows:

$$(\$58{,}000 \times \frac{35 \text{ mos.}}{234 \text{ mos.}} = \$8{,}675) +$$

$$(\$12{,}000 \times \frac{199 \text{ mos.}}{234 \text{ mos.}} = \$10{,}205)$$

$8,675 + $10,205 = $18,880

The June 1, 1971 value of the land is $13,372, calculated as follows:

Current fair market share of land =

$160,000 - ($58,000 + 60,000) = $42,000

$$(\$42{,}000 \times \frac{86 \text{ mos.}}{285 \text{ mos.}} = \$12{,}674) +$$

$$(\$1{,}000 \times \frac{199 \text{ mos.}}{285 \text{ mos.}} = \$698)$$

$12,674 + $698 = $13,372

The June 1, 1971 value of the land and improvements is $32,252, calculated as follows:

$18,880 + $13,372 = $32,252

- **Contributions of Capital and Recoveries of Capital**
  If adjustments to original basis are required to determine the property’s adjusted basis for Pennsylvania income tax purposes because of contributions of capital or recoveries of capital made or received after the property was acquired, historic cost data may need to be adjusted, before using it in the property value formula. Use the following steps to determine the amount of the adjustment:

  Step 1. Determine the date and amount of each contribution of capital and recovery of capital.

  Step 2. Multiply the amount of each contribution of capital by a fraction, the numerator of which is the number of full calendar months in the taxpayer’s entire holding period and the denominator of which is the number of full calendar months between the date of the contribution and the date of disposition of the property.

Step 3. Total the amounts computed in Step 2.

Step 4. Multiply the amount of each recovery of capital by a fraction, the numerator of which is the number of full calendar months in the taxpayer's entire holding period and the denominator of which is the number of full calendar months between the date of the contribution and the date of disposition of the property.

Step 5. Total the amounts calculated in Step 4.

Step 6. Subtract the total calculated in Step 5 from the total computed in Step 3.

Step 7. If the amount calculated in Step 6 is greater than zero, the historic cost must be increased by the amount calculated in Step 6. If less than zero, the historic cost must be reduced by subtracting the amount calculated in Step 6. If zero, no adjustment to historic cost is necessary.

Example 3

Bill purchased a 30 percent interest in PVB Partnership for $12,000 on Aug. 1, 1968. On Sept. 1, 1969, Bill contributed another $6,000. On July 1, 1970, PVB distributed partnership property worth $8,000 to Bill. On Feb. 28, 1987, Bill sold his partnership interest for $47,000. Bill held his partnership interest for 223 months. From Sept. 1, 1969, the date of the contribution, to the date of sale is 210 months. The number of months from the July 1, 1970 distribution to Bill to the date of sale is 200 months. The adjustment to historic cost is calculated using the steps below.

Step 1. Value of contribution 9/1/69 - $6,000
Value of distribution 7/1/70 - $8,000

Step 2. Historic value of contribution to the partnership

$$\$6,000 \times \frac{223}{210} = \$6,371$$

Step 3. Total historic value of contribution - $6,371

Step 4. Historic value of distribution from the partnership

$$\$8,000 \times \frac{223}{200} = \$8,920$$

Step 5. Total historic value of distribution - $8,920

Step 6. Net adjustment to historic cost
$6,371 - $8,920 = ($2,549)

Step 7. Historic cost as adjusted
$12,000 - $2,549 = $9,451

The adjusted historic cost would then be used to calculate the June 1, 1971 value as show in **Example 1.**

Important: The proration method may not be used if a loss is suffered from fire, storm or other casualty, demolition costs were incurred, losses occurred during the holding period or if the property was acquired by gift after May 31, 1971. It also may not be used if the entity in which a property interest was held was a party to a reorganization, consolidation or merger or if other events have transpired during the holding period which would not permit its use.

4. Deemed Value

If the value of a property as of June 1, 1971 cannot be determined, using the listed security, appraisal or proration method, the value of the property as of June 1, 1971, shall be deemed to be its adjusted basis as of June 1, 1971, if determinable, or zero, if not determinable.

VII. CALCULATION OF INSTALLMENT SALES GAIN

When real or personal property is sold at a gain and any portion of the payments is received in a tax year after the year of sale, it is an installment sale. For sales of real or tangible personal property, a cash basis taxpayer has the option to either report the entire gain in the year of the sale or report the gain using the installment sales method of accounting. An accrual basis taxpayer may not use the installment sale method of accounting. Under the installment sales method of accounting, the gain from each installment payment is reported when received and the taxpayer’s basis is allocated proportionally over all of the installment payments.

Although intangible personal property may be sold under an installment sales agreement, for Pennsylvania personal income tax purposes a cash basis taxpayer may not elect to use the installment sale method of accounting for an installment sale of intangible personal property or transactions where the objective is the lending of money or rendering of services. Rather, the cash basis taxpayer may report the entire gain in the year of the sale or use the cost recovery method of accounting (each installment payment is attributable to basis until fully recovered) to determine the gain on each installment payment. However, if the promise to pay the future installments is secured by a note that is assignable, the taxpayer may not use the cost recovery method and must report the entire gain during the year of the sale.

In addition, if a sale results in a loss, the installment method cannot be used and the sale must be reported on PA-40 Schedule D. The installment sales method also cannot be used where the taxpayer elects to exclude the gain from the sale of a principal residence.

If the installment method of reporting is elected, the taxpayer must use *REV-1689, PA Schedule D-1,* to report the sale. If the property was acquired prior to June 1, 1971, the taxpayer must also obtain *REV-1742, PA Schedule D-71,* to determine the adjusted basis or alternative basis.

If the installment method is not elected or permitted or the cost recovery method cannot be used, the taxpayer must report all of the gain on the sale in the year of the sale on his or her PA-40 Schedule D or PA Schedule C.

A. Election

Taxpayers must make an election if they wish to use the installment method. An installment sale election, once made, cannot be revoked. Pennsylvania will deem the election to have been made in the following instances:

If a taxpayer reports an isolated transaction as an installment sale at the time of filing the PA-40 Individual Income Tax Return by:

1. Using *REV-1689, PA Schedule D-1* to calculate the gain to be reported, and

2. Including the gain on PA-40 Schedule D, and

3. Identifying the transaction on PA-40 Schedule D as an installment sale.

Once the election is made, the taxpayer will not be allowed to change the method of reporting in subsequent years.

B. Example

- Jane sold her hunting cabin on Sept. 12 of the current year.
- She purchased it on Aug. 5, 1989.
- The purchase price was $10,000.
- She made improvements of $500 for an adjusted basis of $10,500.
- She sold the cabin for $15,000.
- Closing costs were $775 for net proceeds of $14,225.
- It was sold on the installment plan with payments totaling $4,383 the first-year, of which $4,100 was principal.
- For the second year she collected $7,124 of which $5,251 was principal.

Since Jane chooses the installment sale method to report this sale:

- REV-1689, Schedule D–1 must be used.
- For the year of the sale, the Schedule D–1 shows a net profit in Part 1 of $3,725 ($14,225 - $10,500), and;
- Part 2 shows the calculation of the taxable part of the installment sale for the first-year.
- First, the proportional gain ratio must be determined by dividing the net profit by the gross sales price.
- In this example, it is .249 ($3,725 ÷ $15,000).
- Apply the ratio to the principal payments received during the year ($4,100 x .249 = $1,021).

- Add to this figure any interest payments received during the year, which total $283 ($4,383 - $4,100).
- The resulting figure is a taxable gain of $1,304.

For the following year:

- Complete Part 1 with the same amounts from the first year.
- Part 2 starts with the same ratio as in the prior year of .249. This is applied to the principal payments received in the second year ($5,251 x .249 = $1,308).
- Add to this figure the amount of interest payments received during the second year of $1,873 ($7,124 - $5,251).
- The resulting figure is the taxable gain of $3,181 ($1,308 + $1,873).

Subsequent years would be done the same as the second year.

If Jane had decided not to use the installment method:

- Schedule D would have been utilized and the entire amount of gain would have been reported in the first year.
- Each year's interest on the installment sale would have been reported as interest income on Schedule A.

If Jane was a nonresident and reported the entire gain in the year of sale, she would not report any interest income to Pennsylvania.

C. Defaults and Repossessions

Refer to Repossession of Property in Section III of this chapter for additional information.

VIII. DEPRECIATION AND BASIS ADJUSTMENT

A. Depreciation

In computing income, a depreciation deduction shall be allowed for the exhaustion, wear and tear and obsolescence of property being employed in the operation of a business or held for the production of income. The deduction must be reasonable and shall be computed in accordance with the property's adjusted basis at the time placed in service, reasonably estimated useful life and net salvage value at the end of its reasonably estimated useful economic life. A taxpayer must consistently use the same depreciation method over the life of the asset

Acceptable methods of depreciation are:

1. The straight-line method; or

2. Any depreciation method, recovery method or convention that is also used by the taxpayer in determining Federal net taxable income. This includes such methods as Modified Accelerated Cost Recovery System (MACRS). Such a

method may only be used if the property, when placed in service, has the same adjusted basis for Federal income tax purposes and the method or convention is allowable for Federal income tax purposes at the time the property is placed in service or under the Internal Revenue Code of 1986, whichever is earlier.

B. Federal Bonus Depreciation

Pennsylvania personal income tax does **not** follow the federal provisions for the allowance of bonus depreciation. No bonus depreciation may be taken for Pennsylvania personal income tax purposes.

C. Application of Pennsylvania Basis Adjustment Rules for Depreciation

Personal income tax law in 72 P.S. §7303(a.2) states that the basis in property shall be reduced, but not below zero, for depreciation by the greater of:

1. The amount deducted on the return and not disallowed, but only to the extent the deduction results in a reduction of income; and

2. The amount allowable using the straight-line method of depreciation computed on the basis of the property's adjusted basis at the time placed in service, reasonably estimated useful life and net salvage value at the end of its reasonably estimated useful economic life, regardless of whether the deduction results in a reduction of income.

IX. RETURN-OF-CAPITAL DISTRIBUTIONS

A resident shareholder or partner must report as taxable gain for the tax year in which it was received or credited, the excess of the fair market value of any return-of-capital distribution over the adjusted basis of the stock or partnership interest on the PA-40 Schedule D. A return-of-capital distribution is any distribution that is not made or credited by a business corporation or association out of its earnings and profits. Refer to the PA Personal Income Tax Guide, Chapter 16, Pass Through Entities, for additional information.

X. REORGANIZATIONS

A. Definition of Sale or Exchange or Other Disposition Under Pennsylvania Law

Pennsylvania treatment is similar to Internal Revenue Code Section 368(a)(1). Refer to Pennsylvania Tax Reform Code Section 303(a)(3)(iv) for additional information.

B. PA Personal Income Tax Treatment of Stock and Securities Received in a Reorganization

Securities are considered to be boot in reorganizations. The following chart provides when the boot received results in a taxable or nontaxable transaction for PA personal income tax purposes:

Surrender	Receive	PA Taxability
Stock and Securities	Stock and securities in same proportion	Nontaxable
Stock and Securities	Stock and securities in different proportions	Taxable
Stock Only	Stock only	Nontaxable
Securities Only	Securities only in an equal or lesser principal amount	Nontaxable
Stock Only	Securities only	Taxable
Securities Only	Stock only	Taxable

C. Calculation of Gain or Loss for Taxable Reorganizations

Gain or loss on a taxable reorganization for PA personal income tax purposes is calculated in the same manner as for federal income tax purposes.

XI. BASIS OF INHERITED PROPERTY

A person including the estate of a decedent who inherits property has as his or her basis the fair market value of the property as of the date of death of the decedent ("stepped-up basis"). Additionally, the following rules apply to inherited property:

A. The basis of property acquired through inheritance, whether by testate or intestate succession, is established at the time of death. Pennsylvania does not recognize the alternative "six months after death window" under federal law.

B. There is no Pennsylvania personal income tax stepped-up basis for property acquired as a surviving joint tenant with right of survivorship or by a surviving spouse for property owned as tenants by the entities.

C. Basis does not have to be reduced for state purposes merely because the taxpayer utilized a federal tax credit in conjunction with the depreciable asset.

XII. TRANSFERS OF PROPERTY INCIDENT TO DIVORCE

There is no adjustment of the value to the party receiving the property. When the acquiring party disposes of the property, the original cost basis will be used. In addition, the relinquishing party will report no gain or loss on the sale or disposition of the property.

XIII. GAINS AND LOSSES FROM PARTNERSHIPS AND PA S CORPORATIONS

Refer to the PA Personal Income Tax Guide, Chapter 16, Pass Through Entities for information regarding gains and losses from partnerships and Pennsylvania S corporations.

XIV. DISTRIBUTIONS FROM PARTNERSHIPS

Refer to the PA Personal Income Tax Guide, Chapter 16, Pass Through Entities, for information regarding distributions from partnerships.

XV. DISTRIBUTIONS FROM PA S CORPORATIONS

Refer to the PA Personal Income Tax Guide, Chapter 16, Pass Through Entities, for information regarding distributions from Pennsylvania S Corporations.

XVI. CLASSIFICATION BETWEEN NET PROFITS AND SCHEDULE D GAINS (LOSSES)

Overview

Gains and losses are classified as net profits for Pennsylvania if the funds are reinvested in the same line of business within the same entity. If the funds are not reinvested then the gains are reported on PA-40 Schedule D. If the gains are reported as ordinary income on federal Form 4797, it is not necessarily reported as net profits for Pennsylvania personal income tax purposes. For purposes of this classification, "Line of business" is defined by the North American Inventory Classification System (NAICS). If the funds are not reinvested in the same line of business, then the gains (losses) are reported on PA-40 Schedule D.

NAICS is a two- through six-digit hierarchical classification system, offering five levels of detail. Each digit in the code is part of a series of progressively narrower categories, and the more digits in the code signify greater classification detail. A complete and valid NAICS code contains six digits that consist of:

- The first two digits designate the economic sector;
- The third digit designates the subsector;
- The fourth digit designates the industry group;
- The fifth digit designates the NAICS industry; and
- The sixth digit designates the national industry.

As it relates to classification between net profits and PA-40 Schedule D gains (losses), the first four digits of NAICS are considered as the same line of business. For example, the NAICS code of **336340** would be considered for this purpose ~~as~~ the same line of business as **336312**.

XVII. CLASSIFICATION BETWEEN RENTAL INCOME AND PA SCHEDULE D GAINS (LOSSES)

Overview

When property used in a rental activity is sold, the gain or loss is a PA-40 Schedule D gain. This rule applies to both real and personal property used in the rental business. Such gain is PA-40 Schedule D gain regardless of whether the property is reinvested in a new building or similar type of building.

However, when a dealer in real property sells real property, the gain is classified under the net profit rules. Such gain is classified depending on how and where the proceeds are reinvested. If the proceeds are reinvested in the same type of net profits activity, the gains are included in arriving at a net income or loss of such profits activity. In applying this classification rule, consideration is given whether that new real property is geographically located near the dealer's old property. If the proceeds are invested in new real property located outside of Pennsylvania, the gain is generally PA-40 Schedule D gain. That new net profits activity is servicing new customers. This only applies to dealers in real property. Pennsylvania will follow the federal dealer classification rules in administrating these rules.

As discussed above, when a dealer in real property sells real or personal property, the gain generally is classified under the net profit rules. Gain is classified depending on how and where the proceeds are reinvested by the dealer in real property. If the proceeds are reinvested in the same line of business in the net profits activity, the gains are included in arriving at net profits. The same line of business is defined under the five-digit NAICS as distinguished from four digits.

Example

In applying this classification rule, consideration is given to whether the real property acquired or exchanged is geographically located within Pennsylvania to the dealer's old property. If the proceeds are invested in real property located outside of Pennsylvania, the associated gain is generally PA-40 Schedule D gain. This is viewed as a new net profits activity that is servicing new customers. This rule only applies to dealers in real property. Pennsylvania will follow the federal dealer classification rules in administrating these rules.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 13: NET INCOME (LOSS) FROM RENTS, ROYALTIES, COPYRIGHTS AND PATENTS

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CHAPTER 13: NET INCOME (LOSS) FROM RENTS, ROYALTIES, COPYRIGHTS AND PATENTS

I. DIFFERENCES BETWEEN PENNSYLVANIA PERSONAL INCOME TAX AND FEDERAL INCOME TAXATION

A. Rents Classified as Net Income (Loss) from the Operation of a Business, Profession or Farm

Rental income may be classified as net income from the operation of a business, profession or farm if the lessor provides significant services to the lessee-

1. A lessor provides significant services when he or she provides services for the lessee's convenience and such services are not ordinarily or customarily incurred in leasing property.

2. The entity is a dealer in real property.

B. Treatment of Gain (Loss) From the Sale, Exchange or Disposition of Property

The gain (loss) from the sale, exchange or disposition of property used to produce net income (loss) from rents, royalties, copyrights and patents should generally be reported as income from the sale, exchange or disposition of property on *PA-40 Schedule D*.

C. Passive Loss Rules

Under Internal Revenue Service (IRS) regulations, passive loss rules apply to individuals, trusts and estates, personal service companies, and closely held corporations. Pennsylvania personal income tax (PA PIT) does not follow the federal passive loss rules. Therefore-

1. Rental activities are not subject to federal passive loss limitation rules for Pennsylvania personal income tax;

2. Rental activity losses may be used to offset other income under Pennsylvania personal income tax which is classified as rental, royalty, copyright or patent income;

3. Pennsylvania personal income tax does not include any “grouping” concepts which are contained in the federal passive loss rules; and

4. Pennsylvania personal income tax does not provide that upon disposition, losses are offset against other classes of income.

D. Lease versus Sale Determinations [Reserved]

E. IRC Section 467 Rule

IRC section 467 imposes accrual accounting on lease transactions providing for increasing rent and requires rent to be leveled for tax purposes in the case of certain "disqualified leasebacks and long-term agreements." Pennsylvania personal income tax does not have similar provisions. Consequently, there will be timing differences for Pennsylvania personal income tax purposes.

F. Treatment of Construction Allowances

A tenant may receive a build-out allowance that the landlord grants (but does not actually pay to the tenant) to be used for build-outs designed to the tenant's specifications.

IRC section 110 provides that cash (or an amount treated as a rent reduction) received by a retail tenant is not gross income if the amount is used for qualifying construction of leasehold improvements. For Pennsylvania personal income tax purposes the amount received is treated as gross income.

G. Timber and Coal [Reserved]

Refer to PA PIT Guide Chapter 23 Natural Resources.

H. Prepaid Rental Income

Rental income is reported according to the lessor's method of accounting. If a cash method is used then rental income is reported when received. If an accrual method is used then rental income is reported when earned.

II. DEFINITIONS

A. Rental Income

Rental income is income the taxpayer receives for the use of his or her real or tangible property.

1. Federal Passive Loss Rules

For Pennsylvania personal income tax purposes, there are no passive loss rules as defined under IRC section 469; consequently, there will be both timing and permanent differences for Pennsylvania personal income tax purposes. The federal passive loss rules described below are not applicable.

IRC section 469(j)(8) defines rental activities as activities where payments are received principally for the use of tangible property. The regulations exclude from this definition a number of situations in which substantial services are provided in connection with the use of property-

a. Hotels and similar properties where the average period of each customer's use does not exceed seven days;

b. The average period of each customer's use is no more than 30 days and significant personal services are provided by or on behalf of the owner to customers;

c. Extraordinary personal services are provided and these services render the use of the property almost incidental, such as a hospital;

d. Rentals are incidental to non-rental activity because either–

- The property is held primarily for appreciation and gross rentals are less than 2 percent of the lesser of the adjusted basis or fair market value of the property, or

- The property is used in a trade or business owned by the taxpayer and the rentals are less than the 2 percent test above;

e. The property is customarily available during defined business hours for use by the public; or

f. The property is provided for use in a non-rental activity conducted by a pass through entity that the taxpayer owns an interest in.

If any of the above exceptions apply, the rental activity is not *per se* passive and individual taxpayers may avoid passive loss limitations by materially participating in the activity.

If insubstantial rental activities are conducted as part of a larger economic unit, the net rental income can simply be combined with the dominant trade or business activity. Similarly, if an insubstantial non-rental business is conducted in conjunction with a dominant rental activity, the entire economic unit may be considered rental for purposes of IRC section 469.

The Revenue Reconciliation Act of 1993 added a provision to the federal law that operates to exempt qualifying real estate professionals from the *per se* passive rule. Such taxpayers will not be guaranteed non-passive treatment but instead will be subject to the material participation standard like taxpayers in non-real estate activities.

If the unadjusted basis of depreciable property involved in a rental activity constitutes less than 30 percent of the total unadjusted basis, any net income from the activity is re-characterized as portfolio income and, therefore, unable to free up passive losses from other activities. For example, the net income from a stand-alone ground lease or a parking lot rental is likely to be subject to this re-characterization rule. The rules for a relatively common real estate structure are illustrated by *Wiseman v. Commissioner*, 69 T.C.M. 2564 (1995). In this case, the taxpayer owned interests in two partnerships; one owned land leased to the other that operated a shopping center. The taxpayer attempted to aggregate the activities in order to offset the shopping center losses against the ground lease profits. However, the IRS prevailed in segregating the ground lease income in the portfolio basket under the above re-characterization rule. Pennsylvania personal income tax has no concept as to groupings.

The general rule of IRC section 469 is that gain from the sale of an asset or activity is classified in the same basket as income (loss) previously generated from that asset or activity. Accordingly, gain from the sale of a rental activity will generally be passive unless IRC section 469(c)(7) applied to the activity. However, IRC section 469(l) authorized regulations re-characterizing certain gain as non-passive.

For Pennsylvania personal income tax there are no similar rules.

2. Federal-At-Risk Rules

For Pennsylvania personal income tax purposes there are no at risk rules as defined under IRC section 465. Consequently, there will be timing differences for Pennsylvania personal income tax purposes.

For Pennsylvania personal income tax purposes, a nonresident partner or nonresident shareholder cannot deduct losses in excess of his or her economic investment.

For Pennsylvania personal income tax purposes, a resident partner or resident shareholder basis in an entity cannot be less than zero. A resident partner or resident shareholder is required to have an economic investment to deduct losses for Pennsylvania personal income tax purposes.

B. Royalty Income

Royalty income is income that a taxpayer receives upon the extraction of coal, oil, gas, or other minerals or for the use of the taxpayer’s copyright or patent. Additionally, royalty income includes any amounts a taxpayer receives from licensing his or her secret process, franchise, know-how, assembled workforce, trade brands and similar property.

Refer to PA PIT Guide Chapter 23 Natural Resources.

C. Gross Rents, Royalties, Copyrights and Patents

Gross rents and royalties includes all items of gross income from receipts from rents, royalties, copyrights, patents, secret processes, formulas, goodwill, trademarks, trade brands, franchises and similar property derived in the form of rents and royalties except-

1. Income or receipts from the sale, exchange, or other disposition of rental property, royalty rights, copyrights, secret processes, patents, formulas, goodwill, trademarks, trade brands, franchises and similar property; and

2. Income or receipts from operating oil, gas, or mineral interests includable in the computation of net profits from a business, profession or farm or otherwise derived in the ordinary course of and from the operation of a business.

Refer to Personal Income Tax Bulletin 2005-02 Gain (Loss) Derived From The Disposition Of A Going Concern in PA PIT Guide Chapter 30.

III. DEDUCTIONS AGAINST GROSS RENTS, ROYALTIES, COPYRIGHTS AND PATENTS

A. Allowable Expenses

Allowable expenses include only expenses paid or incurred during the taxable year which are ordinarily incurred in and necessary for–

1. The production of, or collection of rents and royalties; or

2. The management, conservation or maintenance of rents, royalties, copyrights, patents and similar property.

Allowable expenses include such expenses as advertising, cleaning and maintenance, agent commissions, insurance, legal fees, management fees, interest, repairs, supplies, utilities, depreciation and depletion. With the exception of start-up expenses, depletion is an allowable deduction against income for Pennsylvania personal income tax purposes. Refer to Personal Income Tax Statement of Policy 2004-01 Depletion as published in Section 125 of Title 61 of the Pennsylvania Code.

Also, refer to PA PIT Guide Chapter 30 Pennsylvania Department of Revenue Personal Income Tax Policy Guidance and Chapter 23 Natural Resources.

B. Deductions Not Allowed Against Gross Rents, Royalties, Copyrights, and Patents

1. Owner's Labor, Capital or Improvements

No deduction is allowed for a taxpayer's own labor, capital investment or capital improvements.

2. Personal Expenses

No deduction is allowed for personal expenses or for any part of an allowable deduction that is personal.

C. Depreciation

There are some significant differences between federal and Pennsylvania personal income tax depreciation rules.

1. ACRS and MACRS

Deductions allowable under the Federal Accelerated Cost Recovery System (ACRS) and Modified Accelerated Cost-Recovery System (MACRS), including the

IRC section 179 deductions, in effect on Jan. 1, 1986, additional first-year depreciation allowance for individuals and certain small businesses, are acceptable depreciation deductions for Pennsylvania purposes.

Pennsylvania tax law allows ACRS or MACRS only when-

- They are also used for federal tax purposes, and
- The property, when placed in service, has the same adjusted basis for Pennsylvania and federal tax purposes.

Moreover, deductions under ACRS and MACRS are allowable only to the extent allowable under the version of the IRC in effect on Jan. 1, 1986 as amended to Jan. 1, 1997, whichever is less.

Additionally, for any year in which an ACRS or MACRS deduction is allowed or allowable-

- The taxpayer, S corporation or partnership must reduce its basis in the depreciable property by the amount by which the deduction reduced its net income; and
- Each owner must reduce outside basis by the owner's share of net loss or the amount of the owner's share of depreciation allowed or allowable using the straight-line method of depreciation.

2. Thirty Percent or Fifty Percent Additional First-Year Depreciation Not Allowed

For federal purposes, Congress enacted legislation during 2002, 2003 and 2005 that contained provisions providing for additional first-year depreciation on purchases of certain tangible personal property, computer software, and certain leasehold improvements acquired after Sept. 10, 2001. Pennsylvania personal income tax does not follow these federal provisions. Accordingly, neither the 30 percent additional first-year depreciation deduction for 2002 nor the 50 percent additional first-year depreciation deduction for 2003 and 2005 is permitted against income (loss) from rents, royalties, copyrights and patents for Pennsylvania personal income tax purposes. Further federal legislation extended or modified these special depreciation rules. For Pennsylvania personal income tax purposes, individuals, business owners, partnerships, limited liability companies, PA S corporations, estates and trusts cannot take this additional depreciation. However, taxpayers may continue to calculate depreciation on the same basis they would have calculated it under the Internal Revenue Code in effect at the time the property or asset was placed in service, or the Internal Revenue Code of 1986, as amended to Jan. 1, 1997, whichever is earlier. If a taxpayer took the bonus depreciation allowable under federal law for any tax year, they must file an amended PA-40 Individual Income Tax return.

3. IRC Section 179 Property Deductions

Pennsylvania tax law allows IRC section 179 property deductions on a limited basis. They are allowable with respect to the entity and each owner only to the extent allowable under the IRC in effect on Jan. 1, 1997. For example, the aggregate dollar limitation is $25,000 less the amount by which the cost of IRC section 179 properties placed in service during the taxable year exceeds $200,000. Federal increases enacted after 1997 are disregarded for Pennsylvania personal income tax purposes.

Additionally, for any year in which an IRC section 179 property deductions is claimed, basis must be reduced by the amount of the deduction, regardless of whether the deduction results in a reduction of net income.

Refer to Personal Income Tax Bulletin 2010-01 Section 179 Expense Deductions (to be issued in February 2010) for a more detailed explanation of Pennsylvania personal income tax rules.

IV. INTEREST FROM SECURITY DEPOSITS

Interest earned on the deposit of rents (i.e. tenant security deposits) is classified as interest income unless the interest earned is used to operate or maintain the rental property and is not returnable with the return of escrow funds. If the interest earned is actually used to operate or maintain the rental property, then such interest is classified as net income (loss) from rents, royalties, copyrights and patents. Likewise, expenses incurred to operate or maintain a rental property are classified as net income (loss) from rents, royalties, copyrights and patents.

Refer to PA PIT Guide Chapter 8 Interest.

V. RENTS VERSUS NET PROFITS

A. Determination of Rents or Net Profits

The leasing of tangible property would constitute operating a business only if-

1. The taxpayer offers the use of his or her property on a commercial basis to others in a marketplace and at least one of the following applies-

    a. The average period of customer use is 30 days or less; or

    b. The property is customarily made available for use only during defined business hours; or

    c. In addition to the property, the taxpayer also provides significant services (see explanation below) to the lessee; or

    d. The taxpayer incurs significant operating expenses in making the property available for lease; or

    e. The leasing activity is incidental to a real estate sales business; and

2. The taxpayer offers the use of his or her property with the intention of realizing a profit; and

3. The leasing of the property is characterized by regularity and continuity of activities.

B. Significant Services

Rental income may be classified as net income from the operation of a business, profession, or farm if the lessor provides significant services to the lessee. A lessor provides significant services when he or she provides services for the lessee's convenience and such services are not ordinarily or customarily incurred in leasing property.

1. Examples of Services That Do Not Constitute Significant Services

Providing heat, lighting, electric service, elevators, cleaning public access and exit areas, collecting trash and maintenance of the property in a condition suitable for use and rental are not usually significant services.

2. Examples of Services That Constitute Significant Services

Significant services generally are provided with rooms in hotels, boarding houses, apartment houses furnishing hotel services, tourist homes, motor courts, or motels and assisted living facilities. Additionally, providing maid service, room service, valet parking, decorating assistance, delivery services, transportation services and concierge services are significant. Providing food and nursing care are also significant. Payments for parking cars usually are not rents. Payments for warehousing of goods or the use of personal property are not rents if significant services are provided in connection with the payments.

C. Classification as Rental Income versus Net Income from the Operation of a Business, Profession or Farm

The Pennsylvania Department of Revenue's position is that self-rented property or related-party rents do not constitute a "commercial enterprise" as that term is defined under Pennsylvania personal income tax law. A rental property constitutes a commercial enterprise only when the taxpayer offers the use of the property on a commercial basis to others (*i.e.* the public) in a marketplace***.***

In *Wettach v. Commonwealth*. 153 Pa Commw 293, 620 A2d 730 (1992), the court stated:

> The first issue presented is whether the income (loss) of M & M is properly classified as "business profits" under Section 303(a)(2) or "rents" under Section 303(a)(4) of the [Pennsylvania Tax Reform Code of 1971], in view of the nature and origin of M & M's activity and the interrelationship between RSSM and M & M. Section 303(a)(2) states:

NET PROFITS
The net income from the operation of a business, profession or other activity, after provision for all costs and expenses incurred in the conduct thereof, determined either on a cash or accrual basis in accordance with accepted accounting principles and practices but without deduction of taxes based on income.

Section 303(a)(4) states: "Net gains or income derived from or in the form of rents, royalties, patents, and copyrights."

The Taxpayers argue first that the operation of the building is the "business" of 435 Sixth Avenue Associates, which through its hired manager provides significant services: it cleans the building, provides security and 24-hour access, makes repairs, and performs maintenance.

The Taxpayers argue in the alternative, by analogy to cases interpreting municipal net profits taxes, that the courts essentially have discarded the "provision of services" standard and look instead to the purpose for and method of the acquisition. If the property is deliberately acquired for the purpose of rental, then the rental is a business activity. *Oseroff v. City of Pittsburgh,* 70 Pa. Commonwealth Ct. 294 (1982) (property deliberately acquired for rental subject to city's tax on net profits and gross receipts, even though lessor did not provide even minimal service to lessee); *Philadelphia Tax Review Board v. Weiner,* 211 Pa. Superior Ct. 229 (1967) (owners who deliberately acquired one-half interest in a building and then leased it were engaged in a "business" within the meaning of the Philadelphia Wage and Net Profits Tax, rather than merely receiving passive income). The Taxpayers argue that the sole purpose for M & M's existence and its participation in the acquisition of the building is the rental of that building to RSSM, therefore M & M's profit (loss) comes from a business activity.

In response, the Commonwealth urges the court to focus on the limited and exclusive nature of M & M's rental activity, rather than on the provision of services or M & M's intent to rent the building. It cites *Morgan v. Commonwealth,* 42 Pa. Commonwealth Ct. 557 (1979). There an individual bought and sold securities for the purpose of making profit for himself; he held no license and did not offer his services to anyone else. He claimed certain expenses from his personal money management activity as expenses deductible from his operation of a business pursuant to Section 303(a)(2) of the [Pennsylvania Tax Reform Code of 1971]. This court disagreed, quoting the definition of "business" in Section 301(c) of the [Pennsylvania Tax Reform Code of 1971], 72 P.S. § 7301(c), as " 'an enterprise, activity, profession, vocation, trade, joint venture, commerce or any other undertaking of any nature when engaged in as commercial enterprise ....' " *Morgan,* 42 Pa. Commonwealth Ct. at 561, 400 A.2d at 1386 (emphasis added in *Morgan*). We held that the sine qua non of a commercial enterprise is the rendering of goods and services to others in the marketplace, which clearly excluded the petitioner's activity.

> We are constrained to agree with the Commonwealth. These two entities, although enjoying a separate legal existence, work very much "hand in glove," and their relationship reflects the nature of the rental activity in which M & M is involved. As the taxpayers admit in the stipulations, M & M was created for the sole purpose of acquiring ownership of the space in which RSSM conducts its law practice. In *Morgan* this court interpreted the statutory definition of "business" as the rendering of goods and services in the marketplace. Applying this definition to the situation presented, we must conclude that M & M's activity does not equate to doing "business." The income that M & M earns (and the losses that it generates) does not result from engaging in a " commercial enterprise " in the rental real estate market so as to render the activity a "business" within the meaning of Section 301(c) of the [Pennsylvania Tax Reform Code of 1971].

Refer to PA PIT Guide Chapter 11 Net Income (Loss) From the Operation of a Business, Profession or Farm.

D. Dealer in Real Property

For Pennsylvania personal income tax purposes, a dealer in real property is defined for federal income tax purposes, generally receives net profits for a business, profession or farm. For federal income tax purposes, if the property is subdivided or improved by guarding, drainage, paved roads, the installation of utilities or similar activity, the taxpayer gravitates towards dealer status since these changes are comparable to the functions performed by a manufacturer. *See Jersey Land and Development v. U.S.*, 539 F.2d 311. The more numerous, frequent and regular the sales, the more likely it is the property is held for sale to customers in the ordinary course of a trade or business. Extensive advertising, active solicitation, and promotional activities, whether by the taxpayer in person or by employees and brokers are inconsistent with investor status and are evidence that the property is held for sale to customers in the ordinary course of a trade or business. If a dealer has rental property held for the purpose of renting and not for sale, the class of income shall be rental.

A dealer's management of its properties is net profits from a business, profession or farm.

VI. TREATMENT OF GAIN (LOSS) ON THE SALE, EXCHANGE OR DISPOSITION OF PROPERTY FROM RENTS, ROYALTIES, COPYRIGHTS AND PATENTS

The gain (loss) from the sale of investment property used to produce net income (loss) from rents, royalties, copyrights and patents should generally be reported as net gain (loss) from sale, exchange or disposition of property on *PA-40 Schedule D*.

VII. RENTS VERSUS SALES

A. Lease with Option to Buy

A lease with an option to buy real property in Pennsylvania may be a purchase contract. If so, the payments received are reportable as net gain (loss) from the sale, exchange or other disposition of property. The taxpayer must complete and file a *PA-40 Schedule D*.

B. Giving up Mineral Rights or Ownership

If a taxpayer gives up mineral rights or ownership rights to Pennsylvania property or patents or copyrights, the payments the taxpayer receives are reportable as net gain (loss) from the sale, exchange or other disposition of property. The taxpayer must complete and file a *PA-40 Schedule D*.

Refer to PA PIT Guide Chapter 23 Natural Resources.

VIII. ALLOCATION OR APPORTIONMENT OF RENTS AND ROYALTIES FROM COPYRIGHTS AND PATENTS

A. Rents

1. Specific Allocation

Rents received from real estate and tangible personal property (not employed in the operation of a business) and the costs, expenses and liabilities incurred in producing and collecting such rents are allocable to Pennsylvania only if the property is located in Pennsylvania.

2. Formulary Apportionment

If the property is used both within and outside Pennsylvania, the net income allocable to Pennsylvania is determined by multiplying the net income by a fraction, the numerator being the number of days the property was in Pennsylvania during the rental period and the denominator being the total number of days in the rental period.

3. No Apportionment

Rents received from real estate located outside Pennsylvania and the costs, expenses, and liabilities incurred in producing and collecting such rents are allocable to the jurisdiction where the property is located. As such, no Pennsylvania apportionment is allowed.

B. Royalties

1. Allocation of Royalties from Extraction of Minerals

Royalties received from the extraction of minerals and the costs, expenses, and liabilities incurred in generating such royalty income are allocable to Pennsylvania when the property is located in Pennsylvania and the income is not derived from the operation of a business.

Refer to PA PIT Guide Chapter 23 Natural Resources.

2. Allocation of Royalties from Patents and Copyrights

Royalties received from patents and copyrights (not employed in the operation of a business) and the costs, expenses and liabilities incurred in producing and collecting such royalty income are allocable to Pennsylvania only if, and to the extent that, the patent or copyrighted material is employed by the payer in production, fabrication, manufacture or other processing in Pennsylvania, the patented products are produced by the payer in Pennsylvania or the printing or publication by the payer originates in Pennsylvania.

IX. REPORTING REQUIREMENTS

A. PA-40 Schedule E

If making Pennsylvania adjustments to federal rent, royalty, copyright or patent income, attach an explanation.

B. Federal Schedule E

Only Part 1 of federal Schedule E will be accepted with the following adjustments-

1. Passive rental/royalty loss must be claimed in full rather than carried over to future years as the federal government allows.

2. Any capital gains/distributions must be added.

3. Depreciation expense on sales tax that the taxpayer elected to currently expense for personal income tax purposes cannot be claimed (same as for PA-40 Schedule C).

4. Taxpayer's share of gain (loss) from partnerships, PA S corporations or other entities must be shown separately.

C. PA-40 Individual Income Tax Return

Net income (loss) from rents, royalties, patents and copyrights is reported on the *PA-40 Individual Income Tax* return. Total the net income (loss) from all PA-40 Schedule(s) E and all PA-40 Schedule(s) RK-1 or NRK-1 or federal Schedule(s) K-1, if the correct Pennsylvania schedule is not provided. However, spouses may not offset each other's income and losses in this class.

D. Nonresidents

Nonresidents are subject to Pennsylvania tax on net income from rents, royalties, copyrights, or patents from property located and/or used within Pennsylvania. Married taxpayers may not offset income (loss) from separately owned property.

Partnerships and S corporations with nonresident partners or shareholders must remit tax on income from sources within this Commonwealth, which is allocable to a nonresident. The nonresident partner or shareholder may take a credit on their PA-40 Individual Income Tax return for the tax remitted by the partnership or S corporation.

Refer to PA PIT Guide Chapter 17 Credits.

X. RECIPROCAL COMPENSATION AGREEMENTS

Reciprocal agreements apply to compensation only and not any other class of income. For example: In 1996, Joe, a resident of West Virginia, worked in Pennsylvania. He also owned a rental property in Pennsylvania. Joe must report as Pennsylvania-taxable income only the rental income realized on the rental property. Because of the reciprocal agreement with West Virginia, he is not subject to tax on his compensation in Pennsylvania.

Refer to PA PIT Guide Chapter 4 Filing Requirements For Pennsylvania Personal Income Tax Returns.

XI. TAX BENEFIT RULE

The Pennsylvania Department of Revenue does not follow the federal tax benefit rule. Pennsylvania law requires depreciation to be calculated under the straight-line method even if the depreciation did not provide any tax benefit.

If a taxpayer does not utilize the loss from the Schedule E, then the assets of the rental property must be depreciated using straight-line depreciation.

There are no carryovers of losses.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 14: ESTATES, TRUSTS AND DECEDENTS

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PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 14: ESTATES, TRUSTS AND DECEDENTS

I. PENNSYLVANIA ESTATES AND TRUSTS

A. Overview

The Tax Reform Code of 1971 as amended defines net gains or income derived through estates or trusts as a separate Pennsylvania class of income. *See* 72 PA C.S. Section 7303(a)(8). Therefore, income that is distributed from an estate or trust to a trust beneficiary should be reported by the beneficiary as net income derived through estates or trusts. An estate or trust is not a pass-through entity like a partnership or S corporation. Consequently, the estate or trust should **not** classify its distributions as if they retained the same income classification as received by the estate or trust. Further, the estate or trust should **not** provide federal Schedules K-1 for Pennsylvania purposes. A federal Schedule K-1 may be accepted from a nonresident trust that has a Pennsylvania beneficiary but no Pennsylvania source income.

The income of a beneficiary of an estate or trust in respect of such estate or trust shall consist of that part of the income or gains received by the estate or trust for its taxable year ending within or with the beneficiary's taxable year which, under the governing instrument and applicable state law, is required to be distributed currently or is in fact paid or credited to said beneficiary. The income or gains of the estate or trust, if any, taxable to such estate or trust shall consist of the income or gains received by it that is not required to be distributed currently and has not been distributed or credited to its beneficiaries.

An estate or trust reports Pennsylvania-taxable income to its beneficiaries on *PA-41 Schedule L* (for tax years beginning prior to Jan. 1, 2005) and *PA-41 Schedule RK-1 or PA-41 Schedule NRK-1* (for tax years beginning on or after Jan. 1, 2005).[1] The estate or trust reports to each beneficiary the total Pennsylvania-taxable income that it must distribute, pay or credit to each beneficiary.

In order for an estate or trust to determine its total taxable income for the taxable year, it must classify and report its income (loss) on the *PA-41 Fiduciary Income Tax Return*, just as individuals, partnerships and PA S corporations must classify and report their income (loss) on their returns. However, unlike partners or shareholders of partnerships and PA S corporations who are required to recognize their share of income (loss) in each applicable class of income received by the partnership or corporation for its taxable year ending within or with the partners' or shareholders' taxable years, the beneficiaries of an estate or trust are required to recognize whatever part of the estate's or trust's total taxable income that is allocable to them, whether distributed or required to be distributed, as net gains or income derived through estates or trusts.

[1] Beginning on or after Jan. 1, 2005, the department eliminated PA-41 Schedule L, Beneficiaries Share of Income and replaced it with PA-41 Schedule RK-1, Resident Schedule of PA S Shareholder/Partner/Beneficiary Pass Through Income, Loss and Credits and with PA-41 Schedule NRK-1, Nonresident Schedule of PA S Shareholder/Partner/ Beneficiary Pass Through Income, Loss and Credits.

B. Estate

1. Overview

An estate is an artificial entity that comes into being as the result of the death of an individual and consists of the property that the decedent owns upon his or her death. An estate for Pennsylvania purposes does not include the estates of living incompetents, bankrupts or insolvents.

2. Resident Estate

Pursuant to 72 PA C.S. Section 7301(r) a resident estate means the estate of a decedent who at the time of his death was a resident individual in Pennsylvania. The single controlling factor in determining if an estate is a resident estate shall be whether the decedent was a Pennsylvania resident individual at the time of his death. *See* 61 PA Code Section 101.1. The residences of the fiduciary and the beneficiaries of the estate are immaterial. *See* 61 PA Code Section 101.1.

3. Nonresident Estate

Pursuant to 72 PA C.S. Section 7301(n) a nonresident estate means any decedent's estate that is not a resident estate of Pennsylvania.

C. Trust and Settlor

1. Overview

For Pennsylvania personal income tax purposes, a trust includes a taxable trust created by a will and any taxable irrevocable express trust taking effect during the lifetime or after the death of the settlor.

A trust for Pennsylvania personal income tax purposes does not include:

a. A settlor-revocable trust (*see* grantor trusts and settlor-revocable trusts on the pages following)

b. A charitable trust (*see* charitable trust on the pages following)

c. A resulting or constructive trust created by operation of law

d. A trust created exclusively for the benefit of creditors

e. A principal and agent relationship

f. A business trust or real estate investment trust

g. A trust created exclusively for the benefit of employees, their families, or appointees under an employee benefit plan

h. A pension trust or profit-sharing trust

i. A trust that is a common trust fund for federal income tax purposes

j. A trust created by an entity or enterprise other than a Pennsylvania personal income tax taxpayer:

- No part of the income or corpus of which may possibly benefit any beneficiary who is a Pennsylvania personal income tax taxpayer; and

- No part of the property of which consists of property transferred to it (or another trust) by any Pennsylvania personal income tax taxpayer.

A Pennsylvania personal income tax taxpayer means any individual, estate, trust, partnership or PA S corporation.

k. A trust for the benefit of corporate shareholders established to complete the liquidation of a corporation (*see* liquidating trusts on the pages following).

l. Qualified settlement funds and other trusts that are treated as corporations or partnerships for federal income tax purposes.

m. Nuclear power plant decommissioning trusts (*see* nuclear power plant decommissioning trust below).

n. Pre-need funeral trusts or cemetery merchandise trusts (*see* funeral trusts or cemetery merchandise trusts on the pages following).

2. Resident Trust

A resident trust is any of the following:

a. Its settlor (or any of its settlors) was a Pennsylvania resident at the time the trust was created; or

b. All through its taxable year, it consists in whole or in part of real or personal property transferred to it or to another trust by a settlor or other individual, estate or trust that at the time of the transfer was a Pennsylvania resident; or

c. It was created by the will of a decedent who, at the time of his death, was a Pennsylvania resident.

The regulations under 61 PA Code Section 101.1 provide that the single controlling factor in determining if a trust is a resident trust for Pennsylvania purposes is whether the decedent, the person creating the trust, or the person transferring the property was a Pennsylvania resident individual or person at the time of death, creation of the trust, or the transfer of the property. The residences of the fiduciary and the beneficiaries of the trust are immaterial.

3. Nonresident Trust

A nonresident trust must satisfy both of the following conditions:

a. Its settlor (or each of its settlors) was a nonresident of Pennsylvania at the time the trust was created or it was created by the will of a decedent who at the time of his death was a nonresident; and

b. For *any* portion of the taxable year, it consists in no part of real or personal property transferred to it or to another trust by a settlor or other individual, estate or trust that at the time of the transfer was a Pennsylvania resident.

D. Charitable Trust

A charitable trust is one operated **exclusively** for religious, charitable, scientific, literary, or educational purposes. A trust is a charitable trust only if all of the net earnings for the taxable year and remaining life of the trust are for distribution for such purposes. No part of the earnings of a charitable trust may benefit any beneficiary who is a private individual.

Federally qualified charitable remainder annuity trusts (CRAT) and charitable remainder unitrusts (CRUT) are **not** Pennsylvania charitable trusts if, during the current taxable year:

1. Any part of the trust's retained earnings may benefit any private individual in subsequent years; or

2. Any part of the trust's income is required to be currently distributed or is distributed or credited to any private individual.

Trusts for the general care, maintenance, or improvement of public or church cemeteries are charitable trusts. However trusts for the care, maintenance or improvement of the burial lots of the settlor, testator or his or her family are not charitable trusts.

E. Grantor Trusts and Revocable Trusts

Pennsylvania law differs from federal law regarding grantor trusts. For federal purposes, under certain conditions, the grantor or person who has substantial dominion or control over the trust income or *corpus*, rather than the trust or its beneficiaries, reports the income.

Grantor trusts other than settlor-revocable trusts are required to file the *PA-41, Fiduciary Income Tax Return*. The beneficiaries of the trust are taxed on income required to be distributed currently or actually distributed or credited to them. The grantor trust is taxable on the remainder.

These federal rules are inapplicable for Pennsylvania fiduciary income tax purposes. Pennsylvania law imposes the fiduciary income tax on grantor trusts according to the same Pennsylvania personal income tax rules that apply to irrevocable trusts unless the grantor trust is a revocable trust.

A Settlor-Revocable Trust is:

1. A tentative or *Totten* trust; or

2. An express trust when the governing instrument reserves in the settlor:

   a. The power to revoke the trust as an entirety without the declaration of new uses or the consent of any other party; and

   b. The concurrent power to revest in himself or herself legal title to the *corpus* of the trust without the consent of any other party.

A taxpayer (settlor) that establishes a revocable trust does not file a *PA-41 Fiduciary Income Tax Return*. In this case, the taxpayer reports the income (loss) in the appropriate income class or classes on his, her or its own *PA-40 Individual Income Tax Return*.

The term settlor includes either of the following:

a. An individual, estate or trust that is possessed of the legal title to an asset who creates a trust either by a declaration that such individual, estate or trust holds the asset in trust or by a transfer of the legal title thereto to a trustee expressly upon a trust.

b. An individual, estate or trust that furnishes the consideration for the creation of a trust, even though in form the trust is created by another.

The term does not include any individual, estate or trust that merely transfers assets to an existing trust created and funded by another.

II. DECEDENT'S LAST INCOME TAX RETURN

A. Filing the Final Return

The decedent's final *PA-40, Individual Income Tax Return,* covers the tax year ending with the date of his or her death. The tax return for an individual who died during the tax year must be filed as deceased by the executor, administrator, or other person charged with caring for the decedent's property. Any return filed for a deceased individual must show the date of death on the appropriate line.

The personal representative must file a Pennsylvania tax return for a decedent if:

1. The decedent received total Pennsylvania gross taxable income in excess of $33 during the year of death, even if no tax is due with his or her Pennsylvania return; and/or

2. The decedent incurred a loss from any transaction as an individual, sole proprietor, partner in a partnership, PA S corporation shareholder, or association member.

The personal representative must file two income tax returns when an individual dies after the close of the tax year but before the return for that year is filed. The personal representative must file the return for the year before death and the final return for the year in which death occurred. The return for the year before death is considered a regular return.

B. No Joint Returns with Surviving Spouse

Joint returns between a surviving spouse and a deceased spouse are not permitted. If the deceased was married at the time of death, the surviving spouse must file a separate return as "single" unless he or she remarries before the end of the taxable year.

Jointly owned income, such as interest, must be properly allocated between the decedent and the survivor from the beginning of the tax year to date of death. After the date of death all taxable income derived from jointly held property is attributed to the surviving owner.

C. Signing the Final Income Tax Return

The tax return for an individual who died during the tax year must be signed by the executor, administrator, or other person charged with caring for the decedent's property as representative of the estate of the decedent, *i.e.*, Jane Doe, Executrix of the Estate of John Smith, Deceased.

D. Due Date of Return

If the decedent was a calendar-year filer, the final return must be filed before midnight on April 15 including an extension date of Sept. 15 in the year following the decedent's death. If the decedent was a fiscal-year filer, the final return is due on or before the 15th day of the fourth month including an extension date of five months after the 15th day of the fourth month following the close of the decedent's fiscal year. The U.S. Postal Service postmark date on the envelope is proof of timely filing. If you do not file your return by the due date or extended due date and do not pay the tax due by the original due date, the department imposes late filing and underpayment penalties.

E. Amounts Taxable to Decedent, Estate or Survivors

1. Federal Rules for Income in Respect of Decedent Not Controlling

Pennsylvania has no rule similar to that for federal income tax purposes that governs income in respect of a decedent.

2. Amounts Taxable to Decedent

Assuming the decedent used the cash basis of accounting before his death, his or her final return would include only income actually or constructively received through the date of death, plus:

a. His or her distributive share of PA S corporation income calculated by multiplying the daily amount of each class of income by the percentage of stock owned by the shareholder on each day of the corporation's taxable year that he was living;

b. His or her distributive share of partnership income determined as of the date of death.

3. Amounts Taxable to Estate or Survivor

Any item of income or deduction that would have been reportable on the last return if the taxpayer had personally used the accrual method of accounting that is not reportable or deductible thereon using the cash basis method is taxable to, or deductible by, **neither** the decedent **nor** his estate, heirs or beneficiaries. For example, taxpayer earned a bonus as of December 31 payable on April 15, but taxpayer died on March 15. This income would not be taxable anywhere.

4. Installment Obligations Acquired from Decedent

A beneficiary that receives an unrealized installment obligation from a decedent uses the same gross profit percentage that was used by the decedent in order to arrive at the portion of each collection that represents taxable income. For example, a beneficiary may take into account business expenses incurred by the decedent before death.

F. Life Insurance Proceeds are Not Subject to Tax

The proceeds of life insurance that are received under a life insurance contract or policy and are paid by reason of the death of the insured are generally excluded from income.

III. INCOME TAX RETURN OF AN ESTATE OR TRUST

A. FILING THE INCOME TAX RETURN FOR AN ESTATE OR TRUST

An executor or administrator must file a *PA-41 Fiduciary Income Tax Return* if he or she is a fiduciary of a:

1. Resident estate or trust that received taxable income during its taxable year.

2. Nonresident estate or trust that received taxable income allocable to Pennsylvania during its taxable year.

If the department requests, the fiduciary of an estate or trust must file a copy of the will or trust instrument (including amendments), a written declaration under the penalties of perjury that the instrument is a true and complete copy, and a statement indicating which provisions, in the fiduciary's opinion, determine the extent of taxable income to the estate or trust or the beneficiaries.

B. Mailing Instructions

If there is tax due on Line 18 of the *PA-41, Fiduciary Income Tax Return*, mail the return, check and *PA-V Payment Voucher* to:

PENNSYLVANIA DEPARTMENT OF REVENUE
BUREAU OF IMAGING AND DOCUMENT MANAGEMENT
PO BOX 280413
HARRISBURG, PA 17128-0413

If there is an Overpayment on Line 21 of the *PA-41, Fiduciary Income Tax Return*, mail the return to:

PENNSYLVANIA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280505
HARRISBURG, PA 17128-0505

If there is No Tax Due or Overpayment, mail the *PA-41, Fiduciary Income Tax Return* to:

PENNSYLVANIA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280506
HARRISBURG, PA 17128-0506

If you do not have a PA-V, make your check or money order payable to: PA Dept. of Revenue. On the check or money order:

1. Print the estate's or trust's FEIN followed by "F";
2. "2012 PA-41"; and
3. Daytime telephone number of the estate's or trust's representative.

Note. For other forms of payment and for instructions on how to complete the PA-V, go to the PA-41 instructions on the department's website.

C. Due Date for Return

The *PA-41 Fiduciary Income Tax Return* for estates and trusts must be filed by the last date prescribed for the filing of the estate or trust's federal Form 1041 U.S. Income Tax Return for Estates and Trusts (determined without regard to extensions). The U.S. Postal Service postmark date on the envelope is proof of timely filing. A late filing of the fiduciary income tax return can result in penalty and interest fees.

D. Extension of Time to File

1. How To File

The estate or trust must submit *REV-276, Application for Extension of Time to File*, with its *PA-41, Fiduciary Income Tax Return*. Obtain REV-276 from one of the forms ordering services and follow the instructions on the Pennsylvania extension form. An extension cannot exceed five months, unless the fiduciary is outside the U.S.

If the fiduciary expects the estate or trust to owe tax, the fiduciary must submit *REV-276, Application for Extension of Time to File*, and pay the tax due in sufficient time before the due date so that the department may consider and act upon it. The department will not send a letter granting the extension, but will write if there is a question concerning the request.

Estates and trusts may obtain an automatic five-month extension to file their federal Forms 1041. A corresponding automatic five-month extension is also allowed for filing the *PA-41, Fiduciary Income Tax Return* provided a copy of federal Form 7004, filed with the IRS, is filed with the *PA-41, Fiduciary Income Tax Return* and the federal extension is not terminated by the IRS.

Important. An extension of time to file does not extend the time to pay the fiduciary income tax due. An estate's or trust's automatic extension does not extend the beneficiary's return due date.

2. Period of Extension

The department will not grant an estate or trust an extension of time to file the *PA-41, Fiduciary Income Tax Return* for longer than five months regardless of the extension time granted for the federal return. Only taxpayers living outside the U.S. may obtain an extension period greater than five months.

3. Extension Due Date

For a calendar-year filer, the extension due date for the *PA-41, Fiduciary Income Tax Return* is September 15.

For a fiscal-year filer, the extension due date for the *PA-41, Fiduciary Income Tax Return* is five months after the original due date.

4. Tax Due

An extension of time to file a *PA-41, Fiduciary Income Tax Return* does not extend the time for full payment of the tax, nor does it preclude the assessment of penalty and interest for underpayment of the tax due. Pay in full the amount reasonably estimated as your Pennsylvania tax due on or before the original due date.

Remittance should be made payable to the PA Dept. of Revenue and submitted with *REV-276, Application for Extension of Time to File* on or before the original due date of the *PA-41, Fiduciary Income Tax Return* for calendar year filers and the 15th day of the fourth month following the close of the fiscal year for fiscal year filers.

Print the estate's or trust's federal employer identification number on the check or money order made payable to the PA Dept. of Revenue and submit with *REV-276, Application for Extension of Time to File*.

Mail REV-276 and payment, if applicable, to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280504
HARRISBURG PA 17128-0504

Note. If you pay by credit card or ACH debit on or before April 15, you can get an automatic four-month extension without mailing a REV-276. On the Internet, go to www.revenue.state.pa.us and link to the E-Services Center or call, toll free, 1-888-PATAXES (1-888-728-2938).

5. Combat Zone and Hazardous Duty Service

If serving in an area so designated by the President of the U.S., Pennsylvania allows the same automatic extensions of time to file your *PA-41 Fiduciary Income Tax Return* and pay your Pennsylvania tax that the IRS provides for your federal income tax return. The automatic extension of time to file the *PA-41 Fiduciary Income Tax Return* is five months regardless of the amount of time for a federal extension. If using software or paying a preparer to file your *PA-41 Fiduciary Income Tax Return*, please print "COMBAT ZONE" at the top of your PA-41 or computer-generated PA-41 tax return. Copies of your orders and discharge papers must accompany your *PA-41 Fiduciary Income Tax Return*.
If filing an electronic return through Fed/State e-file, if filing by telephone using PA TeleFile, or if filing over the Internet using padirectfile, you must fax or mail copies of your orders and discharge papers. Print "COMBAT ZONE" at the top of each page.

6. Refund Filing Limitations

An extension granted by the department pursuant to *REV-276, Application for Extension of Time to File,* does not extend the time for filing an amended return to obtain a refund. An amended return may be filed within three years from the statutory due date (determined without regard to extension).

Also, an automatic extension of time to file the PA-41 Fiduciary Income Tax Return that is granted when an extension has been granted by the IRS for filing the federal tax return, does not extend the time for filing an amended return. An amended return must be filed within three years from the date the original return was due (determined without regard to extension) to obtain a refund.

E. Penalties for Not Filing or Late Filing

The department will assess an underpayment penalty if:

1. The estate or trust does not pay at least 90 percent of the tax due by the due date for the return; and

2. The estate or trust does not pay the remaining tax with a timely filed *PA-41 Fiduciary Income Tax Return*.

The department will charge interest on the amount not paid by the due date for the return.

If the estate or trust does not complete a timely filing of its *PA-41 Fiduciary Income Tax Return*, Pennsylvania law imposes a penalty unless the estate or trust can show reasonable cause for late filing. The penalty is five percent for each month or fraction of a month that the *PA-41, Fiduciary Income Tax Return* is late. The maximum penalty is 25 percent. The minimum penalty is five dollars. Any estate or trust that attempts to evade or defeat their Pennsylvania fiduciary income tax responsibility is subject to prosecution.

If the estate or trust does not pay its tax by the due date, Pennsylvania law imposes interest from the due date to the date of payment. The annual interest rate is the rate established by the U.S. Secretary of the Treasury that is in effect on January 1 of each calendar year.

Pennsylvania law also imposes:

1. A five percent underpayment penalty if the estate or trust does not pay the full amount of its tax due by the original due date.

2. An additional penalty of 25 percent of the tax due on the unreported income if the estate or trust does not report an amount of taxable income that is more than 25 percent of the taxable income that it reported on the *PA-41, Fiduciary Income Tax Return*.

The department will charge these penalties if the underpayment of tax is due to negligence or intentional disregard of rules and regulations but without intent to defraud.

The department may assess both late filing and underpayment penalties if the fiduciary files the *PA-41, Fiduciary Income Tax Return* after the due date or extended due date and does not pay the tax due by the original due date.

Pennsylvania law also may impose:

1. An additional 50 percent of the tax underpayment to the total amount due if any part of the underpayment is due to fraud.

2. A $500 penalty if the estate or trust:

   a. Files a return that does not contain sufficient information on which to determine its correct liability; and

   b. Files a return that contains information that indicates the liability is significantly incorrect; and

   c. Files a return frivolously or in a manner to delay or impede the administration of the tax law.

A penalty of $50 for each instance when any person required to furnish a *PA-41 Fiduciary Income Tax Return* either furnishes a false or fraudulent PA-41 Schedule L (for tax years prior to Jan. 1, 2005) and a *PA-41 Schedule RK-1 or PA-41 Schedule NRK-1* (for tax years on or after Jan. 1, 2005) to a beneficiary or fails to furnish a *PA-41 Schedule RK-1 or PA-41 Schedule NRK-1* to a beneficiary.[1]

F. Separate Return for Each Estate or Trust

A trustee of two or more trusts must make a separate return for each trust even though the trusts were created by the same individual for the same beneficiaries.

G. Throwback Rules Do Not Apply

Throwback rules that apply under federal law do not apply under Pennsylvania personal income tax.

H. Calculation of Taxable Income - Overview

The taxable income of an estate or irrevocable trust is the current income that it retains for future distribution or disbursement or currently applies to discharge, satisfy, or reduce any person's or its own obligations.

[1] Beginning on or after Jan. 1, 2005, the department eliminated PA-41 Schedule L, Beneficiaries Share of Income and replaced it with PA-41 Schedule RK-1, Resident Schedule of PA S Shareholder/Partner/Beneficiary Pass Through Income, Loss and Credits and with PA-41 Schedule NRK-1, Nonresident Schedule of PA S Shareholder/Partner/Beneficiary Pass Through Income, Loss and Credits.

Each estate or irrevocable trust must classify and report all income and gain (loss) realized in the appropriate Pennsylvania income classes. Estates or trusts cannot offset income in one Pennsylvania income class with a loss in any other Pennsylvania income class. Estates or trusts cannot carry income or loss back or forward to other tax years. Attach the appropriate completed schedule for the income and gain (loss) reported.

The estate or trust must also submit with its *PA-41 Fiduciary Income Tax Return* a *PA-41 Schedule RK-1 or PA-41 Schedule NRK-1* showing all of the distributions to each of its beneficiaries.

The estate or trust must also provide each beneficiary that is an individual, estate, trust, partnership, PA S corporation or disregarded entity with a with a *PA-41 Schedule RK-1 or PA-41 Schedule NRK-1* showing the beneficiary's share of Pennsylvania income that the estate or trust under its governing instrument and applicable state law distributed (or must distribute), credited, or paid to each beneficiary. Each beneficiary reports the Pennsylvania-taxable income from *PA-41 Schedule RK-1 or PA-41 Schedule NRK-1* when filing his or her or its Pennsylvania tax return.

An estate (and its beneficiaries) and an irrevocable trust (and its beneficiaries) are not subject to tax on income that is set-aside exclusively for charitable purposes.

For fiduciary income tax purposes, no distinction is made between grantor trusts and irrevocable trusts. Each must file a *PA-41 Fiduciary Income Tax Return* and pay Pennsylvania personal income tax on any of its income or gains that it does not actually distribute to beneficiaries and which is not required to be distributed currently. So-called grantor trusts are not recognized because Pennsylvania does not have legislation similar to federal law. Conversely, for Pennsylvania personal income tax purposes, a revocable trust is not subject to tax or reporting requirements.

Pennsylvania law also differs from federal law in that trust income is reportable by beneficiaries as net income or gain derived through estates or trusts.

I. Pennsylvania Resident Estates or Trusts

Pennsylvania taxes the income of a resident estate or trust from sources both inside and outside Pennsylvania. A resident estate or trust may claim a resident credit, if it is subject to and pays income tax to another state or country on income taxable in the same taxable year to both Pennsylvania and the other state or country. This credit cannot exceed the amount of Pennsylvania tax the estate or trust owes. To claim the resident credit, the estate or trust must submit a complete *PA-40 Schedule G-L Resident Credit for Taxes Paid* or *PA-40 Schedule G-S*. The credit cannot be assigned or passed through to beneficiaries.

J. Nonresident Estates or Trusts or Nonresident Beneficiaries

Pennsylvania law imposes fiduciary income tax on the income of a nonresident estate or trust from Pennsylvania sources. A nonresident estate or trust must ignore items of income, loss, cost, expense and liability that are not directly related to Pennsylvania when calculating its Pennsylvania-taxable income.

The taxable income of a nonresident beneficiary from a resident or nonresident estate or irrevocable trust is the taxable income received by the estate or trust for its taxable year that:

1. Under the governing instrument and applicable state law, the estate or trust distributed, or must distribute currently, credited, or paid to the beneficiary; and

2. Is Pennsylvania-source income.

K. Estate or Trust is Member of PA S Corporation or Partnership

If the estate or trust is a member of a partnership or a shareholder in a PA S corporation, it must report its share of the income (loss), whether distributed or not, in the same class in which the partnership or PA S corporation received the income. Each resident estate or trust must submit PA-41 Schedule L (for tax years prior to Jan. 1, 2005) and *PA-41 Schedule RK-1* (for tax years on or after Jan. 1, 2005) from the partnership or PA S Corporation. Each nonresident estate or trust must submit *PA-41 Schedule NRK-1* from the partnership or PA S corporation. [1]

L. Costs and Expenses

A fiduciary may deduct only the ordinary, necessary and reasonable costs and expenses directly incurred in realizing income (loss) from:

1. The operation of a business or farm;

2. The sale, exchange or other disposition of property; and

3. The receipt of rental or royalty income.

Such expenses are deductible in determining the amount of net profits, net gains and net rental, royalty, patent and copyright income.

A fiduciary may not deduct:

1. Expenses and fees related to administering the estate or trust;

[1] Beginning on or after to Jan, 1, 2005, the department eliminated PA-41 Schedule L, Beneficiaries Share of Income and replaced it with PA-41 Schedule RK-1, Resident Schedule of PA S Shareholder/Partner/Beneficiary Pass through Income, Loss and Credits and with PA-41 Schedule NRK-1, Nonresident Schedule of PA S Shareholder/Partner/Beneficiary Pass through Income, Loss, and Credits.

2. Costs and expenses attributable to earning or receiving interest or dividend income or managing securities holdings of the estate or trust;

3. Costs and expenses attributable to receiving income from other estates or trusts;

4. Inheritance, succession, estate or gift taxes or taxes based on income;

5. Funeral expenses;

6. Expenses for preservation or maintenance of non-income-producing property;

7. Expenses related to exempt income;

8. Satisfaction of personal debts of the decedent.

M. PA-40 Schedule DD

The IRC creates a distinction between simple trusts and complex trusts. Under the federal income tax, the income of a simple trust is taxed to its beneficiaries, whether or not distributions of current income are in fact made. This treatment is not feasible under the personal income tax because:

1. The personal income tax has no provisions comparable to IRC §§ 651 and 652;

2. A simple trust's total taxable income (line 7, *PA-41, Fiduciary Income Tax Return*) and net income (in the trust accounting sense) are seldom the same because they usually have items of gross income that are gross taxable or excludible from tax and nondeductible expenses; and

3. Simple trusts often have items of gross income that are not allocable to Pennsylvania.

As a consequence, estates, simple and complex trusts, and their beneficiaries are all taxed under the same rules.

PA-40 Schedule DD Distribution Deduction Schedule is designed to calculate how much of the income or gain received by the estate or trust is taxable to the estate or trust and how much of the income or gain is deductible because it is distributed or distributable to beneficiaries. The deduction for distributions to beneficiaries, however, is determined by reference not only to an estate or trust's distributable net income but also to its distributable net income from sources within Pennsylvania.

In determining the distribution deduction, the specific provisions of the governing instrument are controlling if it specifically provides the amounts of income (in the trust accounting sense) and source from which amounts are to be distributed, permanently set aside or used. However, usually the amounts and sources are not specified. In this instance, the applicable distributable net income of the estate or trust sets the limit on the deduction for distributions to beneficiaries. It also usually limits the amount of the distribution taxable to the beneficiary.

Provisions of a governing instrument that depart fundamentally from concepts of local law and primarily serve a tax avoidance purpose shall be disregarded.

PA-40 Schedule DD also is used to report how much of the taxable income or gain that would be taxable to the trust was set permanently aside for charitable purposes and is, therefore, exempt from tax.

No deduction is allowed for any amount paid or credited as a gift or bequest of specific property or of a specific sum of money if the beneficiary is not taxable on the amount under Section P – Distributions to Beneficiaries.

N. Special Rules

Determine all of the following under the terms of the governing instrument and the laws applicable to the administration of estates or trusts:

1. Whether an item of receipt or expense is allocable to *corpus* or income; and

2. What part, if any, of the undistributed net income of a trust (for administrative purposes) is required to be added to *corpus*; and

3. Whether property distributed in-kind is distributed as a gift or bequest of specific property; and

4. Whether an amount is properly paid out of *corpus* as a gift or bequest of a specific amount of money; and

5. Whether payment of a distribution is directed without reference to the existence or absence of income; and

6. Whether the estate or trust must distribute an amount, and whether it pays such amount out of income or *corpus*, or it may pay such amount out of either income or *corpus*.

The specific provisions of the governing instrument are controlling when it specifically provides the source from which amounts are to be permanently set aside or used. In determining whether an amount is set aside or used for a purpose includes particular items of income received by an estate or trust in the absence of specific provisions in the governing instrument, the amount shall be deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes.

In determining whether income derived from a partnership, PA S corporation, estate or trust is required to be distributed currently or is distributed or credited to a beneficiary, the excess of the Pennsylvania-taxable income derived through such partnership, PA S corporation, estate or trust over the amount of distributions or withdrawals there from shall be considered to be income that is required to be retained, accumulated or set aside.

Amounts disbursed to pay taxes measured by the income for another taxable period may not be treated as set aside from current income.

Amounts disbursed to pay nondeductible trustee commissions, legal and accounting expenses and other current expenses that do not reduce the amount of taxable or nontaxable income or gain of the trust for the taxable year shall be treated as nontaxable income or gain for the taxable year which is required to be accumulated, retained, or set aside, if total distributions for the year do not equal or exceed the excess of total taxable and nontaxable income received by the trust for the taxable year over total taxable and nontaxable income received by the trust or estate for the taxable year which is required to be accumulated, retained, or set aside for future distribution. If total distributions for the year do equal or exceed the excess of total taxable and nontaxable income received by the trust for the taxable year over total taxable and nontaxable income received by the trust or estate for the taxable year which is required to be accumulated, retained, or set aside for future distribution, the amounts shall be treated as distributions by the trust or estate and beneficiaries.

Generally, if a resident trust consists in part of intangible investment property, such as stock or securities, or tangible investment property, such as real estate located outside Pennsylvania transferred to it by a person who at the time of the transfer was a nonresident, then the trust must make adjustments to arrive at the correct Pennsylvania-taxable income. All items of income, gain, loss or deduction in respect of such property shall be reduced in the same proportion as the trust’s net Pennsylvania-taxable income bears to the trust’s total taxable income.

If the income or gain is required to be distributed currently, however, there is no reduction; and if the trust is required under applicable law or its governing instrument to retain such income or gain, such items shall be wholly disregarded.

An amount properly paid or credited to the beneficiary within the first 65 days of any taxable year of an estate or trust shall be considered paid or credited to the beneficiary on the last day of the preceding taxable year if the fiduciary of the estate or trust elects to so treat such payments. The election shall be made in a statement attached to the return for the first taxable year of the trust. Any election so made shall be irrevocable for the taxable year and for all subsequent taxable years.

O. Income Taxable to Estate or Trust

The income or gains of the estate or trust, if any, taxable to such estate or trust shall consist of the income or gains received by it that was not required to be distributed currently and has not been distributed or credited to its beneficiaries. *See* PA C.S. § 7305.

P. Distributions to Beneficiaries

1. Specific Bequests of Cash or Property

A beneficiary is not taxable on any amount paid or credited as a gift or bequest of specific property or of a specific sum of money if:

a. The will or trust instrument provides for the gift or bequest,

b. The money or property is ascertainable under the terms of the will as of the decedent's death or ascertainable under the terms of an irrevocable *inter vivos* trust instruction as of the date of the trust's inception, and

c. No part of the payment or credit is paid from the current or accumulated income (in the trust accounting sense) of the trust.

None of the following constitute a specific bequest:

a. A distribution of the income earned by a specific bequest of property or a distribution with respect to an intestate estate:

b. Mandatory or discretionary distributions of current or accumulated income;

c. Annuity payments; and

d. The final required trust distribution of the remaining *corpus* as it then exists.

The income of a beneficiary of an estate or trust in respect of such estate or trust shall consist of that part of the income or gains received by the estate or trust for its taxable year ending within or with the beneficiary's taxable year which, under the governing instrument and applicable State law, is required to be distributed currently or is in fact paid or credited to said beneficiary.

This means that income received by the trust or estate on its assets which is currently distributable or, in fact, is paid or credited to a beneficiary of the trust or estate is taxable to the beneficiary. If the taxpayer is a beneficiary of one or more trusts or estates, PA-40 Schedule J must be completed to report the estate or trust income.

The beneficiary should have received a PA-41 Schedule L (for tax years prior to Jan. 1, 2005) and a *PA-41 Schedule RK-1 or PA-41 Schedule NRK-1* (for tax years on or after

Jan. 1, 2005) indicating the taxable amount of estate or trust income. If the estate or trust did not file a Pennsylvania return and did not provide and a *PA-41 Schedule RK-1 or PA-41 Schedule NRK-1*, the taxpayer must report the amount shown on the federal Schedule K-1 adjusted to reflect Pennsylvania requirements and attach a statement explaining each adjustment.[1]

If the beneficiary is a nonresident, then estate(s) or trust(s) income which is taxable to Pennsylvania includes net income (loss) from the operation of a business, profession or farm, net gain (loss) from the sale, exchange or disposition of property, and net income (loss) from rents, royalties, patents and copyrights from Pennsylvania sources. It does not include investment interest, dividends or income not from Pennsylvania sources.

Q. Filing Amended Returns

1. Amended Return or Federal Change

If after filing the *PA-41, Fiduciary Income Tax Return*, an estate or trust discovers that an incorrect return has been submitted to the department and/or federal Form 1041 has been amended or if the Internal Revenue Service changes or corrects any item of income, gain (loss) previously reported, the estate or trust must submit an amended *PA-41, Fiduciary Income Tax Return* within 30 days to the Pennsylvania Department of Revenue.

In addition, Schedule PA-41X and amended PA-41 Schedules RK-1 and/or NRK-1 must be submitted.

Important. The PA-41, Fiduciary Income Tax Return cannot be amended through Fed/State e-file.

2. Amending the PA-41, Fiduciary Income Tax Return

Beginning with tax year 2011, to amend your original *PA-41, Fiduciary Income Tax Return* use a PA-41 Fiduciary Income Tax Return and Schedule PA-41X for the tax year that is to be amended and fill in the “Amended PA-41” oval at the top of the tax return and follow these steps.

a. Complete Schedule PA-41X.

b. Enter the amended amounts from Schedule PA-41X per the PA-41X instructions.

c. Calculate Line 8, Deductions from PA Schedule DD, distributed to each beneficiary and complete amended PA-41 Schedules RK-1 and NRK-1.

[1] Beginning on or after to Jan, 1, 2005, the department eliminated PA-41 Schedule L, Beneficiaries Share of Income and replaced it with PA-41 Schedule RK-1, Resident Schedule of PA S Shareholder/Partner/Beneficiary Pass through Income, Loss and Credits and with PA-41 Schedule NRK-1, Nonresident Schedule of PA S Shareholder/Partner/Beneficiary Pass through Income, Loss, and Credits.

d. Calculate Line 9, Net PA-Taxable Income.

e. Calculate Line 10, Total PA Tax Liability.

f. Calculate Line 16, 2011 Payments and Credits.

g. Calculate Line 18, Tax Due.

h. Complete Line 19 to report any adjusted penalty and interest to be included on the return.

i. Do not complete Lines 20 and 21. The department's tax system is programed to properly calculate your amended total payment or overpayment.

j. Complete Lines 22 and 23 to notify the department how to disperse your overpayment.

The department will take the original refund or payment into account when reviewing the amended *PA-41, Fiduciary Income Tax Return*.

Be sure to sign the amended return and mail the amended return with all explanations and attachments. *See* Mailing Instructions.

Note. Do not send a copy of the original *PA-41, Fiduciary Income Tax Return* with the amended *PA-41, Fiduciary Income Tax Return*.

Do not file an amended *PA-41, Fiduciary Income Tax Return* after the department issues an assessment if the amendment relates to the same taxable year and assessed item of income, gain, deduction, or loss. In this instance, you either file a timely petition for reassessment or pay the assessment and file a timely petition for a refund.

R. Record Retention

All amounts reported on the *PA-41, Fiduciary Income Tax Return* and accompanying schedules are subject to verification and audit by the department. The fiduciary must retain books and records for at least seven years after filing to verify any information reported on the *PA-41, Fiduciary Income Tax Return*. If the estate or trust has an investment in a partnership or S corporation, it must retain indefinitely all tax returns and schedules RK-1 and/or NRK-1 to substantiate its basis.

S. Charitable Trusts – Special Rules

A charitable remainder or charitable income trust is not a charitable trust for Pennsylvania purposes since the earnings may inure to the benefit of a private individual. All income earned by the trust, whether or not distributed, is taxable as income from an estate or trust to the beneficiary's *PA-40, Individual Income Tax*

Return. If it is necessary to invade the *corpus* of the trust to meet the obligation to pay the grantor, that portion of the distribution attributable to the *corpus* is not subject to tax.

IV. CONVERSION OF A RESIDENT TRUST INTO A NONRESIDENT TRUST

A resident *inter vivos* trust or a testamentary trust can become a nonresident trust if **all** of the following conditions are met:

A. The assets of the trust currently consist in no part of:

1. Real property or tangible personal property located within Pennsylvania;

2. stock, securities or intangible personal property, evidenced by documents, certificates or other instruments that are physically located, or have a business *situs*, within Pennsylvania;

B. The trust is taxable as a resident trust elsewhere for the period in question;

C. The trust has no resident fiduciary, beneficiary, or remainderman;

D. All administration, accounting, bookkeeping, sales, and purchases currently take place outside Pennsylvania;

E. The settlor is no longer a resident of Pennsylvania or died a nonresident of Pennsylvania; and

F. The settlor is not a resident at the times when, during his or her lifetime:

1. An application is made to a court concerning the trust; or

2. He, she, or another might have exercised a reserved power of revocation; and

3. Both of the following apply:

   a. A Pennsylvania court having jurisdiction over the trust has directed that the *situs* of the trust be changed to a place outside Pennsylvania, and

   b. The courts of such place have assumed jurisdiction to:

      - Adjudicate disputes involving the trust; or

      - Order accountings to protect the trust *corpus*, beneficiaries and remaindermen.

Pennsylvania law imposes the fiduciary income tax on the income of a nonresident estate or trust from Pennsylvania sources. A nonresident estate or trust must ignore items of income, loss, cost, expense and liability that are not directly related to Pennsylvania when computing its Pennsylvania-taxable income.

V. INCOME TAX RETURNS OF BENEFICIARIES

A. Taxation of Beneficiaries of Estates and Trusts

Income received by the estate or trust on its assets that is currently distributable or, in fact, is paid or credited to a beneficiary of the estate or trust is taxable to the beneficiary. *See* 72 PA C.S. § 7305. If the taxpayer is a beneficiary of one or more estates or trusts, *PA-40 Schedule J* must be completed to report the estate or trust income. The beneficiary transfers the applicable Pennsylvania-taxable income amounts to their *PA-40 Schedules J* that they submit with their *PA-40, Individual Income Tax Return*.

Each estate or taxable trust must classify and report all income, gains and losses realized in the appropriate Pennsylvania income classes.

The estate or trust must also submit PA-41 Schedules RK-1 for resident individual beneficiaries and PA-41 Schedules NRK-1 for nonresident individual beneficiaries with the estate or trust's *PA-41, Fiduciary Income Tax Return*.

If the beneficiary is an entity such as a partnership, PA S corporation, another estate or trust, the estate or trust completing the *PA-41, Fiduciary Income Tax Return*, must provide the entity with both a PA-41 Schedule RK-1 and NRK-1 showing the entity beneficiary's share of taxable income.

The PA-41 Schedules RK-1 and NRK-1 show all of the distributions to each of its beneficiaries. The estate or trust must provide each beneficiary with a personalized PA-41 Schedule RK-1 and/or NRK-1, showing that beneficiary's share of its 2012 Pennsylvania-taxable income.

A taxable trust (and its beneficiaries) and an estate (and its beneficiaries) are not subject to tax on income that is set aside exclusively for charitable purposes. See Charitable Trust.

B. Basis of Property Acquired from Decedent

If property is acquired by a taxpayer by inheritance, the basis shall be the fair market value at the date of death. On subsequent disposition of the property by the beneficiary, the gain (loss) would be equal to the difference between the fair market value at the date of decedent's death and the selling price. *See* PA Code Section 103.13. Property passing to a decedent's estate by reason of the death of the decedent is considered to be acquired by the estate by inheritance.

C. Charitable Trust – Special Rules

A charitable remainder or charitable income trust is not a charitable trust for Pennsylvania purposes since the earnings may inure to the benefit of a private individual. All income earned by the trust, whether or not distributed, is taxable as income from an estate or trust on the beneficiary's *PA-40, Individual Income Tax Return*. If it is necessary to invade the *corpus* of the trust to meet the obligation to pay the grantor, that portion of the distribution attributable to the *corpus* is not subject to tax.

VI. FIDUCIARY DUTIES

A. Fiduciary Must File a Return

The fiduciary of an estate or trust is required under Pennsylvania law to file a *PA-41, Fiduciary Income Tax Return,* and pay the tax on the taxable income of such estate or trust. If two or more fiduciaries are acting jointly, the return may be filed by any one of them. *See* 61 PA Code Section 117.5(a).

B. Fiduciary Can Be Personally Liable

The executor, administrator or trustee remains liable for tax after his or her discharge if he or she had notice of obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed prior to distribution and discharge. *See* Pa. Stat. Ann. 72 § 7331(g); Pa. Code 61 § 117.5. **Further, 61 PA Code Section 117.5(b) provides as follows:**

> Liability for the payment of tax on the taxable income of an estate attaches to the person of the executor or administrator up to and after his discharge if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. The same considerations apply to trusts.

Upon payment of the tax, interest and penalty liability determined to be due, the fiduciary shall be discharged from personal liability except upon proof of fraud, misrepresentation or nondisclosure of a material fact. *See* 61 PA Code Section 119.4.

C. Liability May Follow Assets Distributed to Beneficiaries

Liability for the tax follows estate assets distributed to heirs, devisees, legatees and distributees, who may be required to discharge the amount of the tax due and unpaid to the extent of the assets distributed to them from the estate or trust. The same considerations apply to trusts. *See* 61 PA Code Section 117.5(b).

VII. LIQUIDATING TRUSTS

The income of a trust for the benefit of corporate shareholders established to complete the liquidation of a corporation is taxed to the taxpayer that furnished the consideration for the creation of the trust.

VIII. NUCLEAR POWER PLANT DECOMMISSIONING TRUSTS

The income of a nuclear power plant decommissioning trust is taxed to the taxpayer that furnished the consideration for the creation of the trust.

IX. PRE-NEED FUNERAL TRUSTS OR CEMETERY MERCHANDISE TRUSTS

The income of pre-need funeral trusts or cemetery merchandise trusts (whether or not electing federally qualified funeral trust status) is taxed to the taxpayer that furnished the consideration for the creation of the trust.

Burial fund earnings are taxable income for Pennsylvania residents when the funeral home holds the account in the name of the taxpayer to pay the future funeral expenses of the taxpayer. Irrevocable burial funds are not taxable to the taxpayer. The funeral home reports the income as the custodian of the account on the *PA-41, Fiduciary Income Tax Return*. If the interest earned is income from a standard savings account it is taxable for Pennsylvania purposes.

A funeral trust is a revocable trust that arises from a contract with a person engaged in the business of providing funeral or burial services or property for these services, with the trust assets designated to pay the funeral expenses of the individual for whom the trust is established. The value of assets deposited into a funeral trust is limited to $12,500 in Pennsylvania. The assets cannot be withdrawn for any reason until after the death of the individual for whom the trust was established. Due to the specific limitations in assets to establish withdrawals and uses, funeral trusts are not required to file the *PA-41, Fiduciary Income Tax Return,* for Pennsylvania personal income tax purposes.

X. QUALIFIED SUBCHAPTER S TRUST (QSST)

A qualified subchapter S trust (QSST) is one with respect to which an election is made and that:

A. Owns stock in one or more electing S corporations;

B. Distributes or is required to distribute all of its income to a citizen or resident of the U.S.;

C. Has certain trust terms, including one requiring that there be only one income beneficiary;

D. Does not distribute any portion of the trust *corpus* to anyone other than the current income beneficiary during the income beneficiary’s lifetime, including the time at which the trust terminates; and

E. Has the income interest of the current income beneficiary cease on the earlier of such beneficiary’s death or the termination of the trust.

This trust is eligible to become a shareholder of an S corporation if the current individual income beneficiary of the trust elects to be treated as the owner of the trust for purposes of the Internal Revenue Code.

For federal income tax purposes, the QSST beneficiary is taxed on all items of income, deduction, loss or credit of the QSST.

To qualify as a QSST, the trust instrument must require that:

A. During the life of the current income beneficiary, there shall be only one current income beneficiary of the trust;

B. Any *corpus* distributed during the life of the current income beneficiary shall be distributed only to such beneficiary;

C. The beneficial interest of the current income beneficiary must terminate upon the earlier of that beneficiary's death or the trust termination;

D. Upon the trust's termination during the life of the current income beneficiary, the trust must distribute all of its assets to such beneficiary; and

E. All *trust income* must be distributed currently (at least annually) to only one individual who is a citizen or resident of the U.S. (successive income beneficiaries are permitted, however).

For Pennsylvania personal income tax purposes, the S corporation income will flow through the trust to the income beneficiary. The income shall be reported to the income beneficiary in the same manner as it was reported by the S corporation to the trust. All income shall retain its original classification.

pennsylvania
DEPARTMENT OF REVENUE

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 15: GAMBLING AND LOTTERY WINNINGS

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PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 15: GAMBLING AND LOTTERY WINNINGS

I. CLASS OF INCOME

Gambling and lottery winnings is a separate class of income under Pennsylvania personal income tax law. See 72 PA C.S. §7303(a)(7). Between July 21, 1983 and Dec. 31, 2015, all prizes of the Pennsylvania Lottery were excluded from this class of income. As a result of Act 84 of 2016, cash prizes of the Pennsylvania Lottery that are paid on or after Jan. 1, 2016, are included in this class of income.

II. GAMBLING AND LOTTERY

A. Gambling and Lottery Defined

For Pennsylvania personal income tax (PA PIT) purposes:

1. Lottery is a game comprised of three elements:
   a. A prize to be won;
   b. Consideration; and
   c. The determination of a prizewinner primarily by the drawing of lots and only secondarily by skill and experience.
2. Gambling means a contest comprised of three elements:
   a. A prize to be won;
   b. Consideration; and
   c. The determination of the prizewinner primarily by chance and only secondarily by skill and experience.

B. Prizes – Cash, Noncash and Mixed

Prizes include cash, property or any advantage or inequality in amount or value that is offered in a contest of chance or lottery and accrues, or is expected to be given, to some, but not all, of the participants in such competition or contest. It includes the right or permission to compete in another competition for a prize or to strive for a prize in another contest of chance or the right to a discount.

1. Cash Prize

A cash prize includes any prize paid in cash or cash equivalent (e.g. check, money order, electronic funds transfer or deposit). A cash prize also includes an annuity in which the annuity payments are paid in cash or a cash equivalent.

2. **Noncash Prize**

   A noncash prize is any prize other than a cash prize. It includes real property and personal property (tangible and intangible). A gift card to a specific store is also considered a noncash prize.

3. **Mixed Prize**

   A "mixed prize" is one that consists of both cash and noncash prizes. In some instances, a mixed prize may include the noncash prize plus taxes or fees paid on behalf of the prize winner. Such taxes and fees are considered a cash prize and are subject to Pennsylvania personal income tax as applicable even if the noncash prize may be excluded from tax.

C. Consideration

Consideration in this context means any valuable advantage or benefit that the person conducting a competition, contest of chance or lottery expects to realize as a result of conducting such competition, contest of chance or lottery. The term, therefore, may include, but is not limited to, bets or wagers of cash or property, making a purchase, being present at a drawing, giving a testimonial for a product of the donor of the prize, filling in an application or contest blank, following any rules; or expending time or personal effort. Commw. v. Lane, 242 Pa. Super. 283, 363 A.2d 1271 (1976); Commw. v. Lund, 142 Pa. Super. 208, 15 A.2d 839 (1940); and Commw. v. Laniewski, 173 Pa. Super. 245, 98 A.2d 215 (1953);

D. Gratuitous Prizes

A plan or system for gratuitously distributing money or property by direct gift or by lot or chance does not constitute a lottery or gambling. Money or property distributed under such plans or systems are not taxable gambling or lottery winnings.

E. Door Prizes

Prizes that are given in a competition or contest are not taxable gambling or lottery winnings if no advantage or inequality in amount or value is offered or striven for by any of the participants.

III. TAXABLE WINNINGS

A. In General

For Pennsylvania and federal income tax purposes, winnings or proceeds from wagering transactions are not taxable until, and to the extent all of the following five conditions are satisfied:

a. The amount of the prize is due;

b. The amount of the prize is appropriated on the books of the obligor;

c. The obligor is willing to pay the amount of the prize;

d. The obligor is solvent; and

e. The prizewinner has knowledge of the foregoing facts; or

- The amount of the prize is unconditionally and irrevocably paid into a fund or trust to be used exclusively for the prizewinner's sole benefit; or

- The prize becomes the equivalent of cash in hand because the prize is transferable at a discount not substantially greater than the generally prevailing premium for the use of money; or

- The amount of the prize is actually paid to the prizewinner or the prizewinner's designee.

B. Residents

Pennsylvania taxes resident individuals, estates or trusts on all gambling and lottery winnings from every source, except noncash winnings of the Pennsylvania Lottery, regardless of where the wager is placed.

C. Nonresidents

Pennsylvania taxes nonresident individuals, estates or trusts on gambling and lottery winnings by reason of a wager placed in this Commonwealth, the conduct of a game of chance, or other gambling activity located in this Commonwealth or the redemption of a lottery prize from a lottery conducted in this Commonwealth, other than noncash prizes of the Pennsylvania State Lottery. These winnings must be included as taxable income.

Pennsylvania taxes nonresident individuals, estates or trusts on gambling and lottery winnings derived from sources within Pennsylvania, other than noncash prizes of the Pennsylvania State Lottery, when employed in the operation of a business, profession or farm. These winnings must be included as taxable income.

Pennsylvania does not tax nonresident individuals, estates or trusts on gambling and lottery winnings by reason of a wager placed outside this Commonwealth, the conduct of a game of chance or other gambling activity is located outside this Commonwealth or the redemption of a lottery prize from a lottery conducted outside this Commonwealth. Nonresidents do not include these winnings as taxable income.

D. Multistate Lotteries

Multistate lottery prizes, such as those from the Powerball and Mega Millions, awarded on tickets purchased through a licensed Pennsylvania state lottery ticket vendor are considered a prize awarded by the Pennsylvania State Lottery. Such prizes are considered Pennsylvania source income and both residents and nonresidents are subject to tax on such income if the prize is a cash prize. Multistate lottery prizes awarded on tickets purchased through a vendor in another state lottery are considered prizes awarded by that state lottery. Such prizes are not considered Pennsylvania source income and only residents are taxed on such income regardless of whether the prize is a cash or noncash prize

E. Sale or Assignment of a Lottery Annuity

Whenever a Pennsylvania resident lottery winner, who originally elected to receive the winnings in the form of annuity payments, sells or assigns the entire interest in the rights to those winnings to a third party for purposes of receiving a lump sum payment from that third party, the proceeds (lump sum payment) received are taxable. The taxpayer's basis in the asset (the annuity) is the total cost of the winning wager. The transaction is recorded on Line 1 of PA Schedule D, Sale, Exchange or Disposition of Property. The net gain from Schedule D would be reported on Line 5 of the PA-40, Net Gain or Loss from the Sale, Exchange or Disposition of Property.

IV. COSTS AND OTHER EXPENSES

Gambling and lottery winnings income may be determined by taking total winnings and subtracting the total costs of wagers.

A. Costs

The cost of wagers during a tax year including amounts paid for lottery tickets, bingo games or cards, raffle tickets, slot machines card allotments, etc. may be deducted from total winnings received during the same tax year.

1. PA Lottery Ticket Costs

The cost of tickets for the Pennsylvania Lottery purchased on or after July 21, 1983 and before Jan. 1, 2016 may not be deducted from winnings. Tickets for the Pennsylvania Lottery purchased during tax years beginning on or after Jan. 1, 2016 may be deducted from winnings received during the same tax year.

2. Other Lottery Ticket Costs

The cost of lottery tickets purchased in other states or countries or for other lotteries during a tax year may be deducted from winnings received during the same tax year.

3. Proof of Costs

Taxpayers must maintain detailed records to substantiate all costs of wagers. Taxpayers have the burden of proving all costs deducted. See 61 PA Code §103.17.

B. Other Expenses

No expenses attributable to gambling and lottery income are deductible. Expenses such as: parking, postage, entry fees, meals and lodging or travel may not be deducted in arriving at gambling and lottery winnings.

V. REPORTING

Resident and nonresident individuals use PA-40 Schedule T, Gambling and Lottery Winnings, to report amount(s) of gambling and lottery winnings. Estates and trusts use PA-41 Schedule A, Interest Income and Gambling and Lottery Winnings, to report gambling and lottery winnings. Partnerships, limited liability companies and S corporations use PA-20S/PA-65 Schedule T, Gambling and Lottery Winnings.

Act 46 of 2003 amended Section 335 requiring that any person required to make a federal Form W-2G, Certain Gambling Winnings return to the Secretary of the Treasury of the U.S. in regard to taxable gambling or lottery winnings from sources within the Commonwealth must also file a copy with the Pennsylvania Department of Revenue by March 1 of each year or, if filed electronically, by March 31 of each year. This applies to taxable years beginning after Dec. 31, 2003.

TYPE OF RETURN	LINE ON RETURN	USE THIS SCHEDULE
PA-40 Individual Income Tax Return	8	PA-40 Schedule T
PA-40 Nonresident Consolidated Income Tax Return	5	PA-40 Schedule T
PA-41 Fiduciary Income Tax Return	1	PA-41 Schedule A
PA-20S/PA-65 PA S Corporation/Partnership Information Return	8	PA-20S/PA65 Schedule T

VI. WITHHOLDING ON PA LOTTERY PAYMENTS

Act 84 of 2016 amended the personal income tax law to require withholding on Pennsylvania Lottery prize payments that are paid by the Pennsylvania Lottery or by a person making a Pennsylvania State Lottery prize payment in the form of an annuity. Pennsylvania withholding is required on such prize payments whenever tax is required to be withheld for federal income tax purposes. The tax is required to be withheld at the Pennsylvania personal income tax rate in effect at the time the prize payment is made. The withholding requirement is in effect for prize payments made after July 12, 2016 and is reported to winners on federal Form W-2G, Certain Gambling Winnings. Withholdings are reported by resident and nonresident taxpayers on PA Schedule T, Gambling and Lottery Winnings.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 16: PASS THROUGH ENTITIES

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CHAPTER 16: PASS THROUGH ENTITIES

I. PARTNERSHIPS

A. Definition of a Partnership

A partnership, for Pennsylvania personal income tax purposes, is any unincorporated entity that is classified as a “partnership” for federal income tax purposes, such as:

1. Partnership For Pennsylvania Personal Income Tax Purposes

A domestic or foreign general partnership, joint venture, limited partnership (LP), limited liability partnership (LLP), limited liability company (LLC), business trust, investment club or other unincorporated entity that for federal income tax purposes is classified as a partnership.

2. Organizations Not Treated as a Partnership

The term “partnership” does not include the following kinds of organizations:

a. Condominium management associations, residential real estate management associations, or similar organizations provided that no part of the income inures, other than by enhancing the value of the property of the association or its members, to the benefit of any member,

b. Political organizations, or

c. Organizations described in IRC §501(c).

Note. For tax year 2005 and forward, an investment club that derives all of its receipts for the taxable year from either federally taxable portfolio interest income or dividends or from the sale and exchange of securities, is considered a partnership for Pennsylvania purposes and is required to file a PA-20S/PA-65 Information Return.

B. Differences Between Federal Tax Law and Pennsylvania Tax Law

For each class of income there are differences in reporting requirements for federal income tax and Pennsylvania personal income tax.

Within each class of income there are certain IRC sections, including elections for federal income tax, that are not allowed in arriving at reportable income for Pennsylvania personal income tax purposes.

Within each class of income there are specific rules for Pennsylvania personal income tax purposes that differ from federal income tax rules.

Within each class of income there are circumstances where Pennsylvania will accept the use of federal tax accounting rules provided they are consistently used and applied. See Table 16-1–*Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for Partnerships* in Part VI - TABLES, for specific circumstances where Pennsylvania may accept the use of consistently applied federal treatment.

C. PA–20S/PA–65 PA S Corporation/Partnership Information Return and Schedules

1. Filing Requirements – Partnership

Every domestic or foreign partnership (72 P.S § 7335(c)) or an entity formed as a limited liability company that is classified as a partnership for federal income tax purposes must file the *PA-20S/PA-65 PA S Corporation/Partnership Information Return (PA-20S/PA-65 Information Return)* if either of the following apply:

a. During the taxable year, the partnership earned, received, or acquired any gross taxable income (loss) allocable or apportionable to Pennsylvania, regardless of the amount of its income (loss) and/or whether or not the income was distributed.

b. The partnership, at year end, had at least one partner that was a Pennsylvania resident individual, estate, trust, or disregarded entity owned by a resident individual or another pass through entity such as a partnership, PA S corporation or limited liability company.

A partnership must file a PA-20S/PA-65 Information Return to report the income, deductions, gains, losses etc. from their operations. The partnership passes through any profits (losses) to the resident and nonresident partners. Partners include their share of the income (loss) on form *PA-40 Individual Income Tax Return*, *PA-41 Fiduciary Income Tax Return,* or other Pennsylvania returns.

A partnership with operations within Pennsylvania whose partners are all C corporations must provide to the department a complete copy of its federal Form 1065. Such a partnership must submit a *PA-65 Corp, Directory of Corporate Partners*, and **does not** complete a PA-20S/PA-65 Information Return. See PA-65 Corp.

Each partnership must submit with the PA-20S/PA-65 Information Return a complete copy of its federal income tax return including all schedules, statements, federal Schedules K-1, and PA-20S/PA-65 Schedules RK-1 and NRK-1 received as an owner in other pass through entities such as a partnership, PA S corporation or limited liability company. With the PA-20S/PA-65 Information Return, the partnership must also submit copies of the PA-20S/PA-65 Schedules RK-1 that it provides to resident partners and copies of the PA-20S/PA-65 Schedules NRK-1 that it provides to nonresident partners. If the entity is a limited liability company, filing as a partnership, and the limited liability company has already forwarded a complete copy of its federal return to the Bureau of Corporation Taxes, with the RCT-101, PA Corporate Tax Report, do not send another copy.

A partnership or limited liability partnership (LLP), jointly owned by husband and wife that elects to file on federal Form Schedule C, E or F with the Internal Revenue Service (IRS) files PA-40 Schedule C, E, or F with the *PA-40 Individual Income Tax Return* for Pennsylvania.

Partners are not employees and are not issued a W-2 form. The partnership must furnish copies of PA-20S/PA-65 Schedule RK-1 and/or NRK-1 to the partners before the PA-20S/PA-65 Information Return is required to be filed, including extensions.

The taxable year of a partnership with respect to a partner ends at the close of business on the day of:

a. Disposition, when the partner sells his or her entire interest in the partnership;

b. Redemption, when the partner liquidates his or her entire interest in the partnership; or

c. The date of death of the partner.

The partnership apportions items of income, gain and expense or loss to a partner only for that portion of the partnership-year when the partner was a member. It may be necessary to divide the partnership-year into daily or other segments and treat each such segment as a separate accounting period in order to satisfy this rule.

2. PA-65 Corp – Directory of Corporate Partners

A partnership or limited liability company filing as a partnership must complete the PA-65 Corp - Directory of Corporate Partners if the partnership has income (loss) from operating a business, profession or farm within Pennsylvania, and/or income (loss) from the ownership of property within Pennsylvania and either of the following applies:

a. If the entity has any partner that is a nonfiling corporation subject to corporate net income tax, and the partnership is making corporate net income tax withholding payments on behalf of its nonfiling corporate partner, or

b. All of its partners are corporations.

Refer to the *PA-65 Corp* instructions on the department's website.

The PA-65 Corp, Directory of Corporate Partners, must be mailed separate from all other PA returns. Do not send corporate net income tax withholding payments to the Bureau of Corporation Taxes. See **Where To File** in the instructions for the PA-65 Corp, Directory of Corporate Partner on the department's website.

Any excess withholding will be refunded when the corporation's RCT-101, PA Corporate Tax Report, is filed and processed. The refund will be sent to the corporate partner and not the partnership submitting the payment.

D. Processible Returns

The PA-20S/PA-65 Information Return for a partnership must satisfy all requirements found in the PA-20S/PA-65 instructions. The applicable PA-20S/PA-65 Schedules RK-1 and NRK-1 are required attachments for resident and nonresident owners' share of income, deductions, credits, etc. The partnership must also submit the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other entities. Refer to *Miscellaneous Tax Bulletin 2008-02 Reproduced Forms and Substitute Forms*.

E. Withholding of Estimated Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Resident Individual, Estate or Trust

Individual resident partners are subject to the estimated quarterly tax provisions under the Pennsylvania Personal Income Tax Act. Resident partners must make declarations and estimated quarterly Pennsylvania tax payments if they reasonably expect income, other than compensation on which Pennsylvania tax is withheld, to exceed $8,000. Individual partners should refer to *REV-413I, Instructions for Estimating PA Personal Income Tax for Individuals Only.*

F. Withholding of Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Nonresident Individual, Estate or Trust

Under Act 22 of 1991, a partnership with partners or members who are nonresident individuals, nonresident estates, or nonresident trusts (owners) must withhold and pay Pennsylvania personal income tax on each owner's expected share of distributable Pennsylvania-source taxable income. If making a quarterly withholding payment for the first time, use *PA-40 ESR (F/C,) Declaration of Estimated or Estimated Withholding Income Tax For Fiduciary or Partnerships*. The partnership makes the initial quarterly withholding payment and all future quarterly withholding payments under the employer identification number, name and address of the partnership.

The entity should refer to *REV-413P/S, Instructions for Withholding PA Personal Income Tax from Nonresident Owners by Partnerships and PA S corporations*.

Note. An entity may not withhold Pennsylvania personal income tax for another entity or a Pennsylvania resident individual, and should not withhold Pennsylvania personal income tax on income from intangibles such as interest, dividends, or sale of stock.

G. Final/Catch-Up Payment of Nonresident Withholding Tax

If the Pennsylvania personal income tax due on the taxable income allocable to nonresidents exceeds the tax withheld, the final payment is due on the date prescribed for the filing of the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or with an extension request.

If the tax of the nonresident owners exceeds the nonresident withholding tax payments, the partnership must pay the deficiency by the date prescribed for filing the entity's PA-20S/PA-65 Information Return or if the nonresident owners elect to file a PA-40 Nonresident Consolidated Income Tax Return, the entity may make the final/catch-up payment with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or with an extension request.

There are three ways to make a final withholding tax payment or final catch-up payment for nonresident owners that are individuals, estates, or trusts. Follow these instructions:

1. With Approved Software Form

If using approved software, submit payment along with the 20XX Nonresident Withholding Payment substitute voucher in the same envelope with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return. Do not staple payment to your return or the substitute voucher.

2. Without Approved Software Form

a. Submit payment with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return. Print the entity's federal employer identification number (FEIN) and 20XX Final Nonresident Withholding on the check or money order made payable to the PA Dept. of Revenue.

b. Submit payment in the same envelope with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or extension request. Do not staple payment to your return.

3. Fed/State e-File

The only acceptable electronic payment method for fed/state partnership e-file is electronic funds withdrawal which is part of the current tax year return submission and is automatically and electronically transferred from taxpayers' bank accounts.

The following types of payments can be electronically transferred with the PA-20S/PA-65 Information Return:

a. final nonresident individual withholding tax "catch-up" payment submitted with the current tax year return; and

b. the next tax year's (future) estimated payments for nonresident individual quarterly withholding tax submitted with the current tax year return.

These future estimated nonresident individual withholding tax payments for the next tax year will be stored in the system as separate electronic transaction payments until the specified due date.

Important. The nonresident individual quarterly withholding tax payment may not be submitted through Electronic Funds Transfer (EFT), credit/debit cards or e-TIDES.

H. Mailing Address for the Nonresident Withholding Payment

When submitting the final withholding payment or final "catch-up" payment with the PA-20S/PA-65 Information Return, with or without the 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280502
HARRISBURG PA 17128-0502

When submitting the final withholding payment or final "catch-up" payment with the PA-40 Nonresident Consolidated Income Tax Return, with or without the 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
CONSOLIDATED RETURN
PO BOX 280418
HARRISBURG PA 17128-0418

When submitting the final withholding payment or final "catch-up" payment with an extension request for any Pennsylvania tax return, send form REV-276 to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280504
HARRISBURG PA 17128-0504

Follow the instructions above, With Approved Software Form or Without Approved Software Form.

I. Operations of a Partnership

1. Elections

Pennsylvania law determines income (loss) under accepted accounting principles and practices. The partnership, not the partners, makes the choices for calculating income (loss) from the partnership's activities. The partnership chooses the recognized methods of accounting, methods of calculating depreciation, capitalization of organizational fees, and the use of the installment sales provisions. All partnership elections are applicable equally to all partners but any election made by the partnership will not apply to any partner's other income or gain outside the partnership. Pennsylvania law does not provide for all the elections that partnerships and partners may make for federal purposes, including the elections under IRC § 614; 1031; 1033; 732(d); 734(b); 754; 743(b); 59(e); 108; 617; 901, and 6222(b).

2. Federal Optional Adjustments to Basis

For Pennsylvania purposes, the partnership may **not** adjust the basis of its property in the manner provided in IRC § 734(b) or IRC § 743(b). Pennsylvania does not permit the IRC § 732(d) or IRC § 754 election.

3. Determining a Partner's Distributive Share

The partnership may allocate each item of income (loss) by class to the partners in the same proportion that it uses for federal purposes. The partnership must submit a statement with its PA-20S/PA-65 Information Return explaining the reason for a different allocation method.

4. Guaranteed Payments to Partners

There are differences between federal tax law and Pennsylvania tax law for reporting guaranteed payments to partners. The partnership characterizes guaranteed payments to partners in the following manner:

a. To the extent paid for services rendered directly in the production of income from a business, profession or farm, the guaranteed payments to the recipient are gross income from that specific income class. If the partnership does not deduct these guaranteed payments on its federal return, it may deduct them to determine net profits on the PA20-S/PA-65 Information Return, Part I.

- For nonresidents a guaranteed payment is allocable or apportionable to Pennsylvania to the same extent as the net profits are allocable or apportionable to Pennsylvania.

b. To the extent paid for services rendered directly in the production of rental or royalty income, the guaranteed payments are gross income from that income class to the recipient. If the partnership does not deduct these guaranteed payments to determine rental income and royalty income on its federal return it may deduct them to determine rental and royalty income on the PA20-S/PA-65 Information Return, Part III.

- For nonresidents a guaranteed payment is allocable to Pennsylvania to the same extent as the rental and royalty income is allocable to Pennsylvania.

c. To the extent paid for other services or for the use of capital, Pennsylvania classifies such distributions as:

- A withdrawal proportionately from the capital of all partners.
- A return of capital by the recipient to the extent derived from his/her own capital. The distributions that the partnership makes that represent repayments of the partner's own capital are not income for Pennsylvania personal income tax purposes.
- A gain from the disposition of the recipient's partnership interest and a loss from the disposition of the other partners' partnership interests, to the extent derived from the capital of the other partners.
- Residents are taxed on 100 percent of their taxable gain.
- For nonresidents a guaranteed payment for other services or for the use of capital is allocable to their state of residence. Nonresidents are not taxed on a guaranteed payment for the use of capital for Pennsylvania personal income tax purposes.
- The partnership does not receive a deduction for a guaranteed payment if the guaranteed payment is for capital or other services.

5. Guaranteed Payments Example

Andy, Betty, and Carl are equal partners in ABC partnership. Andy manages the rental activities of the partnership and receives an annual guaranteed payment of $5,000 for such services. Betty contributed the rental property to the partnership. She receives an annual guaranteed payment of $15,000 for its use. ABC partnership received net rents of $80,000 for the taxable year. The $5,000 guaranteed payment to Andy is an allowable deduction from the net rents of the partnership and is taxable to Andy as gross rents. The partnership calculates Andy's total rental income as follows:

Guaranteed payment	$ 5,000
Share of partnership net rents ($80,000 - 5,000) ÷ 3 =	$25,000
Total	$30,000

Betty and Carl each have total rental income of $25,000 ($80,000 - 5,000) ÷ 3.

The guaranteed payment to Betty is a gain on the disposition of her partnership interest to the extent it is from Andy and Carl's capital. To the extent that the guaranteed payment is a return of Betty's own investment, it is a return of capital distribution. The partnership reflects this amount as guaranteed payments for capital on the *PA-20S/PA-65 Schedules RK-1* and *NRK-1*. The return of capital distribution is not taxable if it does not exceed Betty's basis in the partnership.

6. Guaranteed Payments to a Retired Partner

If the Guaranteed payments to a retired partner meet the requirements of IRC § 1402 then the guaranteed payments to a retired partner may constitute nontaxable retirement benefits. Amounts received by a retiring partner pursuant to a written plan of the partnership that provides for guaranteed payments on account of retirement to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, are excludible retirement benefits if:

a. The above requirements are met, and

b. The plan otherwise constitutes a qualifying retirement benefit plan.

Other payments received in liquidation of the interest of a retiring partner shall be considered as:

a. A distributive share of partnership income if the amount thereof is determined with regard to the income of the partnership,

b. A guaranteed payment, or

c. A distribution made in exchange for the interest of such partner in partnership property, including, unless the partnership agreement provides otherwise, unrealized receivables of the partnership and goodwill of the partnership.

7. Federal Limitations on the Taxation of Retirement Income of Nonresident Partners

Recent federal statutory changes prohibit states from taxing some retirement income of nonresidents. Public Law 109-264, signed Aug. 3, 2006, amends § 114 of Title 4 of the U.S. Code. The law provides that retirement payments made under a nonqualified plan maintained by a partnership and meeting specific criteria are taxable only by a state where the retired partner is a resident or where the retired partner is domiciled at the time the payments are received. To qualify for this tax treatment, the retirement payments must meet all of the following criteria:

a. The payments must be provided for in a written plan, program, or arrangement that was in effect before the partner's retirement,

b. The payments must be in recognition of prior service performed by the partner for the partnership, and

c. The payments must be made over the life or life expectancy of the recipient or over a period of at least 10 years, must be paid at least annually, and must be paid in substantially equal periodic payments.

8. Cancellation of Indebtedness Income

For additional information concerning cancellation of indebtedness, please refer to Pennsylvania Personal Income Tax Guide Chapter 24, Cancellation of Debt for Pennsylvania Personal Income Tax Purposes and related PIT Tax Bulletins 2009-02 through 2009-07.

9. Allocation of Partnership Income and Losses

A partner is taxed on " . . . his share, whether or not distributed, of the income or gain received by the partnership ", 72 P.S. § 7306. The partner's share of income (loss) is the same percentage as for federal income tax purposes. Because Pennsylvania does not have special partnership and partner rules or definitions, the department relies on the federal definition of "substantial economic effect." Where the allocation is consistent with the underlying economic arrangement of the partners and the allocation will substantially affect the dollar amount to be received by the partners, independent of any tax consequences, it is used or accepted. Absent such an effect, the department uses the partner's ownership interest for the allocation of income (loss).

J. Formation and Termination of a Partnership

1. Tax Free Formation of a Partnership

Federal law permits the tax-free formation of a partnership under IRC § 721. IRC § 721 is generally followed for Pennsylvania tax purposes.

2. Contributions in Exchange for an Interest in a Partnership

Neither the partnership nor its partners or members recognize gain or loss in the case of a contribution in exchange for an interest in the partnership, unless:

a. The purpose of the contribution was to affect an exchange of property between two or more partners, or

b. The contributing partner receives, in exchange for its contribution, an interest in the partnership plus other property or cash.

3. Partnership Distributions in Complete Liquidation

Generally the amounts received by a partner in the complete actual winding up of a partnership and distribution of its assets (or the proceeds from the sale of its assets) shall be treated as in full payment in exchange for the partner's interest in the partnership. Accordingly, if property is received in such a distribution, generally, the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

However, if the amounts are received pursuant to a tax-free liquidation made in connection with the transfer of a partnership interest in exchange for an interest in another partnership, no sale, exchange or other disposition is recognized, and the basis of the property in the hands of the distributee shall be the partnership's adjusted basis at the time of the distribution.

If a complete liquidation results in a loss to a partner on the partner's investment in the partnership, the loss is sourced to the partner's state of residence. The loss is classified as a net loss from a disposition of property.

A non-resident partner may not offset this non-Pennsylvania-source loss against Pennsylvania-source net gain or loss from dispositions of property. For example, if the partnership recognizes partnership cancellation of indebtedness income in a foreclosure on partnership property, the non-resident partner may not apply the loss from liquidation of his or her investment against the gain resulting from the foreclosure on partnership property.

The amounts received in a complete liquidation are taxed under the above rules even if the distributions are not made in connection with settling the accounts and liquidating the assets of a partnership for the purpose of dissolving the partnership. The concept of an actual distribution of assets to its partners in the course of complete liquidation is distinct from the legal termination of the partnership.

An existing partnership continues until it terminates. A partnership terminates only when:

a. Neither the partnership nor any of its partners continue the business, financial operation, or venture of the partnership, or

b. Within a 12-month period, the partners sell or exchange 50 percent or more of their ownership interest.

4. Dissolving a Partnership

General partnerships and sole proprietors that are not required to withhold tax at the source (*e.g.* employer withholding and sales tax) are not required to obtain clearance certificates if they are merely ceasing to do business within Pennsylvania or selling their assets in a bulk or auction sale.

However, limited partnerships or general partnerships that withhold at the source must obtain a tax clearance certificate before filing required documents with the Department of State. Limited partnerships not general partnerships file a certificate of termination with the Department of State in addition to the REV-181. If you are a general partner in a limited partnership and want to withdraw from the limited partnership, a *Withdrawal by Limited/General Partner* would be filed with the Department of State.

To obtain a tax clearance certificate from the Department of Revenue, the entity must complete Form *REV-181*, *Application for Tax Clearance Certificate* available on the department's website. Be sure to read the instructions on *Form REV-181-I*

K. Basis of a Partner's Interest in a Partnership

To determine the basis of a partner's interest in a partnership, there are certain federal IRC sections, relating to basis adjustments that Pennsylvania personal income tax law does not allow. In addition, there are certain rules for Pennsylvania personal income tax purposes that are exclusive to Pennsylvania.

Note. A nonresident partner does not adjust basis, however he must determine whether he has sufficient economic investment to be able to utilize losses. Refer to General Rules -Nonresident Partner.

1. Definition of Outside Basis

a. Partner's Outside Basis

The purpose of outside tax basis is to keep track of the partner's adjusted basis in his or her partnership interest. It is the partner's after tax investment. It is also used to determine gain (loss) on the sale or other disposition of a partnership interest.

Outside basis is the individual partner's adjusted basis in his or her partnership interest. In general, a partner's outside basis is his or her separate tax capital account, which reflects adjusted basis, plus his or her share of the partnership's debt.

Initially, outside basis is determined by including the amount of the adjusted basis in the property contributed plus any cash contributed by the partner. If there are liabilities, outside basis includes the partner's share of all liabilities. In subsequent years, the outside basis is increased and decreased by partnership operations.

Outside basis is maintained by each individual partner outside of the partnership books. Outside basis is the calculation that most partners are concerned with because it is the basis that the taxpayer uses to limit losses, determine the taxability of partnership distributions, and calculate gain (loss) on the disposition of their partnership interest. Outside basis is calculated at the end of each partnership tax year.

The following is the calculation of a partner's outside basis based on IRC § 722 and IRC § 705(a).

b. Outside Basis – Adjusted Basis of a Partner's Interest

Adjusted basis in asset or cash contributed by the partner
- Liabilities of the partner assumed by the partnership
+ Partner's share of partnership liabilities
+ Any gain recognized by the partner on the contribution of assets to the partnership
= Beginning Tax Basis

Then partnership operations during the year,

+ Taxable Income
+ Tax exempt Income
- Distributions from the partnership of cash or property
- Partnership expenditures that are neither deductible or capitalized by the partnership
- Oil and gas depletion, calculated at the partner's level
- Losses
+/- Change in partner's share of partnership's liabilities
= Tax Basis at year-end

The year ending tax basis cannot be a negative balance.

2. Definition of Inside Basis

a. Partner's Inside Basis

Inside basis is the partnership's tax basis in its assets. For tax purposes, a partnership takes a carryover basis in the contributed property equal to the contributing partners' adjusted basis in the property at the time of the contribution. Inside basis is the aggregate adjusted basis of all property contributed by all partners.

There is a close relationship between inside and outside basis. They both reflect the adjusted basis of the assets versus the fair market value. However, outside basis deals with each partner's interest in the partnership assets they contributed and inside basis deals with all partners' interests in the partnership assets aggregated together.

3. General Rules – Resident Partner

Generally the initial outside basis of a resident partner's interest in the partnership is the amount of cash and the adjusted basis of property that the partner contributes.

If a partner contributes property that is subject to indebtedness or if the partnership assumes a partner's debt, the contributing partner must reduce basis by the amount of the debt assumed by the other partners. The partnership's assumption of the debt is a distribution of money to the contributing partner.

The assumption by the other partners of a portion of the contributing partner's debt is a contribution to the partnership, and therefore, increases their basis.

If a partner's interest in the partnership's capital is for rendering past, present, or future service, the partner's basis equals the income for those services. The partner recognizes that income when the partner performs the services and the partnership removes any restrictions on withdrawal or disposition of the income.

A partner's outside basis in a partnership can never be less than zero.

A partner that acquires a partnership interest, other than by contributing money, property, or both, determines his or her basis in the partnership under general basis rules.

Important. The basis of a partnership interest acquired by purchase is the purchase price paid. The basis of a partnership interest acquired by inheritance is the fair market value on the decedent's date of death. The basis of a partnership interest acquired by gift or otherwise, such as a joint tenant with right of survivorship, is the donor's basis.

4. Examples

Example 1

Tim acquired a 20 percent interest in a partnership by contributing property. At the time of Tim's contribution, the property had a fair market value of $10,000 and an adjusted basis of $4,000. The property was subject to a mortgage of $2,000. The partnership assumed payment of the mortgage. Tim's basis in the partnership is $2,400, calculated as follows:

Adjusted basis of the property contributed		$4,000
Less the portion of the mortgage assumed by the other partners that must be treated as a distribution to Tim	($2,000 x 80%)	($1,600)
Basis of Tim's partnership interest		$2,400

Example 2
Use the facts from Example 1 above except that the mortgage on the property was $6,000. Tim's basis in the partnership would be zero, calculated as follows:

Adjusted basis of the property contributed		$4,000
Less the portion of the mortgage assumed by the other partners that must be treated as a distribution to Tim	($6,000 x 80%)	($4,800)
Basis of Tim's partnership interest		($800)

Since Tim's basis cannot be less than zero, the $800 in excess of basis is a distribution of money and a gain from the sale or exchange of Tim's partnership interest in excess of basis.

Example 3
Facts: ABC partnership is formed. "A" contributes land with a basis of $200. "B" contributes a building with a basis of $300. "C" contributes $400 cash. "A's" outside basis is $200. "B's" outside basis is $300. "C's" outside basis is $400. ABC has an inside basis in the partnership assets of $900 ($200 in the land, $300 in the building, and $400 in cash).

5. Basis Calculation
A partnership ordinarily determines its outside basis at the end of each taxable year. A partner must separately determine their outside basis. This amount may differ from the amount shown in the partnership's books as the partner's capital, equity, or similar account, or the partner's outside basis for federal income tax purposes.

The department requires the partnership to provide each partner with the information that each partner needs to calculate the Pennsylvania personal income tax outside basis of their partnership interest. Pennsylvania does not require partnerships to account for each partner's Pennsylvania personal income tax basis. Each partner must determine their Pennsylvania personal income tax basis, appropriately applying the Pennsylvania tax rules. The partner is responsible for tracking Pennsylvania personal income tax outside basis. The department requires *PA-40 Schedules RK-1* and/or *NRK-1* and a *PA-40 Individual Income Tax Return* be submitted for all years in which they were a partner.

6. Increase in Basis
The original basis of a resident partner's interest increases by:

a. Additional contributions to the partnership, and

b. The partner's distributive share of:

- The accumulated partnership taxable income,

- The partnership's accumulated tax-exempt gross income (such as, permanent items having a nontaxable difference between book income and taxable income; interest on PA municipal bonds; or life insurance proceeds), and

- Basis is increased when the partner's share of partnership liabilities is increased.

7. Decrease in Basis

The basis of a partner's interest decreases, but not below zero, by:

a. Distributions by the partnership, which is the amount of money and the adjusted basis of property distributed to a partner. In computing the partner's adjusted basis, the partnership takes into account all distributions to a partner before any losses,

b. The sum of the partner's distributive share of partnership losses if the losses enabled the partner to reduce their Pennsylvania-taxable income or income tax liability to another state,

c. Nondeductible partnership expenditures that are not capital expenditures, i.e., partner's retirement contributions and partner's life and health insurance premiums, and

d. Basis is decreased when the partner's share of partnership liabilities is decreased.

8. Basis - Ordering Rules

In calculating the partner's adjusted basis, the partner takes into account all distributions before any losses.

9. No Carry-Forward or Carry-Back of Losses

For Pennsylvania purposes, neither the partnership nor the partners may carry-forward or carry-back any losses to other tax years.

10. No Offsetting Income (Loss) in More than One Class of Income

Per Reg. 121.13 (a), "a person shall not be allowed to offset a gain in one class of income with a loss in another class of income".

Therefore neither the partnership nor the partner may offset income or gain in one class of income with a loss in another class of income.

11. General Rules – Nonresident Partner

To determine the economic interest of a nonresident partner's interest in a partnership, there are certain rules for Pennsylvania personal income tax purposes that are specific and exclusive to the Pennsylvania nonresidents.

a. The economic investment of a nonresident partner's interest in the partnership is the amount of cash and the adjusted basis of property that the nonresident partner contributes.

b. If a nonresident partner contributes property that is subject to indebtedness or if the partnership assumes a nonresident partner's debt, the contributing nonresident partner must reduce economic investment by the amount of the debt assumed by the other partners. The partnership's assumption of the debt is a distribution of money to the contributing nonresident partner. The assumption by the other partners of a portion of the contributing nonresident partner's debt is a contribution to the partnership, and therefore, increases their basis or economic investment.

c. If a nonresident partner's interest in the partnership's capital is for rendering past, present, or future service, the partner's economic investment equals the income for those services. The partner recognizes that income when the nonresident partner performs the services and the partnership removes any restrictions on withdrawal or disposition of the income.

d. All distributions to nonresident partners reduce the nonresident partners' economic investment in the partnership.

e. A nonresident partner cannot utilize losses of a partnership against other income in the same class of income if the nonresident partners' economic investment in the partnership is less than zero.

12. PA-20S/PA-65 Schedules RK-1 and NRK-1

A partnership reports distributions on the partner's PA-20S/PA-65 Schedules RK-1 and/or NRK-1. Each resident partner must reflect distributions from the PA-20S/PA-65 Schedules RK-1 on the form *REV-999, Partner PA Outside Tax Basis in a Partnership Worksheet* to determine whether such distributions are taxable.

Important. The partnership must provide information to the partner on straight-line depreciation so the partner can calculate basis in accordance with 72 P.S. § 7303(a.2).

L. Distributions of Cash, Property and Marketable Securities

1. Income to Partner

Distributions that the partnership makes that represent cash, marketable securities, and other property that are not guaranteed payments may represent Pennsylvania-taxable income to the extent the distributions exceed the resident partner's adjusted outside basis.

2. Non-liquidating Distributions from Partnership to Partner

With respect to non-liquidating distributions from a partnership to a resident partner, the partner's outside basis in their partnership interest is decreased to the extent of the partnership's Pennsylvania personal income tax adjusted basis in the property distributed to the partner. In non-liquidating distributions, a resident partner will recognize taxable income to the extent that the partnership's adjusted basis in the property distributed exceeds the resident partner's outside basis in the owner's partnership interest. Although not taxable to a nonresident partner, the nonresident partner reduces his or her economic investment by the partnership's adjusted basis in the property distributed. Refer to section H part 3 of this chapter for partnership distributions in complete liquidation.

3. General Rules Regarding the Treatment of Partner or Partnership Liabilities

Pennsylvania law generally follows IRC § 752:

a. If the liabilities of a partnership increase, then each partner's share of the liabilities increases. Each partner's share of the increase is treated as a contribution of money to the partnership.

Example: Amy and Bob are equal partners in AB partnership. The partnership borrows $1,000. Each partner's interest in the partnership increases by $500. The partnership uses this rule regardless of its method of accounting.

b. If the liabilities of a partnership decrease, then each partner's share of the liabilities decreases. Each partner's share of the decrease is treated as a distribution of money to the partners by the partnership. The partnership's distributions decrease the economic interest of the non resident partners in the partnership.

c. If a decrease in liabilities exceeds the resident partner's basis in their partnership interest, then the excess constitutes a gain.

d. A partner's percentage share of partnership liabilities ordinarily is the same as their percentage share of losses, unless the partnership agreement establishes otherwise, or by an express undertaking of a liability, such as a note.

e. A decrease in a partner's personal liabilities, because the partnership assumes a portion of them, is a distribution of money to the partner. The contributing partner's basis decreases and the assuming partner's basis increases.

f. When a partner contributes encumbered property, the corresponding decrease in the contributing partner's liability is a distribution of money to such partner. In addition, the liability attributable to the other partners is an increase in each other partner's basis.

Example. Ed, a resident partner, contributes property with a basis of $10,000 in exchange for a one-third interest in a partnership. The property has a mortgage of $1,500. Ed reduces the $10,000 basis for the contributed property by $1,000; two-thirds of his original liability of $1,500 attributable to the other partners which reduces his basis in the partnership to $9,000. The liability attributable to each of the other partners increases their basis.

g. When a partner receives a non-liquidating distribution of partnership property subject to liability:

- the receiving partner is treated as if he/she contributed money to the partnership by reason of the partner's assumption of the liability, and
- all partners are treated as if they received money because of a decrease in the partner's share of partnership liabilities that occurred when the recipient partner assumed the debt from the partnership.
- When a partner sells or exchanges their partnership interest, the general rule for the treatment of liabilities applies.

  Example. Alice, a resident partner, sells her partnership interest for $750. At the same time she transfers to the buyer her pro rata share of the partnership's recourse liabilities of $250 and the partnership's non-recourse liabilities of $500. Alice's sale price is $1,500. This is the amount she applies against the outside basis of her partnership interest to determine her gain (loss).

h. A partnership's obligations for the payment of its outstanding trade accounts, notes, and accrued expenses are liabilities whether or not recorded on the partnership books under its method of accounting. Contingent liabilities, however, are not liabilities until they become fixed or liquidated.

Important. Take into account distributions and decreases in basis, before losses, in determining a resident partner's outside basis. Partners may not reduce their outside basis below zero for Pennsylvania personal income tax purposes.

i. A partnership determines a partner's share of its partnership liabilities in accordance with the partner's ratio for sharing losses under the partnership agreement. However, where none of the partners have any personal liability with respect to a partnership non-recourse liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage) then all partners, including limited partners, share this liability in the same ratio as they share the profits.

Example. In the GL partnership, Gene is a general partner, and Larry is a limited partner. Each made equal contributions of $20,000 to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally. The partnership agreement limits Larry's liabilities to the extent of his contributions. The partnership pays $10,000 for real property that is subject to a $5,000 mortgage. Neither the partnership nor either partner assumes any liability for the mortgage. Gene and Larry increase their partnership interests by $2,500 each, since each partner's share of the $5,000 mortgage partnership liability increased by that amount. However, if the partnership assumed the mortgage so that Gene was personally liable, Gene's basis increases by $5,000, and Larry's basis remains unchanged.

M. Debt Limitation

The partnership may take an amount of indebtedness into account only once. This rule applies even though the partner, in addition to being liable for the indebtedness as a partner, may be liable in a capacity other than as a partner.

N. IRS Investment Tax Credits

For Pennsylvania personal income tax purposes, a partnership need not reduce the basis of an asset by that percentage of the federal investment tax credit taken as required under the IRC.

O. Tax Benefit Rules

The PA Department of Revenue does not follow the federal tax benefit rules. 72 P.S. § 7303(a.2) states that the basis in property shall be reduced, but not below zero, for depreciation by the greater of:

1. The amount deducted on the return and not disallowed, but only to the extent the deduction results in a reduction of income, or

2. The amount allowable, using the straight-line method of depreciation, regardless of whether the deduction results in a reduction of income.

This adjustment is applied at the Pennsylvania personal income tax taxpayer level (*PA-40 Individual Income Tax Return, PA-41 Fiduciary Income Tax Return*).

1. Sole Proprietor

The individual sole proprietor is required to reduce his basis in the assets used in the business by the amount deducted on the tax return. However, if the business incurs a loss in which the individual owner has no other income to offset, he is only required to reduce his basis in the assets by straight-line depreciation.

2. Partner

For Pennsylvania personal income tax purposes, a partner must reduce his outside basis in the partnership by losses, but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income subject to the tax of another state or country. If the partner does not get the benefit of the losses from the partnership, the statute still requires him to reduce his outside basis in the partnership by his share of straight-line depreciation in the assets of the partnership.

The Pennsylvania tax benefit rule applies to nonresident partners only to the extent to verify that they have sufficient basis to reduce their PA-source income by their share of partnership loss. It does not apply to nonresident partners upon disposal of the partnership interest. Nonresidents are not taxed on the gain from the sale of intangibles nor allowed the loss. A partnership interest is an intangible asset. Losses from the sale of a partnership interest are not sourced to Pennsylvania for nonresidents.

This issue is addressed in *Legal Letter Ruling No. PIT-05-003 and PIT Tax Bulletin 2005-02, Section 2*.

The partnership must provide the amount of straight-line depreciation on the PA-20S/PA-65 Schedules RK-1 and/or NRK-1.

See Table 16-2 – *Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for Partners* Outside Basis Calculation in Part IX - TABLES.

II. PENNSYLVANIA S CORPORATIONS

A. Definition of a PA S Corporation

1. Statutory Definition

72 P.S. § 7301(n.1) states a "Pennsylvania S Corporation means any small corporation as defined in § 301(s.2) which does not have a valid election under § 307 in effect."

2. Small Corporation

Per 72 P.S. § 7301(s.2), "Small corporation means any corporation which has a valid election in effect under subchapter S of chapter 1 of the IRC of 1986, as amended to January 1, 2005."

For purposes of determining whether a corporation qualifies as a small corporation:

a. A qualified subchapter S subsidiary (QSSS) owned by a small corporation shall not be treated as a separate corporation, and all gross receipts and passive investment income of such qualified subchapter S subsidiary shall be treated as earned by the parent corporation, and

b. All inter-corporate payments or distributions between the parent corporation and any qualified subchapter S subsidiary owned by such corporation shall be disregarded.

Note. A corporation includes a business trust or limited liability company that the IRS classifies as a corporation for federal purposes except a business trust that qualifies as a real estate investment trust or a regulated investment company.

B. Differences Between Federal Tax Law and Pennsylvania Tax Law

For each class of income there are differences in reporting for federal income tax and Pennsylvania personal income tax. Within each class of income there are certain IRC sections including elections for federal income tax, which are not allowed in arriving at reportable income for Pennsylvania personal income tax purposes.

Within each class of income there are specific rules for Pennsylvania personal income tax purposes.

Within each class of income there are circumstances where Pennsylvania will accept the use of federal tax accounting rules provided they are consistently used and applied.

See Table 16-3 - Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for PA S Corporations in Part IX - TABLES.

C. PA-20S/PA–65 PA S Corporation/Partnership Information Return and Schedules

1. Filing Requirements – PA S Corporation

Every domestic or foreign PA S corporation (72 P.S. § 7330.1) or an entity formed as a limited liability company that is classified as a PA S corporation for federal income tax purposes must file the *PA-20S/PA-65 PA S Corporation/ Partnership Information Return (PA-20S/PA-65 Information Return)* if either of the following apply:

a. During the taxable year, the PA S corporation or its qualified subchapter S subsidiary earned, received, or acquired any gross taxable income (loss) allocable or apportionable to Pennsylvania, regardless of the amount of its income (loss) and/or whether or not the income was distributed; and/or

c. During the taxable year, the PA S corporation had at least one shareholder that was a Pennsylvania resident individual, estate, trust, disregarded entity owned by a resident individual or another pass through entity such as a PA S corporation or limited liability company.

PA S corporations must file a PA-20S/PA-65 Information Return to report the income, deductions, gains, losses etc. from its operations. The PA S corporation passes through any profits (losses) to the resident and nonresident shareholders. Shareholders include their share of the income (loss) on the *PA-40 Individual Income Tax Return, PA-41 Fiduciary Income Tax Return*, or other Pennsylvania returns.

Each PA S corporation must submit with the PA-20S/PA-65 Information Return a complete copy of its federal income tax return including all schedules, statements, federal Form 1120S Schedules K-1, along with the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other pass through entities, such as a partnership or limited liability company. With the PA-20S/PA-65 Information Return, the entity must also submit copies of the *PA-20S/PA-65 Schedule RK-1* that it provides to resident shareholders and copies of the *PA-20S/PA-65 Schedule NRK-*1 that it provides to nonresident shareholders.

If the entity has already forwarded a complete copy of its federal return to the Bureau of Corporation Taxes with the RCT-101, PA Corporate Tax Report, do not send another copy.

All PA S corporations that conduct business in Pennsylvania must file the *RCT-101, PA Corporate Tax Report,* for the capital stock/foreign franchise tax.

A PA S corporation, incorporated in another state with a Pennsylvania resident shareholder having no PA-source income or Pennsylvania activity is not required to file the *RCT-101, PA Corporate Tax Report*.

D. Processible Returns

The PA-20S/PA-65 Information Return for an S corporation must satisfy all requirements found in the PA-20S/PA-65 instructions. The applicable PA-20S/PA-65 Schedules RK-1 and NRK-1 are required attachments for resident and nonresident owners' share of income, deductions, credits, etc. The S corporation must also submit the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other entities. Refer to *Miscellaneous Tax Bulletin 2008-02 Reproduced Forms and Substitute Forms*.

E. Withholding of Estimated Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Resident Individual, Estate or Trust

Individual resident shareholders are subject to the estimated quarterly tax provisions under the Pennsylvania Personal Income Tax Act. Resident shareholders must make declarations and estimated quarterly Pennsylvania tax payments if they reasonably expect income, other than compensation on which Pennsylvania tax is withheld, to exceed $8,000. Individual shareholders should refer to *REV-413I, Instructions for Estimating PA Personal Income Tax for Individuals Only.*

F. Withholding of Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Nonresident Individual, Estate or Trust

Under Act 22 of 1991, a PA S corporation with shareholders who are nonresident individuals, nonresident estates, and nonresident trusts (owners) must withhold and pay Pennsylvania personal income tax on each owner's expected share of distributable Pennsylvania-source taxable income. If making a quarterly withholding payment for the first time, use *PA-40 ESR (F/C,) Declaration of Estimated or Estimated Withholding Income Tax for Fiduciary or Partnerships.* Associations and PA S corporations may also use this form. The PA S corporation makes the initial quarterly withholding payment and all future quarterly withholding payments under the employer identification number, name, and address of the PA S corporation.

The entity should refer to *REV-413P/S, Instructions for Withholding PA Personal Income Tax from Nonresident Owners by Partnerships and PA S Corporations*.

Note. An entity may not withhold Pennsylvania personal income tax for another entity or a Pennsylvania resident individual, and should not withhold Pennsylvania personal income tax on income from intangibles such as interest, dividends, or sale of stock.

G. Final/Catch-Up Payment of Nonresident Withholding Tax

If the Pennsylvania personal income tax due on the taxable income allocable to nonresidents exceeds the tax withheld, the final payment is due on the date prescribed for the filing of the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or with an extension request.

If the tax of the nonresident owners exceeds the nonresident withholding tax payments, the PA S corporation must pay the deficiency by the date prescribed for filing the entity's PA-20S/PA-65 Information Return or if the nonresident owners elect to file on a PA-40 Nonresident Consolidated Income Tax Return, the entity may make the final/catch-up payment with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or with an extension request.

There are three ways to make a final tax withholding payment or final catch-up payment for nonresident owners that are individuals, estates, or trusts. Follow these instructions:

1. With Approved Software Form

If using approved software, submit payment along with the 20XX Nonresident Withholding Payment substitute voucher in the same envelope with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or extension request. Do not staple payment to your return or the substitute voucher.

2. Without Approved Software Form

a. Submit payment with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or extension request. Print the entity's federal employer identification number (FEIN) and 20XX Final Nonresident Withholding on the check or money order made payable to the PA Dept. of Revenue.

b. Submit payment in the same envelope with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or extension request. Do not staple payment to your return.

3. Fed/State e-File

The only acceptable electronic payment method for fed/state partnership e-file is electronic funds withdrawal which is part of the current tax year return submission and is automatically and electronically transferred from taxpayers' bank accounts.

The following types of payments can be electronically transferred with the PA-20S/PA-65 Information Return:

a. The final nonresident individual tax withholding "catch-up" payment submitted with the current tax year return; and

b. The next tax year's (future) estimated payments for nonresident individual quarterly tax withholding submitted with the current tax year return.

These future estimated nonresident individual tax withholding payments for the next tax year will be stored in the system as separate electronic transaction payments until the specified due date.

Important. The nonresident individual quarterly tax withholding payment may not be submitted through Electronic Funds Transfer (EFT), credit/debit cards or e-TIDES.

H. Mailing Address for the Nonresident Withholding Payment

When submitting the final withholding payment or final "catch-up" payment with the PA-20S/PA-65 Information Return, with or without the 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280502
HARRISBURG PA 17128-0502

When submitting the final withholding payment or final “catch-up” payment with the PA-40 Nonresident Consolidated Income Tax Return, with or without 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
CONSOLIDATED RETURN
PO BOX 280418
HARRISBURG PA 17128-0418

When submitting the final withholding payment or final “catch-up” payment with an extension request for any Pennsylvania tax return, send form REV-276 to-

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280504
HARRISBURG PA 17128-0504

Follow the instructions above, With Approved Software Form or Without Approved Software Form.

I. Operations of a PA S Corporation

1. How Does a Corporation Become a PA S Corporation

Effective for tax years beginning on or after Dec. 31, 2005, any corporation with a valid federal S corporation election is automatically a PA S Corporation.

2. Effect of PA S Corporation Status

S corporation shareholders include their share of the corporation's separately stated items of income, deduction, loss, and credit, and their share of non-separately stated income (loss) on their tax returns.

A PA S corporation will only be subject to the corporate net income tax on its net recognized built-in gain reported on federal Schedule D, federal Form 1120S. If any tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation) pursuant to § 1374 of the IRC of 1986, the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

A PA S corporation will remain subject to all other Pennsylvania corporate taxes including capital stock (CS) or foreign franchise (FF) tax.

The PA S corporation passes its income (loss), and credits to its shareholders in the applicable class of income taxable under the Pennsylvania personal income tax rules and regulations.

3. **Election Not to Be Taxed as a PA S Corporation**

Starting with tax years beginning on or after Jan. 1, 2006, a corporation with a valid federal S election is no longer required to file *REV–1640, PA S Corporation Election and Shareholders' Consent* in order to be a PA S corporation. Under Act 67 of 2006, Senate Bill 300 PN 1986, all federal S corporations are PA S corporations. Act 67 also includes a provision for federal S corporations to make an election NOT to be taxed as a PA S corporation. To make this election, the taxpayer is required to file *REV-976, Election Not to be Taxed as a Pennsylvania S Corporation* on or before the due date or extended due date of the report for the first period in which the election is to be in effect.

Example: A federal S corporation that does not want to be a PA S corporation for the tax year ending Dec. 31, 20X1 must file *REV–976, Election Not to be Taxed as a Pennsylvania S Corporation* on or before April 15**.** If the taxpayer has a valid extension to file the *RCT-101, PA Corporate Tax Report*, then REV-976 would be due on or before Oct. 15.

Note. REV-1640, PA S Corporation Election and Shareholders' Consent, became an obsolete form as of Dec. 31, 2005.

4. **Pennsylvania Resident Shareholders of S Corporations in Another State**

Any federal S corporation that does not make this election and is an S corporation in another state that has a Pennsylvania resident shareholder will be taxed as a PA S corporation and is required to file a PA-20S/PA-65 Information Return. The entity is not required to file the *RCT-101, PA Corporate Tax Report* as was previously reported in June/July 2006, *PA Tax Update #121*. In addition, each shareholder will be subject to Pennsylvania personal income tax on each shareholder's pro rata share of the S corporation income, whether distributed or not.

5. **Revocation of Election Not To Be Taxed as a PA S Corporation**

First, it is important to remember the election to not be taxed as a Pennsylvania S corporation may not be revoked for five years from the date it went into effect. A revocation received within this five year period will be effective for the first tax period for which the taxpayer is eligible to revoke the election.

Elections which first went in effect in 2006 may be revoked for 2011. To revoke the election the corporation must send a letter signed by shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made. This letter must contain the name of the corporation, the federal employer identification number (FEIN), the PA corporate tax account number and the effective date of the revocation. If no effective date is provided the revocation will be effective for the first tax period for which the revocation was timely submitted. In the case of a corporation with qualified subchapter S subsidiaries, the letter must include the names and PA corporate tax account numbers of all qualified subchapter S subsidiaries doing business in Pennsylvania. Mail the letter to:

PA DEPARTMENT OF REVENUE
BUREAU OF CORPORATION TAXES
PROCESSING DIVISION
PO BOX 280705
HARRISBURG PA 17128-0705

The deadline for revocation of an election not to be taxed as a Pennsylvania S corporation is the 15th day of the third month of the year in which the revocation is to be in effect. A revocation submitted after the due date will be in effect for the next tax period.

6. Qualified Subchapter S Subsidiaries (QSSS)

Pennsylvania personal income law does not treat a qualified subchapter S subsidiary (QSSS) owned by a PA S corporation (parent) as a separate corporation for personal income tax.

However for corporation tax, Pennsylvania law does treat a QSSS owned by a PA S corporation as two separate corporations.

Consequently a QSSS may not have a personal income tax filing obligation but may have a corporation tax filing obligation.

Pennsylvania personal income tax law treats all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary as assets, liabilities, and items of income, deduction, and credit of the parent PA S corporation for income tax purposes.

The parent PA S corporation must report the assets, liabilities, and items of income, deduction, and credit of the qualified subchapter S subsidiary on the parent's PA-20S/PA-65 Information Return.

Note. Shareholders receive the income distribution from the parent corporation not from each qualified subchapter S subsidiary.

The following provisions apply only to a qualified subchapter S subsidiary in Pennsylvania:

a. A qualified subchapter S subsidiary cannot elect corporation treatment independent of its parent corporation.

If a qualified subchapter S subsidiary and/or parent of a qualified subchapter S subsidiary does not desire to be taxed as a PA S corporation, the parent must file form REV-976, Election Not to be Taxed as a Pennsylvania S Corporation, for itself and all qualified subchapter S subsidiary (s). The parent corporation submits a schedule with the election, identifying the name, address, Revenue ID, and federal employer identification number (FEIN) of each qualified subchapter S subsidiary owned by the corporation and doing business in Pennsylvania.

b. The parent corporation is not required to register with the Department of State if its only activity in Pennsylvania is its investment in the qualified subchapter S subsidiary that is registered in Pennsylvania.

Therefore, the parent corporation is not required to file the RCT-101, PA Corporate Tax Report. If the qualified subchapter S subsidiary is not registered, then either the parent or the qualified subchapter S subsidiary must register.

Additionally, the parent is required to file a PA-20S/PA-65 Information Return and list the qualified subchapter S subsidiary(s) on Part IX and include all qualified subchapter S subsidiaries' items of income, deduction and credit on the return. There is no ownership percentage for the qualified subchapter S subsidiary because it is a division of the parent company.

Since the qualified subchapter S subsidiary is a division of the parent company, the qualified subchapter S subsidiary is not included on the Partner/Member/Shareholder Directory. Only the owners of the parent company are listed on the directory.

c. For Pennsylvania corporation tax purposes (capital stock and foreign franchise tax) the parent corporation and each qualified subchapter S subsidiary is a separate entity with its own Revenue ID.

Each entity must file an RCT-101, PA Corporate Tax Report, on a separate company basis. On a separate company basis, each entity submits with its RCT-101, PA Corporate Tax Report, its individual income statement, beginning and ending balance sheet and statement of retained earnings (or a pro–forma federal Form 1120S).

d. If the parent corporation must file the RCT-101, PA Corporate Tax Report, the parent must also submit a consolidated beginning and ending balance sheet that includes all foreign and domestic qualified subchapter s subsidiaries. Please refer to REV-1200, CT-1 PA Corporation Tax Booklet, on the department's website for additional guidelines.

Note. The parent PA S corporation may also file the PA-40 Nonresident Consolidated Income Tax Return, for its nonresident individual owners if the nonresident individual owners meet the parameters. Refer to the PA-40 NRC instructions on the department's website for further information.

J. Termination of a PA S Corporation

1. Corporate Distributions in Complete Liquidation

Generally, the amounts received by a shareholder in the complete actual winding up of a PA S corporation and distribution of its assets (or the proceeds from the sale of its assets) shall be treated as a full payment in exchange for the shareholder's stock. Accordingly, if property is received in such a distribution, generally, the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution. However, if the amounts are received pursuant to a tax-free reorganization to which the PA S corporation is a party, no sale, exchange or other disposition is recognized, and the basis of the property in the hands of the distributee shall be the corporation's adjusted basis at the time of the distribution.

The amounts received in a complete liquidation are taxed under the above rules even if the distributions are not made in connection with settling the accounts and liquidating the assets of a corporation for the purpose of dissolving the corporation. The concept of an actual distribution of assets to its shareholders in the course of complete liquidation is distinct from the legal termination of the entity.

K. Termination of PA S Corporation Status

A corporation's PA S corporation status remains effective until it is terminated by the IRS or the federal election was revoked. If the corporation is no longer a federal S corporation, the PA S status is automatically terminated. No separate revocation of the PA S status is required.

L. PA S Corporation Revocation or Termination Year

A PA S corporation revocation or termination year is the tax year of a PA corporation in which the corporation is treated as a PA S corporation for part of the tax year and a corporation subject to corporate net income tax for the balance of the tax year.

The PA S corporation revocation or termination year is divided into two periods for filing tax returns. These periods are known as:

1. The PA-20S/PA-65 Information Return short taxable year, and

2. The RCT-101, PA Corporate Tax Report short taxable year.

The corporation must file two returns to cover the revocation or termination year; one that covers the PA-20S/PA-65 Information Return short taxable year and one that covers the RCT-101, PA Corporate Tax Report short taxable year and includes:

1. **PA-20S/PA-65 Information Return Short Taxable Year Return**
   The *PA-20S/PA-65 Information Return* short taxable year is the part of the termination year that begins on the first day of the corporation's tax year and ends the day before the termination is effective.

   The PA-20S/PA-65 Information Return that is due for the corporate net income tax short year is due 3½ months after the last day of the tax year.

2. **RCT-101, PA Corporate Tax Report Short Taxable Year Return**
   The RCT-101, PA Corporate Tax Report, short taxable year is the part of the PA S corporation revocation year that begins on the day the termination is effective and ends on the last day of the corporation's tax year. The *RCT-101, PA Corporate Tax Report,* is due for the corporate net income tax short year. The *RCT-101, PA Corporate Tax Report,* for the short taxable year is due 30 days after the date on which the corporation's federal tax return is due.

3. **Division of Income**
   After the PA S corporation termination year is divided into two periods, the separately stated items of income, loss and credit, and the amount of the non-separately calculated income or loss must be divided between the periods. There are two methods that can be used to make this division:

   a. **Pro Rata Allocation**
   This method of allocation must be used unless the shareholders and the PA S corporation specifically choose the other allocation method discussed under Allocating Based on Normal Accounting Rules.

   The pro rata allocation is made as follows:

   - First determine the amount of each separately stated item of income, deduction, loss or credit, and the amount of the non-separately calculated income or loss.

   - Then divide each amount by the number of days in the PA S corporation revocation or termination year (total tax year).

   - Multiply the amounts from the second step above by the number of days in the S corporation's short taxable year. Use
   - these amounts to file the PA-20S/PA-65 Information Return for the revocation or termination year.

- Multiply the amounts from second step above by the number of days in the *RCT-101, PA Corporate Tax Report* short taxable year. Use these amounts to file the RCT-101, PA Corporate Tax Report for the PA S revocation or termination year.

b. Allocation Based on Normal Accounting Rules

A normal accounting rules basis is the alternate method of allocation. The corporation must choose this method and all persons who are shareholders during the PA S corporation revocation or termination year must consent to the choice. The corporation will then report all items of income, loss, or credit based on the corporation's books and records (including worksheets). Therefore, the items will be split between the PA-20S/PA-65 Information Return short taxable year and the RCT-101, PA Corporate Tax Report short taxable year according to the time they were realized or incurred based on the books and records of the corporation.

M. Allocation of Income

Shareholders who are nonresident individuals, estates, or trusts are taxed only on taxable income allocable or apportionable to Pennsylvania. Items of income (loss), cost, expense, and liability not allocable to Pennsylvania are ignored in computing the PA-taxable income of such shareholders.

Special allocation rules apply to each of the following:

a. Net income or loss from trusts, estates, partnerships, and other PA S corporations,

b. Net income or loss from business, profession or farm activities,

c. Net gains or losses from the sale, exchange or disposition of tangible or real property,

d. Net gains or losses from the sale, exchange or disposition of intangible personal property,

e. Net rental income or loss from ownership of property.

1. Cancellation of Debt Income

For additional information concerning cancellation of indebtedness income, please refer to the Pennsylvania Personal Income Tax Guide, Chapter 24, Cancellation of Debt for Pennsylvania Personal Income Tax Purposes and PIT Tax Bulletins 2009-02 through 2009-07.

2. Built-In Gains

If any tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation) pursuant to § 1374 of the IRC of

1986, the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax. The built-in gains taxes imposed on the PA S corporation are treated as losses to be reported to the shareholders. The losses are allocated to the class of income that gave rise to the built-in gain and may be deducted by the shareholders. Tax for built-in gains is reported on the *RCT-101, PA Corporate Tax Report.*

3. Gain Rules

There are differences between federal income tax reporting and Pennsylvania personal income tax reporting. Refer to the *PA-20S/PA-65 Schedule D instructions* on the department's website.

N. Basis of a Shareholder's Interest in a PA S Corporation

There are differences between federal income tax and Pennsylvania personal income tax reporting at the entity level. IRC rules for determining basis, adjustments to basis and gains by the corporation generally are to be followed with these exceptions:

- For business assets placed into service after 1982, their basis will not have to be reduced by a percentage of the federal income tax credit for which the asset qualifies.

- Losses realized by a PA S corporation on bona fide sales or exchanges of property with related taxpayers may be offset against any gains received from other sales or exchanges.

1. Figuring Shareholder Taxable Income (Loss)

Each shareholder reports the applicable pro rata share of each item of income (loss) or credit from business, profession or farm reported to them on the PA-20S/PA-65 RK-1 and/or NRK-1 on their *PA-40 Individual Income Tax Return*, or the *PA-41 Fiduciary Income Tax Return*. Refer to the PA-40 or PA-41 tax forms and instructions for this reporting.

2. Pennsylvania Does Not Permit Offsetting Between the Classes of Income (Losses)

Pennsylvania does not permit offsetting between the classes of income (loss) that the PA S corporation passes through to its shareholder. The character of any PA S corporation item included in the shareholder's pro rata share is determined as if the item were realized directly by the shareholder. For more information, refer to the PA-20S/PA-65 Information Return instructions on the department's website.

3. Adjustments to Basis of Stock (Shareholders' Capital Investment)

Each shareholder must adjust the basis of stock in the PA S corporation as indicated below:

a. Increases

Each shareholder's pro rata share of the following items increases the basis of stock:

- Non separately stated net profits from business, profession, and farm that are passed through to the shareholder,
- Separately stated other personal income items passed through to the shareholder, and
- Nontaxable income.

b. Decreases

Each shareholder's pro rata share of the following items decreases the basis of stock, but not below zero:

- Non separately stated losses from business, profession or farm activities that are passed through to the shareholder,
- Separately stated other personal loss items that are passed through to the shareholder,
- Distributions other than dividend distributions, and
- Nondeductible expenses.

Basis is reduced only to the extent that the losses reduce the shareholder's income subject to Pennsylvania personal income tax or a tax on or measured by income imposed on the shareholder by any other state.

If losses are not used, basis must be reduced by the shareholder's share of straight-line depreciation. Percentage of unused loss is multiplied by the shareholder's share of straight-line depreciation.

c. Limitation on Losses and Loss Carryovers

The aggregate amount of losses taken into account by a shareholder is limited to the sum of the adjusted basis of the shareholder's stock for the tax year and the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder figured before any adjustments for the tax year.

There is no provision allowing for carryover of losses by the shareholders of the corporation.

d. No Carry-Forward or Carry-Back of Losses
For Pennsylvania purposes, neither the S corporation nor the shareholders may carry-forward or carry-back any losses to other tax years.

e. No Offsetting Income or Losses in More than One Class of Income
Per Reg. 121.13 (a), "a person shall not be allowed to offset a gain in one class of income with a loss in another class of income".

Therefore neither the S corporation nor the shareholders may offset income or gain in one class of income with a loss in another class of income.

O. Shareholder Adjustments to Basis of Indebtedness (Shareholder's Loans to PA S Corporations)

1. Reduction in Basis of Indebtedness
If the shareholder's basis of stock in a PA S corporation is decreased to zero, any amount of excess losses shall be used to reduce the shareholder's basis of indebtedness of the PA S corporation to the shareholder, but not below zero.

2. Restoring Basis
If the shareholder's basis in indebtedness is reduced under "1" above, the reduction shall be restored before the shareholder's basis in the stock of the PA S corporation is increased.

P. Adjustments to Basis for PA S Corporation Distribution

1. Determine Stock and Loan Basis
Determine the year-end stock basis excluding all tax year distributions. This is the adjusted basis figure used in the determination of the tax treatment of any distributions during the tax year.

a. **PA S Corporations with no Pennsylvania Personal Income Tax Accumulated Earnings and Profits (AE&P)**
Distributions from a corporation with no accumulated earnings and profits for Pennsylvania personal income tax purposes are a nontaxable reduction to the stock basis.

b. **PA S Corporations with C Corporation Accumulated Earnings and Profits**
Distributions from a corporation in excess of accumulated adjustments account (AAA) with earnings and profits for Pennsylvania personal income tax purposes is handled as follows:

- Reduce the distribution by the pro rata share of the accumulated adjustments account. If the distribution is not pro rata for any given year, a resident shareholder cannot receive tax-free distributions in excess of what the resident previously reported in prior years for Pennsylvania personal income tax. Nonresidents are not taxed on distributions from the PA S corporation. Consequently, when distributions are made which are not pro rata in any given year, adjustments are required for either the resident and or nonresident to properly reflect the appropriate treatment for Pennsylvania personal income tax purposes.

- The excess of the distribution over the members share of accumulated adjustments account is a taxable dividend to the extent of the shareholder's pro rata share of the accumulated earnings and profits of the corporation.

- The excess of the distribution beyond accumulated adjustments account and accumulated earnings and profits is a nontaxable reduction to the basis. (Cannot go below zero.)

- Any distributions in excess of basis calculated above are treated as gain from the sale, exchange or disposition of property.

For a nonresident, all distributions are nontaxable. The nonresident's economic investment is reduced by the fair market value of the distribution. A nonresident cannot deduct losses in excess of his/her/its economic investment.

In summary, distributions are:

- Nontaxable to the extent of the accumulated adjustments account to the extent of basis,

- Taxable as dividends to the extent of corporate accumulated earnings and profits,

- Nontaxable return of capital to the extent of basis,

- Taxable as a gain from the sale, exchange or distribution of property.

Q. PA S Corporation Distributions

1. Distributions to Residents

A distribution that a PA S corporation pays from the accumulated earnings and profits of the corporation before it elected PA S status is dividend income to its resident shareholders. All other distributions represent a nontaxable return of the resident shareholders' basis in its stock.

Nontaxable return of basis distributions will reduce each resident shareholder's basis in the stock first. If the nontaxable return of basis distribution exceeds the shareholder's basis in his/her/its stock holdings, the shareholder can apply the excess against the basis of any indebtedness of the PA S corporation to that shareholder. If the distribution exceeds the shareholder's basis in the stock and the PA S corporation's indebtedness, the resident shareholder must report a gain from the disposition of property.

2. Distributions to Nonresidents
All distributions to nonresident shareholders reduce the nonresidents' economic investment in the PA S corporation. Distributions are nontaxable.

3. Distribution of Appreciated Property
If the PA S corporation distributes appreciated property, it must treat the distribution as if it had sold the property to the shareholders at fair market value. Such a distribution will produce a gain from the sale of property that the PA S corporation will have to report as net gain (loss) from the sale, exchange, or disposition of property.

4. PA-20S/PA-65 Schedule RK-1 and NRK-1
A PA S corporation must report distributions on the shareholder's *PA-20S/PA-65 Schedules RK- 1 and NRK- 1.*

a. **Residents**
Each resident shareholder must reflect distributions on the *PA-20S/PA-65 Schedule RK-1* and on form *REV-998 Shareholder Tax Basis in PA S Corporation Stock Worksheet* to determine whether such distributions are taxable.

b. **Nonresidents**
Distributions to nonresidents are not taxable.

R. Accumulated Adjustments Account

1. Pennsylvania Personal Income Tax Accumulated Adjustments Account
Pennsylvania accumulated adjustments account should not usually equal the federal accumulated adjustments account because of the differences between the federal tax law and Pennsylvania personal income tax law. Pennsylvania generally parallels federal rules for the PA S corporation's accumulated adjustments account with these significant differences:

a. The PA S corporation accumulated adjustments account only reflects the income (loss) or distribution from the inception of PA S corporation status.

b. The PA S corporation does not make an adjustment for any income (loss) that is not enumerated in Pennsylvania personal income tax law or any nondeductible expense. For example, for Pennsylvania personal income tax purposes, tax-exempt income is not added to the Pennsylvania personal income tax accumulated adjustments account.

c. The Pennsylvania accumulated adjustments account is based on the Pennsylvania personal income tax income (loss) or distributions.

2. Distributions from Pennsylvania Accumulated Adjustments Account

Distributions to a resident shareholder from Pennsylvania accumulated adjustments account are tax free to the resident shareholder unless the Pennsylvania accumulated adjustments account exceeds the resident shareholder's basis in his/her/its stock.

The resident shareholder will recognize taxable income to the extent that the Pennsylvania accumulated adjustments account distribution exceeds the shareholder's basis in his/her/its stock. Although not taxable to a nonresident shareholder, the nonresident shareholder reduces his/her/its economic investment by the fair market value of the property distributed.

3. Distributions of Cash, Marketable Securities, and Property (other than distribution from Pennsylvania Accumulated Earnings and Profits)

Distributions of cash, marketable securities and property (in excess of Pennsylvania accumulated adjustments account) are considered a tax-free return of investment to the extent of the resident shareholder's basis in his/her/its stock. The resident shareholder will recognize taxable income to the extent that the fair market value of such distribution exceeds the shareholder's basis in his/her/its stock. Although not taxable to a nonresident shareholder, the nonresident shareholder reduces their economic investment by the fair market value of the property distributed.

4. Accumulated Adjustments Account Distributions May Exceed Shareholder Basis

Distributions that the PA S corporation makes that represent cash, marketable securities, and other property may represent Pennsylvania-taxable income to the extent the distributions exceed the resident shareholder's personal basis.

5. Negative Accumulated Adjustments Account

Pennsylvania follows the federal rule in that the PA S corporation's accumulated adjustments account may become negative because of losses not distributions.

The accumulated adjustments account is a corporate account. Future income must be used to restore the negative closing balance of Pennsylvania accumulated adjustments account before the PA S corporation can make PA tax-free distributions.

S. Accumulated Earnings and Profits

Pennsylvania follows the federal tax laws regarding the calculation of accumulated earnings and profits. Accumulated earnings and profits is a measure of the undistributed earnings of a C corporation, but from a tax point of view. C corporations generate positive or negative accumulated earnings and profits each year, calculated by making annual adjustments to taxable income.

When a C corporation becomes a PA S corporation, the accumulated earnings and profits retains its character. The PA C corporation's accumulated earnings and profits is frozen on the date the corporation converts to PA S status. The accumulated earnings and profits generally will not increase except when the corporation acquires another corporation with accumulated earnings and profits. However, it can be reduced by distributions from accumulated earnings and profits and the payment by the PA S corporation of C corporation period tax.

The tax treatment of distributions made by an S corporation is partially determined based on whether the corporation has accumulated earnings and profits. The shareholder's stock basis must also be considered because distributions in excess of basis always result in taxable income to the shareholder.

Federal subchapter S corporations that have been Pennsylvania S corporations throughout their corporate existence always should have tracked their Pennsylvania adjustments account and Pennsylvania accumulated earnings and profits, if applicable, to provide the information required for resident shareholders to correctly report distributions.

Federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006 similarly should track Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits. However, it may be extremely difficult to obtain the necessary information to calculate the initial Pennsylvania accumulated earnings and profits.

There are significant differences among the federal accumulated adjustments account, Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits calculations.

The Pennsylvania Department of Revenue will allow a transitional election by federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006. The department may allow a "new" Pennsylvania S corporation taxpayer to elect to use its federal accumulated adjustments account as the functional equivalent of its Pennsylvania accumulated earnings and profits.

This election may be filed with the *PA-20S/PA-65 PA S Corporation/Partnership Information Return*. Attach a statement indicating the PA S corporation elects to use its federal accumulated adjustments account to calculate the amounts reported as dividends from accumulated earnings and profits. Report those amounts on PA-20S/PA-65 Schedule RK-1, Line 15 and PA-20S/PA-65 Schedule NRK-1, Line 13.

Both C corporations and PA S corporations can distribute taxable dividends to the extent they have accumulated earnings and profits. Although PA S corporations do not generate accumulated earnings and profits, they can have accumulated earnings and profits from:

1. C corporation operations during any period in which the corporation did not have a valid S corporation election in effect, or

2. Being a party to a reorganization whereby the S corporation acquires the assets of another corporation that has accumulated earnings and profits.

Accordingly, a PA S corporation will not have accumulated earnings and profits if it:

1. Was never a C corporation, or

2. Has not acquired another corporation with accumulated earnings and profits.

See Table 16-4 - Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for PA S Corporations Outside Basis Calculation in Part IX - TABLES.

T. IRC Section 338(h)(10) Elections Not Permitted

IRC § 338(h)(10) election is an election whereby a selling group and buying corporation can elect jointly to have the selling group recognize gain or loss as if the target corporation sold its assets while still a member of the selling group. There is no income tax on the sale of the stock to the acquiring company. The income tax attributes of the target company stay with the selling parent company, which is responsible for taxes on the deemed sale of asset. The deemed sales price is determined under the modified aggregate deemed sales price method, which depends on the actual purchase price of the stock, adjusted for liabilities and other relevant items.

Pennsylvania personal income tax law does not recognize IRC § 338(h)(10) elections. Accordingly, the sale of a share of stock in a PA S corporation is never treated as a sale of the shareholder's proportionate interest in each asset of that corporation; nor is there any basis under Pennsylvania personal income tax law for treating a target PA S corporation as if it had sold all of its assets at the close of the acquisition date at fair market value in a single transaction and then repurchased all of the assets at the beginning of the day after the acquisition date if no such sale and repurchase actually occurred.

For Pennsylvania personal income tax purposes, gain recognized by shareholders under IRC § 338 is “deemed gain” from the sale of assets that is not to be taken into account.

However, the resident shareholders must report their gain or loss on the sale of stock on *PA-40 Schedule D, Sale, Exchange, or Disposition of Property*.

A resident shareholder may claim a resident credit for taxes paid to another state on Schedule D gain resulting from an IRC § 338(h)(10) transaction. Refer to PA PIT Guide Chapter 17, Credits.

U. Treatment of Life Insurance Proceeds Received by a PA S Corporation Where S Corporation Paid Premiums

1. Proceeds Used to Fund a Buy or Sell Arrangement

No expense deduction is allowed for life insurance premiums if the life insurance proceeds are to be used to fund a buy or sell arrangement. The proceeds payable upon death are not taxable at the shareholder level.

2. Proceeds Used to Buy-Out a Decedent’s Interest

No expense deduction is allowed to free up funds to buy-out a decedent’s interest. The proceeds are not taxable at the shareholder level.

3. Proceeds Used to Continue Business or Secure Loans

72 P.S. § 7303(a)(6)defines interest income as any amount paid under contract of life insurance…,which is includable for federal income tax purposes. However, if the exclusive purpose of the policy is to keep the business going, including the use of the insurance policy to secure business loans, the insurance premiums are deductible by the PA S Corporation and the life insurance proceeds are taxable. These proceeds are included in the PA S Corporation’s business income from operations.

III. BONUS DEPRECIATION

Under Pennsylvania personal income tax law, a PA S corporation or partnership may not use any of the bonus depreciation elections enacted for federal purposes.

Many provisions of the 2004 American Jobs Creation Act were not adopted for Pennsylvania personal income tax purposes. Specifically, the provisions regarding Internal Revenue Code (IRC) § 199 domestic production activities expense deduction and immediate expensing of intangible costs for start-up expenses, organizational expenses, and syndication fees may not be used in the calculation of Pennsylvania personal income tax liabilities.

A. OTHER DEPRECIATION EXPENSE DIFFERENCE

Pennsylvania tax law allows ACRS or MACRS only when:

1. They are also used for federal tax purposes, and

2. The property, when placed in service, has the same adjusted basis for Pennsylvania and federal tax purposes.

Moreover, deductions under ACRS and MACRS are allowable only to the extent allowable under the version of the IRC in effect as amended to Jan. 1, 1997.

Additionally, for any year in which an ACRS or MACRS deduction is allowed or allowable and regardless of the method of accounting:

1. The S corporation or partnership must reduce its basis in the depreciable property by the amount by which the deduction reduced its net income; and

2. Each owner must reduce outside basis by the owner's share of net loss or the amount of the owner's share of depreciation allowed or allowable using the straight-line method of depreciation.

B. IRC SECTION 179 PROPERTY DEDUCTIONS

Pennsylvania tax law allows IRC § 179 property deductions on a limited basis. They are allowable with respect to the entity and each owner only to the extent allowable under the Internal Revenue Code in effect on Jan. 1, 1997. For example, the aggregate dollar limitation is $25,000 less the amount by which the cost of IRC § 179 property placed in service during the taxable year exceeds $200,000. Federal increases enacted after 1997 are disregarded for personal income tax purposes.

The deduction limits apply both the business entity and the owner. Each entity calculates its 179 expenses and applies the limit. The expenses (subject to the limit) are then passed through to the owner. The owner then adds up all 179 expenses passed through to him/her from all business entities. The owner then applies the 179 limit to the sum. The result is the owner's allowable 179 deduction.

Additionally, for any year in which an IRC § 179 property deduction is claimed, basis must be reduced by the amount of the deduction, regardless of whether the deduction results in a reduction of net income.

IV. APPORTIONMENT

A. How to Apportion Income From a Business, Profession or Farm Derived From Sources within Pennsylvania, Wholly Outside Pennsylvania, or Partly Within Pennsylvania

1. Operation Wholly Within Pennsylvania

If the operation of the business is wholly within Pennsylvania, the entity allocates income (loss) exclusively to Pennsylvania. The operation of a business is wholly within Pennsylvania if, during the entire taxable year:

a. The entity, or its representative, maintained or operated within Pennsylvania an office, shop, store, warehouse, factory, agency, or

b. Commercial establishment where it systematically and regularly conducted or managed such business; and

c. The entity, or its representative, did not maintain and operate outside Pennsylvania any office, shop, store, warehouse, factory, agency, or commercial establishment where it systematically and regularly conducted or managed such business.

For purposes of this rule, do not take into account any establishment maintained or operated by a representative of a PA S corporation or partnership if the representative acted as an independent contractor.

2. Operation Wholly Outside Pennsylvania

If the operation of the business is wholly outside Pennsylvania, the entity cannot allocate to Pennsylvania any item of income (loss), cost, or expense that it derives or incurs. The operation of a business is wholly outside Pennsylvania if, during the taxable year:

a. The entity does not conduct in Pennsylvania any acts or transactions in the ordinary course of operating its business, or

b. The entity only conducts in Pennsylvania acts or transactions in the ordinary course of operating its business that, with a fair measure of permanency or continuity, are either or both of the following–

- The solicitation of orders or sales of tangible personal property which are sent outside Pennsylvania for approval or rejection and, if approved, are filled by shipment or delivery of goods or services from a point outside Pennsylvania, or

- The solicitation of orders in Pennsylvania by the entity or entity representative, to a prospective customer, and such customer sells entity's product to its customers via solicitation as described in bullet point above.

For purposes of the above, an entity is not engaged in business activities within Pennsylvania during a taxable year merely by reason of sales of tangible personal property in Pennsylvania or the solicitation of orders for sales of tangible personal property in Pennsylvania on behalf of the entity by one or more independent contractors that maintain an office in Pennsylvania solely for making sales or soliciting orders for sales.

3. **Operation Partly Within Pennsylvania**

When an entity operates a business that is neither wholly within nor wholly outside Pennsylvania under the above definitions, it allocates by separate accounting if:

a. The business operations within Pennsylvania and the business operations outside Pennsylvania constitute independent profit centers. This means there are no transfers of finished or partly finished goods, raw materials, supplies, services, or operational assets interspersed; and each center is free to buy outside; and because of geographical location, no center is in direct competition with another, and

b. The entity keeps its books so that the amounts of revenues, costs, and expenses attributable to Pennsylvania operations can be properly disclosed.

Otherwise, the entity must complete a *PA-20S/PA-65 Schedule H*.

Submit a statement that lists all places both within and outside Pennsylvania where the PA S corporation or partnership conducts business activity or farming. Include the street address, city, state, and the type of business, profession or farm.

B. Real Estate and Tangible Property (Property Factor)

The property factor is a fraction. The numerator is the average value of real and tangible personal property employed in the business and located in Pennsylvania. The denominator is the average value of the real and tangible property employed in the business everywhere. For purposes of calculating the property factor:

1. The PA S corporation or partnership values owned property at its original cost.

2. Real property includes real property the entity rents and uses in the business.

3. The entity values rental property by multiplying the gross rents paid during the taxable year by eight.

4. If the values of the Pennsylvania real or tangible personal property that the entity employs in its business are zero at the beginning of any calendar month during its taxable year, the entity determines its average value of property by averaging the values at the beginning and ending of the taxable year. Otherwise, the entity determines its average value of property by averaging the monthly values.

5. Gross rents are the actual sum of money or other consideration paid directly or indirectly by the PA S corporation or partnership or for its benefit for the use or possession of the property. Gross rents include:

a. The amount paid for the use or possession of real property or any part thereof, whether designated as a fixed sum of money or a percentage of sales, profits, or otherwise.

b. The amount paid as additional rent, or instead of rent, the amount the entity paid in interest, taxes, insurance, repairs, or other amounts under the terms of a lease or other arrangement.

c. The portion of the cost of any improvement to real estate made by or on behalf of the taxpayer which reverts to the owner or the lessor upon termination of the lease or other arrangement based on the unexpired term of the lease commencing with the completion date of the improvement, or the life of improvement, if its life expectancy is less than the unexpired term of the lease. If the entity erects, or another entity erects on behalf of the entity, a building on leased land, the entity determines the value of the land by multiplying the gross rent by eight and the value of the building in the same manner as if owned by the PA S corporation or partnership. The proportional part of the cost to an improvement (other than the building on leased land) is generally equal to the amount of allowable amortization in calculating Pennsylvania net income, whether the lease does or does not contain an option of renewal.

6. Gross rents shall not include:

a. Any portion of a payment or credit to the proprietor of the business, or to a shareholder in a PA S corporation or partner in a partnership conducting the business for the use of real property,

b. Amounts payable for separate charges for water and electric service furnished by the lessor,

c. Amounts payable for storage if no designated space under the control of the taxpayer as a tenant is rented for storage purposes,

d. That portion of any rental payment that, in the discretion of the department, is applicable to property subleased by the taxpayer and not used by him or her in the carrying on of the business.

C. Wages, Salaries, Commissions, and Other Compensation (Payroll Factor)

The payroll factor is a fraction. The numerator is the total current employee wage and salary expense for the taxable year the PA S corporation or partnership incurs in connection with its business activity within Pennsylvania. The denominator is the total current employee wage and salary expense the entity incurs in connection with its business everywhere.

The entity incurs employee wage and salary expense in connection with its business activity in Pennsylvania if one of the following applies:

1. The employee performs personal services entirely within Pennsylvania, or

2. The employee performs personal services outside Pennsylvania that are incidental to the usual services the employee performs in Pennsylvania, or

3. The employee performs some personal services in Pennsylvania, and at least one of the following applies:

    a. The employee's base of operations is in Pennsylvania.

    b. The place from which the employee receives direction or control is in Pennsylvania.

    c. The employee is a resident of Pennsylvania.

The term base of operations refers to the place or fixed center from which the individual works. An individual's base of operations may be their business office, or a place at which the employee is to receive their directions and instructions if their contract of employment so specifies. In the absence of more controlling factors, an individual's base of operations may be the place to which they have their business mail, supplies, and equipment sent, or the place where they maintain their business records.

D. Sales (Sales Factor)

The sales factor is a fraction. The numerator is total gross receipts derived from sales in Pennsylvania during the taxable year. The denominator is total gross receipts derived from all sales during the taxable year.

For purposes of calculating the sales factor, only sales of stock in trade or inventory held primarily for sale to customers in the ordinary course of the business, sales of services to customers, and sales of operational assets shall be taken into account. A sale of stock in trade or inventory is in Pennsylvania if:

1. The seller delivers or ships the property from outside Pennsylvania into Pennsylvania to any purchaser other than the federal government.

2. The seller delivers or ships the property from Pennsylvania and the purchaser is the federal government.

3. The seller delivers or ships the property from Pennsylvania to another state or country, and the other state or country has no jurisdiction to tax the net income of the business derived from such sales.

4. The seller delivers or ships the property from a point within Pennsylvania to a purchaser in Pennsylvania. A sale of services is in if the seller performs the services wholly within Pennsylvania.

A sale of services is in Pennsylvania if the seller performs a greater portion of the services in Pennsylvania than outside Pennsylvania, based on costs of performance. A sale of an operational asset that is in Pennsylvania is a sale of property within Pennsylvania.

E. Allocating Gains or Losses from the Disposition of Tangible Property

Generally, the revenues, costs, expenses, and liabilities that a PA S corporation or partnership derives from, or incurs in, the sale, exchange, or other disposition of real property or tangible personal property are entirely derived from or incurred in the state or country in which the property is physically located. Special rules, however, apply with respect to the following:

1. Stock in trade or other property of a kind that the entity includes in its inventory if on hand at the close of the taxable year.

2. Property the entity holds primarily for sale to customers in the ordinary course of its business operations.

3. Assets that the entity employs in and serves as an operational function in the operation of the business.

The general rule for apportionment applies with respect to such assets if:

1. The entity disposes of the assets pursuant to the sale, discontinuation, or abandonment of a business, or segment thereof, or

2. The sale or other disposition is of a type that the entity does not reasonably expect to recur in the near future and possesses a high degree of abnormality.

Otherwise, the PA S corporation or partnership allocates the gain (loss) under the rules applicable to allocating income (loss). See Table 16-6 Reporting Gain (Loss) For Pennsylvania Personal Income Tax Purposes.

The entity may not take into account any item of revenue, cost, expense, or liability allocable to a state or country other than Pennsylvania, under these rules, in computing its income from PA sources.

F. Gains or Losses from the Disposition of Intangible Personal Property

Generally, the revenues, costs, expenses, and liabilities that the PA S corporation or partnership derives from, or incurs in, the sale, exchange, or other disposition of intangible personal property are entirely derived from or incurred in the state or country in which the property is physically located. The general rule for apportionment applies with respect to assets if:

1. The entity disposes of the asset pursuant to the sale, discontinuation, or abandonment of that business or segment thereof, or

2. The sale or other disposition is of a type that the entity does not reasonably expect to recur in the near future and possesses a high degree of abnormality.

Otherwise, the entity allocates gains or losses under the rules applicable to allocating income and loss.

Please refer to *PA PIT Bulletin 2005 -02 Gain or Loss Derived from the Disposition of a Going Concern* contained in the *Pennsylvania Personal Income Tax Guide, Chapter 30.*

G. Interest Income

Generally, the PA S corporation or partnership allocates any item of interest, cost, expense, or liability incurred in the production of interest to Pennsylvania.

However, special rules apply with respect to the following:

1. Interest the PA S corporation or partnership derives from, and costs, expenses, or liabilities the PA S corporation or partnership incurs in connection with, purchase money mortgages on real estate or land contracts,

2. Interest the PA S corporation or partnership derives from, and costs, expenses, or liabilities the PA S corporation or partnership incurs in connection with, assets that it employs as working capital (generally current assets) in its business and from accounts and notes receivable from sales or products or services it sells in the ordinary course of business, and

3. Interest incidental to the production or collection of rental or royalty income.

The PA S corporation or partnership apportions such items under the rules applicable to apportioning net profits (losses). Therefore, classify interest income associated with current assets as net profits from a business, profession or farm.

H. Dividend Income

Generally, the PA S corporation or partnership allocates any item of dividend, cost, expense, or liability incurred in the production of dividends to Pennsylvania. The special rules for allocating interest income, described above, also apply to dividend income. Therefore, generally classify dividend income associated with current assets as net profits from a business, profession or farm.

I. Rental Income From Real Estate

Rent that the PA S corporation or partnership derives from real estate, and costs, expenses, and liabilities the entity incurs in the production or collection of such rents are allocable to Pennsylvania only if the rental property is in Pennsylvania.

J. Rental Income From Tangible Personal Property

The PA S corporation or partnership allocates the rent it derives from tangible personal property that it does not employ in its business operation, and costs, expenses and liabilities that it incurs in the production or collection of such rents, by multiplying the net rent by a fraction. The numerator is the number of days the property is physically in Pennsylvania during the rental period. The denominator is the number of days for all rental periods in the taxable year.

If the physical location of the property during the rental period is unknown, the entity allocates it to the state or country in which the property was located at the time the rental payer obtained possession.

K. Royalties from Real Property

Proceeds derived from non-operating interests in coal, oil, gas, or other minerals in place and costs, expenses, and liabilities incurred in the production of such receipts are allocable to Pennsylvania only if the property from which the operating interests serves is located in Pennsylvania.

L. Royalties From Patents and Copyrights

The PA S corporation or partnership allocates patent and copyright royalties that are not includable in the calculation of net profits from the operation of a business, and the costs, expenses, and liabilities incurred in the production and collection of such royalties to Pennsylvania only if and to the extent that:

1. The payer employed the patent in the production, fabrication, manufacturing, or other processing in Pennsylvania, or

2. The payer produced the patented products in Pennsylvania, or

3. The payer originates the printing or publication in Pennsylvania.

M. Allocating Income from Estates and Trusts

Estate or trusts must provide to each beneficiary a *PA-41 Schedules RK-1 and NRK-1,* detailing the beneficiary's share of income, credits and distributions during the taxable year. The *PA-41 Schedules RK-1 and NRK-1* lists each beneficiary's resident taxable income or nonresident taxable income (respectively). The nonresident taxable income represents the beneficiary's total net income or gain derived through the estate or trust which the beneficiary must allocate to Pennsylvania.

V. LIMITED LIABILITY COMPANY (LLC)

A. Filing Requirements

1. Regardless of how a **limited liability company** is classified for federal income tax purposes, the limited liability company is subject to capital stock/foreign franchise tax, reported on the RCT-101, PA Corporate Tax Report. A limited liability company that meets the de minimis standards as outlined in Corporation Tax Bulletin 2004-01 may file the RCT-101D, Declaration of de minimis PA Activity, in lieu of the RCT-101, affirming the Pennsylvania activity during that period is de minimis.

2. A limited liability company that elects to file as a **C corporation** for federal income tax purposes files as a C corporation for Pennsylvania and is subject to Pennsylvania corporate net income tax, reported on the RCT-101, PA Corporate Tax Report. A limited liability company that files as a C corporation with the IRS does not file the PA-20S/PA-65 Information Return.

3. A limited liability company that elects to file as an **S corporation** for federal income tax purposes and has not elected out of PA Subchapter S status for Pennsylvania by filing REV-976, Election Not To Be Taxed as A Pennsylvania S Corporation, must file as an S corporation for Pennsylvania using the PA-20S/PA-65 Information Return. The members are subject to personal income tax.

4. A limited liability company that elects to file as a **partnership** for federal income tax purposes files as a partnership for Pennsylvania using the PA-20S/PA-65 Information Return. The partners are subject to personal income tax.

5. **Income Reported on Federal Tax Return of an Individual**
   A single member limited liability company (SMLLC) owned by an individual or a limited liability company jointly owned by husband and wife that files as a disregarded entity for federal income tax purposes is an entity separate from its owner for corporation tax purposes and is liable for capital stock/foreign franchise tax but not for Pennsylvania corporate net income tax.

   For personal income tax purposes, a SMLLC owned by an individual or a limited liability company jointly owned by husband and wife is a disregarded entity. The income of the limited liability company is reported on PA-40 Schedule C, Profit or Loss from Business or Profession, or PA-40 Schedule E, Rent and Royalty Income (Loss), of the member's PA-40, Individual Income Tax Return, and the single-member limited liability company does not file a PA-20S/PA-65 Information Return. Examples include rental property or partnership interest held by a limited liability company.

6. **Income Reported on Federal Tax Return of another Business Entity**
The income of a SMLLC owned by another entity is reported on the tax return of the member as if earned by the member. The limited liability company is an entity separate from its owner for corporation tax purposes and is liable for capital stock/foreign franchise tax. It is prohibited to combine the activity of the limited liability company with the activity of the member when reporting capital stock/foreign franchise tax.

See Table 16-5 – PA Filing Requirements for Corporate Net Income Tax and Personal Income Tax Purposes in Part IX - TABLES.

VI. PA-20S/PA-65 SCHEDULE M

A. Reconciliation of Federal Taxable Income to Pennsylvania-Taxable Income

Use Part A to classify taxable income (loss) as shown on federal Form 1120S or the federal Form 1065 for Pennsylvania purposes. The entity must classify its federal amounts using Pennsylvania personal income tax rules.

Use Part B to reconcile from the entity's federal business income (loss) and rental/royalty income (loss) to its Pennsylvania income (loss). If the entity is separately allocating its income, keeps separate books and records for financial statement purposes, and there are no business transactions between multiple businesses, the "PA Allocated Income (loss)" column, and the "Total Income (loss) Total Business Income (loss) before Apportionment" column will be completed. If the entity is apportioning its income, only the Total column will be completed.

Important. Use *PA-20S/PA-65 Schedule M* for business income (loss) or rental/royalty income (loss). The entity should complete the appropriate PA-20S/PA-65 Schedules A, B, and D for all other income classes. Use of PA-20S/PA-65 Schedule M for the other income classes' results in the improper classification of income and reporting errors.

See Table 16-6 – Reporting Gain (Loss) For PA PIT Purposes in Part IX - TABLES.

See Table 16-7 – PA Partnerships and PA S Corporations Entity Distinctions in Part IX - TABLES.

B. PA-20S/PA-65 Schedule M, Part A

1. Classifying Federal Income (Loss) for Pennsylvania Personal Income Tax Purposes

Use Part A to classify the federal amounts from federal Form 1120S, Schedule K or federal Form 1065, Schedule K.

For each line, analyze the components of the federal amounts. Then, classify the federal amounts to the applicable Pennsylvania income class in its entirety, or the appropriate portion of each amount, without adjustment for Pennsylvania personal income tax rules. If the entity does not have to allocate an income (loss) amount, place that amount in the appropriate column for the Pennsylvania income class. The partnership or PA S corporation should transfer amounts from columns (c) through (e) to the corresponding PA Schedules. Columns (b) and (f) are reported on PA-20S/PA-65 Schedule M, Part B, for further adjustment as required.

2. Pass Through Income from Another Pass Through Entity

If the partnership or PA S corporation completing this PA-20S/PA-65 Information Return received a PA-20S/PA-65 Schedule RK-1 and/or NRK-1 from the other entity on which it is a member, it already has the classified income (loss) amount for completing PA-20S/PA-64 Schedule M, Part A.

3. Partnership Example

The ABC partnership is a partner in the XYZ partnership. The ABC partnership receives an RK-1 from the XYZ partnership that includes Pennsylvania-taxable business income (loss) from operations in the amount of $1,000, interest Income in the amount of $500, net gain (loss) from the sale, exchange or disposition of property in the amount of $10,000, and net income (loss) from rents, royalties, patents, and copyrights in the amount of $3,000. The ABC partnership will classify on Line 1b of their PA-20S/PA-65 Information Return the $1,000 of PA-taxable business income (loss) from operations as share of income from all other entities. The $500 of interest income will be classified on PA-20S/PA-65 Schedule A, Line 1. The $10,000 of net gain (loss) from the sale, exchange, or disposition of property will be classified on PA-20S/PA-65 Schedule D, Line 9, or Line 19.

The $3,000 of net income (loss) from rents, royalties, patents and copyrights will be classified on their PA-20S/PA-65 Schedule E, Line 23, or Line 24.

4. PA-20S/PA-65 Schedule M, Part B

Part B is similar to, but more specific than the PA Schedule C that individuals, estates, and trusts use to reconcile federal income (loss) for Pennsylvania personal income tax purposes.

For line-by-line instructions for PA-20S/PA-65 Schedule M, Part A and Part B, please see *PA-20S/PA-65 Schedule M Instructions* on the department's website.

VII. PENALTIES, ADDITIONS AND FEES

If a taxpayer fails to include in taxable income an amount more than 25 percent of the taxable income that was reported by reason of negligence or intentional disregard of rules and regulations but without intention to defraud, there shall be added an amount equal to 25 percent of the amount of underpayment. See Section 352(b)(2).

Any partnership required to furnish an information return who furnishes a false or fraudulent return shall be subject to a penalty of $50.00 for each failure.

A partnership that did not file a return and did not request an extension would be penalized $50 for each non filed year. If the partnership files the required returns, the $50 penalty per return will not be imposed. However, if the partnership has nonresident withholding tax and or corporate net income tax withholding due with the nonfiled returns, interest and penalty will be applied.

Every PA S Corporation required to file a return that furnishes a false or fraudulent return or fails to file a return shall be subject to a $250 penalty for each failure. See Section 352(f).

If any individual, estate or trust files a return which does not contain sufficient information to determine the correct liability or which contains information which indicates the liability is significantly incorrect and the return is filed frivolously or to delay or impede the administration of the tax law, the filer shall pay a $500 penalty. See Section 342(l).

VIII. FRAUDULENT INVESTMENT SCHEMES

In response to taxpayer inquiries regarding fraudulent investment schemes and losses as they relate to Pennsylvania personal income tax, the Department of Revenue provides the following guidance.

Pennsylvania's treatment of losses from such schemes, often referred to as "Ponzi" schemes, differs from federal income tax treatment.

The Internal Revenue Service (IRS) recently published guidance on the application of federal income tax to losses from fraudulent investment schemes. *See* Rev. Proc. 2009-20, 2009-14 IRB; and Rev. Rul. 2009-9, 2009-14 IRB (3/17/2009). The IRS determined that a loss from a fraudulent investment scheme is treated as a theft loss under IRC § 165 rather than a capital loss. The loss is an itemized deduction that is taken in the year the loss is discovered, and the loss is not subject to the deduction limitations of IRC §§ 67, 68 or 156(h). Further, the IRS will allow the taxpayer to carry the loss forward and backward under certain circumstances.

Pennsylvania personal income tax law does not have a corresponding provision to IRC § 165. Consequently, the department does not follow the federal income tax treatment of losses from fraudulent investment schemes.

For Pennsylvania personal income tax purposes, a loss from a fraudulent investment scheme must be reported as a loss from the sale, exchange or disposition of property on the PA-40 Schedule D.

This rule applies to both direct and indirect investors in S corporations and partnerships. A direct investor is one whose investment was an ownership interest in the fraudulent investment scheme or in the assets purportedly to be purchased in the investor's name by the perpetrator of the investment fraud. An indirect investor is one who was exposed through fund investments diversified in some of the fraudulent investment scheme or who was exposed through investments in third party funds (such as "funds of funds") with unreported investments in the fraudulent investment scheme.

An Investor experiences a loss upon a disposition of their direct or indirect investment to the extent that the taxpayer's basis in the investment is greater than the amount recovered from the investment. The investor's basis in the investment is the initial investment and any subsequent actual or fictitious income from the investment – reported by the investor and on which Pennsylvania personal income tax was paid – less any distributions and any losses utilized by the taxpayer in Pennsylvania or any other state. If the investment is in a partnership, the basis would be determined using Pennsylvania personal income tax rules. For calculation of the basis of a partner's interest in a partnership refer to the Part I of this chapter.

If a taxpayer reported fictitious income from a fraudulent investment scheme in a prior tax year, the department will not accept an amended return to remove such income from the prior tax year. Rather, such income increases the taxpayer's basis in the investment. Consequently, upon final disposition of the investment, any loss will be greater because of the basis increase from the fictitious income reported in prior years.

A loss from a direct or indirect investment in a fraudulent investment scheme can only be reported in the year in which some identifiable event closed and completed the transaction and fixed the loss amount so there is no possibility of any eventual recoupment. Any actual recovery from a direct or indirect investment is considered a distribution and reduces taxpayers' basis in the investment. Any recovery in excess of basis is reported as gain from the disposition of property and is reported on PA-40 Schedule D. The recovery period is considered final at the conclusion of all court and legal action to obtain a recovery on the investment, when the taxpayer receives notification that all proceeds have been paid out of existing funds, and/or when any other legal or final acts to dissolve the investment.

Losses are only recognized on transactions entered into for profit, such as investments, business property, and real estate. Losses are not recognized on the sale of property that was not acquired as an investment or for profit. Carry-forward or carry-back of any unused losses on the sale, exchange or disposition of property is not permitted.

If your investment was held in any entity other than a pass-through (i.e., partnership or S-corporation), please contact the department for further guidance.

Questions on reporting or calculating losses from fraudulent investment schemes may be directed to 717-787-8201.

IX. TABLES

Table 16-1 Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for Partnerships

Table 16-1

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 108	Exclusion of cancellation of indebtedness (COD) income	Pennsylvania does not follow federal treatment. Refer to Chapter 24: Cancellation of Debt for Pennsylvania Personal Income Tax Purposes
§ 179	Federal law extends and expands the IRC § 179 enhanced expensing provisions beginning in 2002 through year 2011. It provides an increase in the expensing limit from $125,000 to $500,000 with phase-out beginning at $2,000,000 for 2010 and 2011.	Pennsylvania follows federal treatment. However, any changes made to IRC § 179 after Jan. 1, 1997 are not applicable to Pennsylvania. The Pennsylvania § 179 expense is limited to $25,000 and will be phased out for purchases in excess of $200,000. Pennsylvania allows a carry-over of the excess. Refer to PA PIT Tax Bulletin 2009-08.
§ 469	Passive or portfolio income	Pennsylvania does not follow federal treatment.
§ 704(b)	Special allocations with substantial economic effect	Pennsylvania follows federal treatment.
§ 704(c)	Allocations with respect to pre-contribution gain inherent in contributed assets	Pennsylvania follows federal treatment.
§ 704(d)	Limitation of losses to the extent of adjusted basis	Pennsylvania follows federal treatment; however, there is no provision for carryover of losses. For Pennsylvania personal income tax, a partner must reduce their basis in their partnership interest by losses, but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income tax of another state or country. If losses are not used, the basis must be reduced by the partner's share of straight-line depreciation
§ 705(a)	Determination of basis of partner's interest (general rule)	Pennsylvania follows federal treatment.
§ 706(c)	Federal closing of the books	Pennsylvania follows federal treatment.
§ 707(a)	Federal disguised sale rules	Pennsylvania follows federal treatment.
§ 707(c)	Guaranteed payments for the use of capital – unreasonable guaranteed payments	Pennsylvania follows federal treatment.

Table 16-1

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 707(c)	Guaranteed payments for the use of capital or other services	Pennsylvania does not follow federal treatment for guaranteed payments for services. Under Pennsylvania tax law, to the extent paid for other services or for the use of capital, a guaranteed payment is: a. A withdrawal proportionately from the capital of all partners; b. A gain from the disposition of the recipient's partnership interest and a loss from the disposition of the other partners' partnership interests, to the extent derived from the capital of the other partners; and c. A return of capital by the recipient to the extent derived from his/her own capital. Pennsylvania allows the deduction
§ 708	Technical termination of a partnership (involves greater than 50% change in ownership)	Pennsylvania follows federal treatment.
§ 709(a)	Treatment of organization and syndication fees (general rule)	Pennsylvania follows federal treatment.
§ 722	Basis of Contributing Partner's Interest	Pennsylvania follows federal treatment.
§ 721	Contribution of property to a partnership on a tax-free basis	Pennsylvania generally follows federal treatment. Neither the partnership nor the partners, recognize gain or loss in the case of a contribution of property in exchange for an interest in the partnership. The partners recognize gain or loss in the following circumstances: • The purpose of the contribution was to affect an exchange of property between two or more partners; or • The contributing partner receives, in exchange for his or her contribution, an interest in the partnership plus other property or cash.
§ 731		Pennsylvania has not adopted the following concepts: 731(c)(3)(C)(iv) – Look-Thru of Partnership Tiers, 731(c)(5) – Subsection Disregarded in Determining Basis of Partner's Interest in Partnership and of Basis of Partnership Property.
§ 733		Pennsylvania has not adopted the following concepts: 732(d) – Special Partnership Basis to Transferee, 732(f) – Corresponding Adjustment to Basis of Assets of a Distributed Corporation Controlled by a Corporate Partner.

Table 16-1

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 752	Increases or decreases in liabilities create deemed cash contribution or distributions to partner	Pennsylvania follows federal treatment.
§ 732(d) **§ 734(b)** **§ 743(b)** **§ 754**	Election to step-up or down basis upon certain events	Pennsylvania does not follow federal treatment.
§ 1031	No gain (loss) recognized on any like-kind exchange transactions.	Pennsylvania does not follow federal treatment.
NA	Tax benefit rule (requirement to adjust basis)	For Pennsylvania personal income tax, a partner must reduce their basis in their partnership interest by losses, but only to the extent that the losses reduce either the income subject to PA tax or the income tax of another state or country. If losses are not used, the basis must be reduced, but not below zero, by the partner's share of straight-line depreciation.

Table 16-2 Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for Partner's Outside Basis Calculation

Table 16-2

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Personal Income Tax Treatment	Pennsylvania Tax Benefit Rule
§ 465	Federal loss not allowed due to federal-at-risk limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal-at-risk carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 469	Federal loss not allowed due to federal passive loss limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal passive loss carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 704	Federal loss not allowed due to federal basis limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. The loss is only allowed if the partner is responsible for making up losses to the partnership. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal loss carryover	There is no carryover of a loss for Pennsylvania personal income tax.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
	Federal loss allowed because of federal basis. For Pennsylvania personal income tax no income to offset in class	No loss allowed for Pennsylvania personal income tax against any other class of income. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of Pennsylvania personal income tax adjustments	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Do not use federal loss.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.

Table 16-3 Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for PA S Corporations

Reconciliation of Federal-Taxable Income to Pennsylvania-Taxable Income

The PA S corporation should use the PA-20S/PA-65 Schedule M, Reconciliation of Federal-Taxable Income to Pennsylvania-taxable Income to reconcile from federal ordinary income (loss) to Pennsylvania-taxable income (loss) from business, profession, or farm operations, and from rental or royalty income (loss).

In many instances, Pennsylvania personal income tax law and regulations do not provide specific treatment similar to federal tax laws. This is especially true with regard to federal elections concerning the timing of income and expense items. Taxpayers should not use federal elections to determine Pennsylvania personal income tax income (loss).

Table 16-3

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 108	Exclusion of cancellation of indebtedness (COD) income	Pennsylvania does not follow federal treatment. See new Chapter 24: Cancellation of Debt for Pennsylvania Personal Income Tax Purposes
§ 179	Federal law extends and expands the IRC § 179 enhanced expensing provisions beginning in 2002 through year 2011. It provides an increase in the expensing limit from $125,000 to $500,000 with phase-out beginning at $2,000,000 for 2010 and 2011.	Pennsylvania follows federal treatment. However, any changes made to IRC § 179 after Jan. 1, 1997 are not applicable to Pennsylvania, including the PA § 179 expense is $25,000 and will be phased out for purchases in excess of $200,000.
§ 338(h)(10)	Election to treat a stock as an asset sale	Pennsylvania does not follow federal treatment.
§ 351	Contribution of property to a corporation on a tax-free basis	Pennsylvania follows federal treatment.
§ 465	Federal loss not allowed due to federal at risk limitations Federal loss for year higher than Pennsylvania loss as a result of federal at risk carryover	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result. There is no carryover of a loss for Pennsylvania personal income tax purposes. Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.

Table 16-3

§ 469	Federal loss not allowed due to federal passive loss limitations Federal loss for year higher than Pennsylvania loss as a result of federal passive loss carryover	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result. There is no carryover of a loss for Pennsylvania personal income tax purposes. Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 1031	No gain (loss) recognized on any like-kind exchange transactions.	Pennsylvania does not follow federal treatment.
§ 1361	One class of stock requirement Qualified Subchapter S Subsidiaries (QSSS)	Pennsylvania follows federal treatment. Pennsylvania permits qualified subchapter S subsidiaries; however, each qualified subchapter S subsidiaries is considered a separate corporation for purposes of the capital stock / foreign franchise tax. See Act 2006–67.
IRC Code Section	**Description of Federal Tax Treatment**	**Pennsylvania Tax Treatment**
§ 1362	Election of S corporation	Pennsylvania follows federal treatment for tax years beginning Jan. 1, 2006.
§ 1362(d)	Passive income test	Pennsylvania does not follow federal treatment.
§ 1368	Accumulated Adjustments Account (AAA)	Calculation required for years when PA S status is in place. Federal subchapter S corporations that have been Pennsylvania S corporations throughout their corporate existence always should have tracked their Pennsylvania adjustments account and Pennsylvania accumulated earnings and profits, if applicable, to provide the information required for resident shareholders to correctly report distributions. Federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006 similarly should track Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits. However, it may be extremely difficult to obtain the necessary information to calculate the initial Pennsylvania accumulated earnings and profits. The Pennsylvania Department of Revenue will allow a transitional election by federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006. The department may allow such a "new" Pennsylvania S corporation taxpayer to elect to use its federal accumulated adjustments account as the functional equivalent of its Pennsylvania accumulated earnings and profits.

Table 16-3

§ 1374	Built-in-gains tax	Pennsylvania generally follows federal treatment. Pennsylvania does not follow federal for 25 percent passive income test. If any built-in-gains tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation), the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.
§ 1377	Election to terminate year	Pennsylvania follows federal treatment.
NA	Tax Benefit Rule	For Pennsylvania purposes, a shareholder must reduce basis in the S corporation by losses but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income tax of another state or country. If losses are not utilized, the basis must be reduced by the shareholder's share of straight-line depreciation.

Table 16-4 Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for S Corporation's Outside Basis Calculation

Table 16-4

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Personal Income Tax Treatment	Pennsylvania Tax Benefit Rule
§ 465	Federal loss not allowed due to federal at risk limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal at risk carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 469	Federal loss not allowed due to federal passive loss limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal passive loss carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 1367	Federal loss not allowed due to federal basis limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal loss carryover	There is no carryover of a loss for Pennsylvania personal income tax.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
	Federal loss allowed because of federal basis. For Pennsylvania personal income tax no income to offset in class	No loss allowed for Pennsylvania personal income tax against any other class of income. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of Pennsylvania personal income tax adjustments.	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Do not use federal loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.

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Table 16-5 PA Filing Requirements for Corporate Net Income Tax and Personal Income Tax Purposes

LLC Type	Federal Classification:	CNI Tax	CSF Tax	Loans Tax	PIT
Multiple members • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S.§ 8925	Regular corporation Submit RCT-101 and federal Form 1120	YES	YES	YES	NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2)	YES	YES	YES	NO
	Subchapter S corporation Federal & Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2) Submit PA-20S/PA-65 Information Return	YES (for net recognized built-in gains only)	YES	YES	YES
	Partnership Submit RCT-101 and : • Federal Form 1065 Submit PA-20S/PA-65 Information Return	NO	YES	YES	YES
Single member • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S. § 8925	Regular corporation Submit RCT -101 and: • Federal Form 1120	YES	YES	YES	NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2)	YES	YES	YES	NO
	Subchapter S corporation Federal & Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2) Submit PA-20S/PA-65 Information Return	YES (for net recognized built-in gains only)	YES	YES	YES
	Disregarded entity (sole proprietorship owned by a natural person) Submit RCT-101 and: • Balance sheet (PA Schedule L) • Reconciliation of book income to income reported on federal Schedule C, E, or F (PA Schedule M-2) Submit PA-40 & required schedules	NO	YES	YES	YES
	Disregarded entity (a branch or division) - Submit RCT-101 and: • Pro Forma Separate Company • Federal Form 1120S or 1065 Income for the disregarded entity is filed with parent RCT-101 or PA-20S/PA-65 Information Return	NO	YES	YES	YES

LLC Type	Federal Classification:	CNI Tax	CSF Tax	Loans Tax	PIT
Restricted Professional Company (RPC) * • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S. § 8925 • 15 Pa. C.S. § 8997	Regular corporation Submit RCT-101 and federal Form 1120	YES	YES	YES	NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year	YES	YES	YES	NO
	Subchapter S corporation federal & Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year Submit PA-20S/PA-65 Information Return	YES (for net recognized built-in gains only)	YES	YES	YES
	Partnership Submit PA-20S/PA-65 Information Return Not required to file RCT-101	NO	NO	NO	YES
	Disregarded entity (sole proprietorship owned by a natural person) Prior to Jan, 1, 2006: Submit RCT-101 and: • Balance sheet • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year Submit PA-40 & required schedules	NO	YES	YES	YES
	Disregarded entity (sole proprietorship owned by a natural person) Beginning Jan. 1, 2006: Submit PA-40 & required schedules Not required to file RCT-101	NO	NO	NO	YES

* A Restricted Professional Company (RPC) engaged in activities other than activities authorized for an RPC is subject to corporation taxes and required to file the RCT-101 in the same manner as any other Limited Liability Company.

Table 16-6 Reporting Gain (Loss) For Pennsylvania Personal Income Tax Purposes

Table 16-6

Classified Gains (Losses) for PA-20S/PA-65 and Reporting Gains (Losses) for Pennsylvania Personal Income Tax			
Type of Gain	**Classification**	**Gain Treatment**	
		Pennsylvania Resident	**Nonresident**
Sale of intangible personal property used in a business, profession or farm, including goodwill contractually sold with the business and allocated by the parties as to value in the sales agreement	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of intangible personal property not used in a business, profession or farm, including goodwill contractually sold with the business and allocated by the parties as to value in the sales agreement	PA-20/PA-65 Schedule D	Taxable	Not Taxable
Sale of tangible personal property used in a business, profession or farm - proceeds reinvested and used to acquire similar property used in the same kind of business, profession or farm	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of tangible personal property used in a business, profession or farm - proceeds not reinvested and used to acquire similar property used in the same kind of business, profession or farm	PA-20S/PA-65 Schedule D	Taxable	Taxable (If property is located in Pennsylvania)
Sale of inventory	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of stock in trade	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of other current assets	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of tangible non-current assets and intangible non-current assets used in operating a business, profession or farm	PA-20S/PA-65 Schedule D	Taxable	Taxable

Table 16-6

Sale of tangible non-current assets and intangible non-current assets held for investment not used in operating a business, profession or farm	PA-20S/PA-65, Schedule D	Taxable	Taxable (If property is located in Pennsylvania)
Sale of land and/or buildings constituting the abandonment of a business or business segment i.e. sale of a division or line of business where the seller does not continue the division or business activity	PA-20S/PA-65 Schedule D	Taxable	Taxable (If property is located in Pennsylvania)
Sale of land and/or buildings used as a facility in the operation of a business, profession or farm - proceeds reinvested in a similar facility and used in the same kind of business, profession or farm	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of land and/or buildings held for investment regardless of reinvestment of proceeds	PA-20S/PA-65 Schedule D	Taxable	Taxable (If property is located in Pennsylvania)
Sale of stocks and bonds, other than federal or Pennsylvania obligations, and used in the operating cycle of the business, profession or farm	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of stocks and bonds, other than federal or Pennsylvania obligations, and not used in the operating cycle of the business, profession or farm	PA-20S/PA-65 Schedule D	Taxable	Not taxable
IRC § 1035 - exchange of insurance policy With boot Without boot	PA-20S/PA-65 Schedule D	 Taxable Not Taxable	 Not Taxable Not Taxable
Sale of ownership interests in partnerships and business enterprises	PA-20S/PA-65 Schedule D	Taxable	Not taxable

Table 16-7 PA Partnerships and PA S Corporations Entity Distinctions

Table 16-7

PA PARTNERSHIPS AND PA S CORPORATIONS ENTITY DISTINCTIONS		
Description	**PA Partnerships**	**PA S Corporations**
Capital Stock Tax or Foreign Franchise Tax	Not applicable, except in the case of an LLC or business trust.	Applicable
Entity Election	Not applicable	Follows federal treatment.
Built-In Gains Tax	Not applicable	Follows federal treatment.
Share of liabilities as part of basis	Liabilities included in basis.	Liabilities not included in basis, unless shareholder lends directly to PA S corporation.
Contribution To Owner's Retirement	Not deductible for partners.	Deductible for shareholder/employees only per plan.
Corporate Net Income Tax	Not applicable to partnerships, unless filing as a corporation for federal purposes.	Only if built-in gains tax applies.
Corporate Net Income Tax	Corporate partners will reflect their allocable share of partnership income (loss) on their respective RCT-101, PA Corporate Tax Return.	If the S corporation has built-in gains tax it is required to file a RCT-101, PA Corporate Tax Return and a PA-20S/PA-65 Information Return.
Health Insurance Premiums	Not deductible for premiums paid to partners. Not included as guaranteed payments.	Entity can deduct premiums paid for shareholder employees if it is a non-discriminatory plan. Not included as wages for shareholder.

Table 16- 8 Classified Federal Schedule K Lines for Pennsylvania Personal Income Tax Purposes

Table 16-8

Classified Federal Schedule K Lines for Pennsylvania Personal Income Tax Purposes	
Net income (loss) from rental real estate activities	• If the rental activity includes providing significant services (e.g. hotel) - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If the rental activity does not include providing significant services - Part III, Line 6. • If the rental activity includes providing significant services (e.g. rental of tangible personal property) - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If the rental activity is an investment property and does not include providing significant services - Part III, Line 6.
Interest income	• If derived from assets employed as working capital in a business, profession, or farm or from accounts and notes receivable from sales of products or services sold in the ordinary course of business, generally current assets - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If derived from assets that are held for long-term investment purposes or otherwise serve an investment function, generally long-term assets - Part III, Line 3.
Dividend income	• If derived from assets employed as working capital in a business, profession or farm, or from accounts and notes receivable from sales of products or services sold in the ordinary course of business, generally current assets - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If derived from assets that are held for long-term investment purposes or otherwise serve an investment function, generally long-term assets - Part III, Line 4.
Sale of property federal Form 4797 Net IRC § 1231 gain (loss) other than due to casualty or theft	• If from a sale, exchange, or disposition of property used in the business, profession, or farm, and the proceeds reinvested and used to acquire similar property used in the same kind of business - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If from a sale, exchange, or disposition of property NOT USED in the ordinary course of operating the business, profession, or farm as described above - Part III, Line 5.
Guaranteed payments to partners	• Guaranteed payment treatment for partners (partnerships only)
Other income (loss)	• Determine the appropriate Pennsylvania income class from the activity, operation, and transactions (and purpose) that generated the income (loss). Include the amount on the applicable line of the PA-20S/PA-65 Information Return.

X. BASIS WORKSHEETS

REV-998 – Shareholder Tax Basis in PA S Corporation Stock Worksheet and REV-999 – Partner PA Outside Tax Benefit in a Partnership Worksheet

REV-998 is used by owners in a PA S corporation and the REV-999 is used by partnerships to calculate each owner's basis in that entity. Both forms are available on the department's website.

Pennsylvania law requires an entity to depreciate property by a minimum amount it determines using the straight-line method even if the depreciation calculated under this method does not provide any tax benefit. A tax benefit means that the owner reduces the Pennsylvania tax liability or the tax liability to another state. Therefore, if an owner receives a distributable share of a loss and does not receive a benefit from the loss, the owner must still reduce the basis by their share of straight-line depreciation. However, if the owner only received a partial benefit from the loss, the owner must reduce the basis by (1) the loss utilized and (2) a portion of the owner's share of straight-line depreciation. This is calculated by the unutilized loss divided by the total loss multiplied by the owner's share of straight-line depreciation. If the owner receives full benefit of the loss then the maximum amount the taxpayer must reduce their basis by is the total loss.

XI. TAX WORKSHEET FOR NON PENNSYLVANIA TAXES PAID ON INCOME (SCHEDULE M)

REV-1190, Tax Worksheet for PA-20S/PA-65 Schedule M, Part B, Section E, Line a

For tax year 2012, the tax worksheet for PA-20S/PA-65 Schedule M, Part B, Section E, Line a has been change to REV-1190. REV-1190 must be attached to PA-20S/PA-65 Schedule M when reporting non-Pennsylvania taxes paid on income. REV-1190 is available on the department's website.

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DEPARTMENT OF REVENUE

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 17: CREDITS

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CHAPTER 17: CREDITS

I. RESIDENT CREDIT

A. Resident Credit for Tax Paid to Another State or Country

A Pennsylvania resident taxpayer who has income subject to both Pennsylvania personal income tax ("PA PIT") and the income or wage tax of another state or country on the same income during the same taxable year, can claim all or a portion of the tax paid to the other state or country as a credit against his or her Pennsylvania personal income tax. However, Act 2013-52 effective Jan. 1, 2014, eliminates the resident credit for personal income tax paid to foreign countries.

B. Amount of Credit

The amount of the allowable credit is the lower of:

1. The actual amount of tax paid to the other state or country for the same taxable year on income subject to Pennsylvania income tax and source-able to the other state or country using Pennsylvania sourcing rules; or

2. The product of the Pennsylvania personal income tax rate for the tax year in which the credit is being claimed multiplied by the amount of income subject to Pennsylvania income tax and source-able to the other state or country using Pennsylvania sourcing rules.

   Note. Pennsylvania does not permit a resident credit for income taxes or wage taxes paid to another state or country on Pennsylvania source income or income from intangible sources that cannot be sourced to any state or country using Pennsylvania sourcing rules.

C. PA-40 Schedules G-R, G-S and G-L

If a taxpayer claims a credit for taxes paid to other states or countries, the taxpayer must complete *PA-40 Schedule G-S or G-L.* The taxpayer must also submit with the *PA-40, Individual Income Tax Return* a copy of the income tax return (see 61 PA Code §111.5) and W-2(s) filed with the other state or country. The credit will be disallowed if the taxpayer does not provide the tax return from the state listed on *PA-40 Schedule G-S or G-L,* Line 1. Individual taxpayers submitting PA-40 Schedule G-S or G-L must also submit PA-40 Schedule G-R; however, this schedule does not apply to fiduciary taxpayers or pass through entities.

If the taxpayer is claiming a credit for taxes paid in more than one state or country (not including Pennsylvania), the taxpayer must complete a *PA-40 Schedule G-S or G-L* for each state or country and list all items on PA-40 Schedule G-R. The credits from each schedule should be totaled and the total entered on the *PA-40, Individual Income Tax Return*, Line 22.

In the event that more than one state or country imposes tax on income subject to Pennsylvania income tax, the credit may not be claimed twice. The credit is limited to a maximum 3.07%.

D. Grantor Trusts

Pennsylvania does not follow Federal grantor trust rules. For federal income tax purposes, the income of the grantor trust is treated as income of the settlor. Income of a grantor trust is taxable income to the trust for Pennsylvania purposes. Because of this discrepancy, when a Pennsylvania resident trust receives income sourced to another state that follows a federal income tax base, Pennsylvania will tax the income as income of the grantor trust and the other state will tax the income as income of the trust settlor. Because the trust and the settlor are different taxpayers for Pennsylvania income tax purposes, the trust cannot claim a resident credit for taxes paid to the other state on the trust income.

E. Compensation Earned in Indiana, Maryland, New Jersey, Ohio, Virginia, or West Virginia by Residents

A resident credit will not be granted for taxes paid to Indiana, Maryland, New Jersey, Ohio, Virginia or West Virginia on compensation earned in those states. These states do not impose tax on compensation of Pennsylvania residents.

Note**.** Ohio Reciprocal Compensation Agreement **-** Commencing Jan. 1, 2004, remuneration paid to a Pennsylvania resident 20 percent shareholder-employee of an Ohio S corporation for services performed in Ohio is not covered by the Pennsylvania/Ohio Reciprocal Compensation Agreement and is (can be) subject to tax in Ohio.

F. Tax Paid to Political Subdivisions of Other States

No resident credit will be granted for taxes paid to political subdivisions of other states or countries. A taxpayer may, however, be allowed to claim a credit against his or her local income tax for taxes paid on earned income to political subdivisions outside Pennsylvania.

G. Foreign Taxes Paid

The taxpayer must submit a copy of the federal Form 1116, Foreign Tax Credit plus a copy of the statement showing the amount of foreign income and any taxes withheld at the source. Even if the taxpayer does not claim the credit on the federal tax return, the department wants the federal schedule. The department does not have a Pennsylvania schedule for this specific situation.

Note**.** Act 2013-52 effective Jan. 1, 2014, eliminates the resident credit for personal income tax paid to foreign countries.

II. TAX CREDITS CLAIMED ON SCHEDULE OC

A. General Information

These tax credits are often awarded to PA S corporations or partnerships and passed through to entity owners. However, sometimes they are awarded to individual or fiduciary taxpayers. The PA S corporations and partnerships report tax credits on PA-20S/PA-65 Schedule OC. The individuals and entity owners report tax credits on PA-40 Schedule OC. Different provisions apply to various situations, so please review the specific information for each tax credit.

Following is general information regarding tax credits:

1. Restricted tax credits claimed on Line 23 of the PA-40, Individual Income Tax Return or Line 14 of the PA-41, Fiduciary Income Tax Return are listed on PA-40 Schedule OC.

2. Married taxpayers who claim PA-40 Schedule OC tax credits must file separate returns, even if both taxpayers claim the tax credits on their returns. Joint filing is only permitted when the tax credit is claimed by the primary taxpayer, and the secondary taxpayer has no taxable income to report on the return.

3. All of the restricted tax credits can be claimed against any class of income.

4. Restricted tax credits are nonrefundable. If applicable, other nonrefundable credits must be applied to the account before restricted credits: resident credit first, followed by tax forgiveness.

   Credits claimed on Schedule OC for an individual taxpayer on his or her PA-40 cannot exceed the tax liability less the resident credit and/or tax forgiveness credit. For example, a taxpayer with a $4,000 tax liability who receives a $3,000 resident tax credit cannot claim credits on Schedule OC that exceed $1,000. If the credits exceed $1,000, a reduction in the amount of the Schedule OC credits will be required.

5. The request to pass through tax credit to an entity owner is irrevocable, therefore the entity should not pass through more than the owner can use in any single tax year.

6. Tax credits passed through from pass through entities to other pass through entities or to estates or trusts may not be passed through to owners or beneficiaries.

7. Generally, Pennsylvania does not limit the deduction of expenses related to the qualifications for a tax credit. However, Pennsylvania does not allow the deduction of certain expenses used to qualify for the Neighborhood Assistance Program (NAP) and the Educational Improvement Tax Credit (EITC).

For additional information, see the specific section for these tax credits.

B. Saleable or Assignable Tax Credits

The saleable restricted tax credits include Research and Development, Film Production, Neighborhood Assistance Program, Resource Enhancement and Protection, and Keystone Innovation Zone. The portion of the tax credit that exceeds the tax liability of the awardee of the tax credit may be carried forward unless the awardee elects to sell or assign the tax credit or pass it through to its owners.

Special rules apply for taxpayers that sell/assign restricted tax credits as well as the taxpayers who purchase them or to whom tax credits are assigned. The rules apply to all taxpayers, whether or not they are incorporated. For specific information regarding these rules, review Corporation Tax Bulletin 2008-02 on the Department's website, www.revenue.state.pa.us

Tax credits are often sold through credit brokers; however, a credit broker is not a requirement of sale. For additional information about using purchased or assigned tax credits, see the specific section for each tax credit.

C. Personal Income Tax Reporting Requirements for Sale of Restricted Tax Credits

1. Seller of a Restricted Tax Credit

For Pennsylvania personal income tax purposes, the sales of restricted tax credits are taxable as gains on the sale, exchange or disposition of property to the sellers or original awardees of the restricted tax credits. The taxpayer selling the restricted tax credit reports the sale of the tax credit as a sale of intangible property for Pennsylvania personal income tax purposes on PA-40 Schedule D, PA-41 Schedule D or PA-20S/PA-65 Schedule D. The taxpayer's cost basis in the restricted tax credit sold is usually $0 as the credit is awarded based upon income or expenses already included in the current or a prior year's tax return(s) whereas no adjustment or reduction in income or expenses is required to be made to obtain such credit. A reduction in the sales price may be reported if commissions are paid to an agent or broker for the sale of such restricted tax credits in the amount of the commissions paid that reduce the amount of net proceeds received by the taxpayer. The taxpayer reports the date of the award of the restricted tax credit as the acquisition date and the date sold as the date the sale was consummated. The gross proceeds the taxpayer receives from the sale of the restricted tax credit less any commissions paid are included as the sales price of the tax credit sold.

2. Purchaser of a Restricted Tax Credit

A taxpayer who purchases a restricted tax credit at a cost to him or her of less than the full value of the tax credit must also report a gain on the sale, exchange or disposition of property for Pennsylvania personal income tax purposes. The taxpayer purchasing the restricted tax credit reports the transaction as a sale of intangible property for Pennsylvania personal income tax purposes on PA-40

Schedule D, PA-41 Schedule D or PA-20S/PA-65 Schedule D. Unlike the sale of a restricted tax credit, the purchaser records as his or her cost basis, the full purchase price of the credit (complete sales price of all such tax credits purchased plus any commissions paid by the purchaser). The taxpayer records the purchase date as the date acquired and records the tax year end date (usually December 31) for the tax year to which the tax credit is applied as the date the restricted tax credit was sold. The sales price of the tax credit is the full value of the tax credit permitted or allowed to be applied to the tax return of the taxpayer. By recording only the amount of tax credit allowed or permitted as the sales price and the full purchase price of the tax credit as the basis, restricted tax credits purchased and not able to be used due to any tax limitations imposed under the law permitting the use of a purchased tax credit require no pro-ration of credit cost and no separate reporting of the loss on unused tax credits.

A taxpayer who sells a tax credit and/or offsets their tax liability with a purchased or assigned tax credit does not need to send documentation of sale or assignment with their Pennsylvania tax return. However, the department reserves the right to request this documentation if needed.

Individual taxpayers are reminded that joint tax returns cannot be filed if restricted tax credits are claimed. A separately filed PA-40, Individual Income Tax Return for the taxpayer and spouse are required to report the use of restricted tax credits. Restricted tax credits purchased and used by taxpayers should also have code "PA" entered in the credit description code box for the appropriate line on the PA-40 Schedule OC.

D. Passing Through Tax Credit to Entity Owners

Some tax credits must first be applied to the entity's corporate tax liability, if any, for the year in which the tax credit is granted, prior to being passed through to its owners. If the entity has a tax liability for the tax year in which the contribution was made, the tax credit must first be applied to that tax liability. Review the specific information for each tax credit to determine if the tax credit must first be applied to corporate tax liability.

If an entity does not use all approved tax credits, it may elect in writing to pass through all or a portion of the tax credit to owners in proportion to the share of the entity's distributive income to which the owner is entitled. In most cases the tax credit may be applied up to the full amount of owners' tax liabilities (minus any other nonrefundable credits that are applied first). See the information regarding specific tax credits to review existing restrictions or limitations.

An owner of a pass through entity to whom a tax credit is transferred shall immediately claim the tax credit in the taxable year in which the transfer is made. The owner may not carry forward, carry back, obtain a refund of, sell, assign or pass through the tax credit again.

Married couples with joint ownership in pass through entities must be separately listed on the entity's pass through of credit request in order for credit to be applied to each individual's tax number.

EXAMPLE. Husband and wife Jim and Jane jointly own a 50 percent interest in a partnership, and their son John owns the other 50 percent. All income is distributed according to the ownership percentages. The request to pass through credit must separately list Jim's and Jane's tax numbers, each receiving 25 percent of the credit, and John receiving the remaining 50 percent under his tax number. This method must be followed even though Jim and Jane receive a separate RK-1 or NRK-1 from the partnership.

To pass through tax credits to owners, an entity must submit a request on entity letterhead to the Department of Revenue at the address below, listing total amount of credit to be distributed to the entity owner(s), the name and address of each owner, amount of tax credit to be passed through to each owner, tax year, tax type and owner's tax identification number. See the Example.

A request to pass through the available tax credits must be returned to-

PA DEPARTMENT OF REVENUE
BUREAU OF CORPORATION TAXES
PO BOX 280701
HARRISBURG PA 17128-0701

There are two exceptions. To pass through an Educational Improvement Tax Credit, complete and submit form REV-1123 Educational Improvement Tax Credit Election Form. To pass through a Keystone Innovation Zone tax credit, visit the Department of Community and Economic Development's (DCED) website at http://www.newpa.com or call DCED Customer Service at 1-800-379-7448.

For each tax credit's carry-forward and pass through rules, applications, guidelines, and developments, refer to the description and website referenced for each tax credit.

E. Specific Information about Each Tax Credit

1. Employment Incentive Payments (EIP) Tax Credit

This tax credit expired Dec. 31, 2009. Although no new tax credits are being issued, carry forward of unused tax credits is allowed.

The Pennsylvania Department of Labor and Industry (L&I) administers the award of this tax credit. Eligibility is based on the hiring of eligible public welfare recipients and/or individuals receiving or who have received rehabilitation services through a state rehabilitation service program or the Veterans' Administration. The taxpayer receives certification for this tax credit from L&I.

Qualified businesses, including pass through entities, can apply the tax credit against the following Pennsylvania state taxes:

- Corporate net income tax
- Bank and trust company shares tax
- Title insurance company shares tax
- Mutual thrift institutions tax
- Insurance gross premiums tax
- Personal income tax

Note: This tax credit is not applicable against capital stock/foreign franchise tax liabilities.

This tax credit is limited to 90 percent of a business' total tax liability in any given year. Unused tax credits may be applied to one or more of the ten immediate succeeding years, as long as tax credits do not exceed 90 percent of the tax liability in any year.

An employer claims the tax credit by submitting the certification received from Pennsylvania Department of Labor and Industry for each employee hired and the PA Schedule W with the appropriate Pennsylvania tax return.

For more information and to apply for an Employment Incentive Payment Tax Credit, visit the Department of Revenue's website at www.revenue.state.pa.us

2. Job Creation Tax Credit

The Pennsylvania Department of Community and Economic Development (DCED) administers the award of this tax credit. Eligibility is based on employers creating 25 or more jobs or increasing employment by 20 percent within three years from a negotiated start date. The tax credits are authorized as single-year or multiple-year credits. If the business is a small business (fewer than 100 employees), it needs to increase employment by 10 percent within three years. The amount of tax credit for each job is $1,000. However, if an unemployed individual (for at least 60 days) is hired, the credit is increased to $2,500, effective July 2, 2012. This tax credit can be rescinded if the job is not maintained for 5 years.

Qualified businesses, including pass through entities and individuals, can apply the tax credit against the following Pennsylvania state taxes:

- Capital stock/ foreign franchise tax
- Corporate net income tax
- Bank and trust company shares tax
- Mutual thrift institutions tax
- Insurance gross premiums tax
- Utilities gross receipts tax
- Title insurance company shares tax

- Personal income tax

Guidelines for the Job Creation Tax Credit for Pennsylvania Personal Income Tax Purposes

- The entity decides if the tax credit will be applied towards corporation tax and/or passed through to its partners, shareholders or members.

- Credit must be claimed by the taxpayer within five years of the effective date on the certificate issued by DCED.

- The entity may claim the tax credit for each new job for a one-, two- or three-year period, except no tax credit may be claimed for more than five years from the date the entity first submits a Job Creation Tax Credit certificate to the Department of Revenue.

- Unused tax credits expire five years from the date the entity submits a Job Creation Tax Credit certificate to the Department of Revenue.

- Tax credits dated July 1, 2001, or later can be assigned (in whole or part) to an entity holding less than a majority of the voting common stock of another related company, or in which both companies are subsidiaries of a third company as defined in IRC §1504 as an affiliated entity.

- Tax credits may not be sold or assigned to any other entities with no relationship or ownership ties to the entity selling or assigning the credit_as defined in IRC §1504 as an unaffiliated entity.

- The tax credit can be used to pay liabilities prior to the effective date on the certificate issued by DCED with interest imposed from original return due date to effective date of credit.

- The tax credit can be used to offset 100 percent of the entity's tax liabilities or 100 percent of the entity owners' tax liabilities if passed through.

- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of ownership in the entity receiving the tax credit.

- A company which receives job creation tax credits and fails to substantially maintain existing operations and the operations related to the job creation tax credits in this commonwealth for a period of five years from the date the company first submits a job creation tax credit certificate to the Department of Revenue shall be required to refund to the commonwealth the total amount of tax credit or tax credits granted.

- A company which receives job creation tax credits and fails to create the approved number of new jobs within three years of the start date will be required to refund to the commonwealth the total amount of tax credit or tax credits granted.

- The tax credit cannot be applied against any tax withheld by an employer from an employee under Article III of the Tax Reform Code.

An employer claims the tax credit or passes it through to entity owners by submitting the claim form with the certification received from DCED for each job created to:

PA DEPARTMENT OF REVENUE
BUREAU OF CORPORATION TAXES
PO BOX 280701
HARRISBURG PA 17128-0701

If this certification form is not received, the tax credit will not be applied to any tax accounts. The tax credit must be claimed by the taxpayer within five years of the effective date.

For more information and to apply for a Job Creation Tax Credit, visit the Department of Community and Economic Development's website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

3. Research and Development Tax Credit

The Department of Revenue's Bureau of Corporation Taxes administers the award of this tax credit to businesses and individuals performing qualified research in Pennsylvania, to encourage businesses in the commonwealth to conduct research, especially research of a technological or scientific nature.

Effective July 2, 2012, the sunset date has been removed, the cap on the credit is reestablished at $55 million a year and $11 million of the credit will be used by qualifying small business.

Qualified businesses, including pass through entities and individuals may apply the tax credit against the following Pennsylvania state taxes:

- Capital stock/foreign franchise tax
- Corporate net income tax
- Personal income tax

Guidelines for the Research and Development (R & D) Tax Credit for Pennsylvania Personal Income Tax Purposes

- The tax credit must first be applied to the entity's corporate tax liability, if any, for the year in which the tax credit is awarded before it can be passed through to its partners, shareholders or members.
- The tax credit can be sold or assigned. Refer to Saleable or Assignable Tax Credits.
- A purchased or assigned tax credit may be applied to no more than 75 percent of the tax liability of the purchaser or assignee.
- The tax credit may not be carried back and is not refundable.
- The amount of the tax credit passed through to partners, shareholders and members is based on the percentage of income distribution from the entity receiving the tax credit.
- Buyer shall immediately claim the credit in the taxable year in which sale or assignment is made.
- As of Jan, 1, 2005, the R & D tax credit can be applied to 100 percent of the recipient's tax liability. However, any R & D tax credit issued before 2005 may only be applied to 50 percent of the tax liability. Refer to Passing Through Tax Credit to Entity Owners.
- Any R & D tax credit issued before 2006 could be passed through and then carried over if not completely used in the year the tax credit was passed through. However, any R & D tax credit issued after Dec. 31, 2005 that is passed through must be used in the year the tax credit is passed through.
- The tax credit cannot be applied against any tax withheld by an employer from an employee under Article III of the Tax Reform Code.

The entity may pass the tax credit through to entity owners by submitting the claim form with the certification received from the Department of Revenue to:

PA DEPARTMENT OF REVENUE
BUREAU OF CORPORATION TAXES
PO BOX 280701
HARRISBURG PA 17128-0701

For more information and to apply for a Research & Development Tax Credit, visit Revenue's Online Customer Service Center at www.revenue.state.pa.us and complete form REV-545.

To sell/assign a Research & Development Tax Credit, visit the Department of Community and Economic Development's (DCED) website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

4. Film Production Tax Credit

The Pennsylvania Department of Community and Economic Development (DCED) administers the award of this tax credit to individuals or companies that produce a feature film, television film, television talk or game show series, television commercial, television pilot or each episode of a television series intended as programming for a national audience. Additional credit is available to individuals or companies that use a "Pennsylvania qualified production facility". Act 2013-52 effective July 1, 2013, requires that Pennsylvania personal income tax shall be withheld by a production company and paid on that portion of Pennsylvania income paid to individual talent through a pass-through entity.

Qualified businesses, including pass through entities and individuals may apply the tax credit against the following Pennsylvania state taxes:

- Capital stock/foreign franchise tax
- Corporate net income tax
- Bank shares tax
- Insurance gross premiums tax (excluding surplus lines, unauthorized, domestic/foreign marine)
- Personal income tax

Guidelines for the Film Production Tax Credit for Pennsylvania Personal Income Tax Purposes

- The tax credit must first be applied to the entity's corporate tax liability, if any, for the year in which the tax credit is awarded before it can be passed through to its partners, shareholders or members.

- The tax credit may be applied to 100 percent of the entity's liability, or to 100 percent of the entity owners' tax liabilities.

- The tax credit can be sold or assigned. Refer to Saleable or Assignable Tax Credits.

  A purchased or assigned tax credit may be applied to no more than 50 percent of the tax liability of the purchaser or assignee. If the credit was purchased in 2010 it can be carried forward to 2011 and 2012. Act 2013-52 provides that a film production tax credit purchased or assigned in calendar year 2013 may be used in 2014. Act 52 also provides that a film production tax credit purchased or assigned in calendar year 2014 may be used in 2015.

- The entity may carry over any unused tax credits to no more than the three succeeding taxable years.
- The tax credit may not be carried back and is not refundable.
- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the credit. The partner, shareholder or member must use the tax credit in the year it is passed through. Refer to Passing Through Tax Credit To Entity Owners.
- A taxpayer which claims a tax credit and fails to incur the amount of qualified film production expenses agreed to in section 1703-D(c)(3) for a film in that taxable year shall repay to the commonwealth the amount of the film production tax credit claimed under this article for the film.
- The tax credit cannot be applied against any tax withheld by an employer from an employee under Article III of the Tax Reform Code.

For more information and to apply for a Film Production Tax Credit, visit the Department of Community and Economic Development's website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

To sell/assign the Film Production Tax Credit, visit the Department of Community and Economic Development's website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

5. Organ and Bone Marrow Donor Tax Credit

The Department of Revenue's Bureau of Corporation Taxes administers the award of this tax credit to eligible businesses that provide paid leave of absences to employees for organ or bone marrow donation.

The amount of the tax credit is equal to the employee compensation paid during the leave of absence, the cost of temporary replacement help and any miscellaneous expenses authorized by regulation incurred with the leave of absence period.

Qualified businesses, including pass through entities can apply the tax credit against the following Pennsylvania state taxes:

- Capital stock/ foreign franchise tax
- Corporate net income tax
- Bank and trust company shares tax
- Mutual thrift institutions tax
- Title insurance company shares tax
- Insurance gross premiums tax (excluding surplus lines, unauthorized, domestic/foreign marine)

- Personal income tax

Guidelines for the Organ and Bone Marrow Donor Tax Credit for Pennsylvania Personal Income Tax Purposes

- The entity decides if the tax credit will be applied towards corporation tax and/or passed through to its partners, shareholders or members.
- The tax credit may be applied to 100 percent of the entity's liability or to 100 percent of the entity owners' liabilities.
- The tax credit cannot be sold or assigned.
- The entity may carry over any unused tax credits to no more than the three succeeding taxable years.
- The tax credit may not be carried back and is not refundable.
- The tax credit cannot be applied against any tax withheld by an employer from an employee under Article III of the Tax Reform Code.
- The Organ and Bone Marrow Donor Tax Credit expired at the end of 2010.

For more information and to apply for an Organ and Bone Morrow Donor Tax Credit, visit the Department of Revenue's website http://www.revenue.state.pa.us at and complete form REV-984.

6. Keystone Innovation Zone (KIZ) Tax Credit

The Pennsylvania Department of Community and Economic Development (DCED) administers the award of this tax credit to businesses and individuals that create designated geographic zones to foster innovation and create entrepreneurial opportunities by aligning the combined resources of educational institutions and the private sector.

Qualified businesses, including pass through entities and individuals with business activity in a KIZ can apply this tax credit against the following Pennsylvania state taxes:

- Capital stock/foreign franchise tax
- Corporate net income tax
- Personal income tax

Guidelines for the Keystone Innovation Zone Tax Credit for Pennsylvania Personal Income Tax Purposes

- The tax credit must first be applied to the entity's corporate tax liability, if any, for the year in which the tax credit is awarded before it can be passed through to its partners, shareholders or members.
- The tax credit may be applied to 100 percent of the entity's liability or to 100 percent of the entity owners' liabilities.
- The tax credit may not be carried back and is not refundable.
- The tax credit can be sold or assigned. Refer to Saleable or Assignable Tax Credits.
- A purchased or assigned tax credit may be applied to no more than 75 percent of the tax liability of the purchaser or assignee.
- The entity may carry over any unused tax credits to no more than the four succeeding taxable years. The partner, shareholder or member must use the tax credit in the year it is passed through.
- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the credit. **This tax credit cannot be passed through using a claim form or a request to the Bureau of Corporation Taxes**. An application to pass through the tax credit must be sent to Department of Community and Economic Development.

For more information, to apply for a Keystone Innovation Zone tax credit or to sell/assign/pass through a credit, visit the Department of Community and Economic Development's website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

7. Resource and Enhancement Protection Tax Credit

The program is administered by the State Conservation Commission (SCC) under the Pennsylvania Department of Agriculture. The program allows farmers and businesses to earn tax credits in exchange for best management practices on agricultural operations that will enhance farm production and protect natural resources.

The REAP tax credit in many cases is granted directly to individual taxpayers and may be carried forward to future tax years for use by that individual. However, many individuals prefer to sell the REAP tax credit instead of carrying it forward.

An individual receiving a REAP tax credit must wait a year after the tax credit is awarded. The tax credit must be applied to 100% of the individual's personal income tax liability, not including the tax liability of a spouse.

Qualified businesses, including pass through entities and individuals can apply the tax credit against the following Pennsylvania state taxes:

- Capital stock/ foreign franchise tax
- Corporate net income tax
- Bank and trust company shares tax
- Mutual thrift institutions tax
- Title insurance company shares tax
- Insurance gross premiums tax
- Personal income tax

For projects to be eligible for the tax credit, farms, farmers and sponsors must apply to the SCC. Resource Enhancement and Protection Tax Credits (REAP) can be used by the applicant for up to 15 years, and they are transferable and can be sold or assigned to other taxpayers.

Guidelines for the Resource Enhancement and Protection Tax Credit for Pennsylvania Personal Income Tax Purposes

- The tax credit must first be applied to the entity's corporate tax liability, if any, for the year in which the tax credit is awarded before it can be passed through to its partners, shareholders or members.

- The tax credit can be sold or assigned. Refer to Saleable or Assignable Tax Credits.

- A purchased or assigned tax credit may be applied to no more than 75 percent of the tax liability of the purchaser or assignee.

- The entity may carry over any unused tax credits to no more than the 15 succeeding taxable years.

- The tax credit may not be carried back and is not refundable.

- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the credit. The partner, shareholder or member must use the tax credit in the year it is passed through. Refer to Passing Through Tax Credit To Entity Owners.

- A business which claims a tax credit and fails to maintain a best management practice for the required period, the owner of the property upon which the project exists shall return to the PA Department of Revenue the amount of the tax credit originally granted.

- The tax credit may be applied to 100 percent of the entity liability or to 100 percent of the entity owners' liabilities.

- The tax credit cannot be applied against any tax withheld by an employer from an employee under Article III of the Tax Reform Code.

The entity claims the tax credit or passes it through to entity owners by submitting the claim form with the certification received from the Department of Revenue to:

PA DEPARTMENT OF REVENUE
BUREAU OF CORPORATION TAXES
PO BOX 280701
HARRISBURG PA 17128-0701

If this certification form is not received, the tax credit will not be applied to any tax accounts. The tax credit must be claimed by the taxpayer within 15 years of the effective date.

For more information, to apply for a Resource Enhancement and Protection Tax Credit or to sell/assign a tax credit, visit the Dept. of Agriculture's website at www.agriculture.state.pa.us or call 717-787-8821.

8. Neighborhood Assistance Program (NAP) Tax Credit

The Pennsylvania Department of Community and Economic Development (DCED) administers the award of this tax credit to businesses and individuals that contribute to neighborhood organizations and engage in activities that promote community economic development in impoverished areas or provide charitable food programs as part of their community service.

The NAP tax credit also includes the Enterprise Zone tax credit. All the same rules for passing through and selling/assigning tax credits apply to both programs.

Qualified businesses, including pass through entities and individuals can apply the tax credit against the following Pennsylvania state taxes:

- Capital stock/ foreign franchise tax
- Corporate net income tax
- Bank and trust company shares tax
- Alternative bank shares tax
- Mutual thrift institutions tax

- Title insurance company shares tax
- Alternative title insurance companies tax
- Insurance gross premiums tax
- Excise tax on foreign corporations
- Personal income tax

Guidelines for the Neighborhood Assistance Program Tax Credit for Pennsylvania Personal Income Tax Purposes

- The tax credit must first be applied to the entity's corporate tax liability, if any, for the year in which the tax credit is awarded before it can be passed through to its partners, shareholders or members.

- The tax credit can be sold or assigned. Refer to Saleable or Assignable Tax Credits.

- A purchased or assigned tax credit may be applied to 100 percent of the tax liability of the purchaser or assignee.

- The entity may carry over any unused tax credits to no more than the five succeeding taxable years.

- The tax credit may not be carried back and is not refundable.

- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the credit. The partner, shareholder or member must use the tax credit in the year it is passed through. Refer to Passing Through Tax Credit To Entity Owners.

- Pennsylvania does not allow the deduction of certain expenses used to qualify for the Neighborhood Assistance Program tax credit. If the expenses were deducted in calculating federal-taxable income, the amount should be reported as a reduction in expenses on PA-20S/PA-65 Schedule M, Part B, Section E, line f. Do not reduce Pennsylvania-taxable income by amounts paid to qualify for the tax credit.

- The tax credit may be applied to 100 percent of the entity liability or to 100 percent of the entity owners' liabilities.

For more information, to apply for a Neighborhood Assistance Program Tax Credit or to sell/assign a tax credit, visit the Department of Community and Economic Development's website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

9. Strategic Development Area Job Creation Tax Credit

The Pennsylvania Department of Community and Economic Development (DCED) administers the award of this tax credit to eligible businesses and individuals whose business activities contribute to economic development and foster growth in designated areas.

Job tax credits are also available for businesses to maintain and create new jobs in these areas. Tax credit is available for tax years beginning on or after Jan. 1, 2008.

Qualified businesses, including pass through entities and individuals can apply the tax credit against the following Pennsylvania state taxes:

- Capital stock/ foreign franchise tax
- Corporate net income tax
- Bank and trust company shares tax
- Mutual thrift institutions tax
- Title insurance company shares tax
- Insurance gross premiums tax
- Utilities gross receipts tax
- Personal income tax

Guidelines for the Strategic Development Area Job Creation Tax Credit for Pennsylvania Personal Income Tax Purposes

- The tax credit cannot be applied to more than 50 percent of the tax liability of the awardee or of the owner of a pass through entity.

- The entity decides if the tax credit will be applied towards corporation tax and/or passed through to its partners, shareholders or members.

- The tax credit cannot be sold or assigned.

- Any unused tax credits may not be carried back or carried over and are not refundable. The tax credit must be used in the taxable year of the contribution or the taxable year following the year of contribution.

- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the tax credit. See the guidelines under Passing Through Tax Credit To Entity Owners.

- The tax credit cannot be applied against any tax withheld by an employer from an employee under Article III of the Tax Reform Code.

- The tax credit expires Dec. 31, 2022.

For more information and to apply for a Strategic Development Area Tax Credit visit the Department of Community and Economic Development's website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

10. Educational Improvement Tax Credit

The Pennsylvania Department of Community and Economic Development administers the award of this tax credit to eligible businesses and individuals contributing to scholarship organizations (including pre-kindergarten scholarship organizations) and educational improvement organizations, in order to promote expanded educational opportunities for students in Pennsylvania.

Qualified businesses, including pass through entities and individuals can apply the tax credit against the following Pennsylvania state taxes:

- Capital stock/ foreign franchise tax
- Corporate net income tax
- Bank and trust company shares tax
- Mutual thrift institutions tax
- Title insurance company shares tax
- Insurance gross premiums tax (excluding unauthorized, domestic/foreign marine)
- Surplus lines tax
- Personal income tax

Guidelines for the Educational Improvement Tax Credit for Pennsylvania Personal Income Tax Purposes

- The entity decides if the tax credit will be applied towards corporation tax and/or passed through to its partners, shareholders or members.

- The tax credit cannot be sold or assigned.

- Although any unused tax credits may not be carried forward, the entity may elect in writing prior to the due date of the entity's tax return to pass through all or a portion of the tax credit to its owners in the taxable year of the contribution or the taxable year immediately following the year of contributions.

- To make an irrevocable election to pass through an Educational Improvement Tax Credit to partners, shareholders or members, a business should visit the Department of Revenue's website at www.revenue.state.pa.us and complete REV-1123, Educational Improvement Tax Credit Election Form. The entity must complete a separate REV-1123 each year the tax credit is awarded and not used in whole or in part.

- REV-1123 must be sent to the Revenue's Bureau of Corporation Taxes by the tax return filing due date (including extensions) of the entity. However, REV-1123 must be sent separately from the entity's tax return.

- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the tax credit.

- The tax credit may be applied to 100 percent of the entity's tax liability or 100 percent of the entity owners' liabilities.

- Pennsylvania does not allow the deduction of certain expenses used to qualify for the Educational Improvement Tax Credit. If the expenses were deducted in calculating federal-taxable income, the amount should be reported as a reduction in expenses on PA-20S/PA-65 Schedule M, Part B, Section E, Line f. Do not reduce Pennsylvania-taxable income by amounts paid to qualify for the tax credit.

- The tax credit cannot be applied against any tax withheld by an employer from an employee under Article III of the Tax Reform Code.

- There is no expiration date for the awarding of the Educational Improvement Tax Credit.

For more information and to apply for an Educational Improvement Tax Credit, visit the Department of Community and Economic Development's website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

11. Volunteer Responder Recruitment and Retention Tax Credit

The Volunteer Responder Recruitment and Retention (VRRR) Tax Credit was issued only for tax year 2008 to individual taxpayers who volunteered for qualified volunteer organizations. The tax credit is nonrefundable and cannot exceed $100 per taxpayer. The tax credit may be applied to 100% of the individual's personal income tax liability. The law allows taxpayers who do not use the entire amount of the 2008 tax credit to carry forward the unused balance for three years. However, taxpayers may not apply for a new tax credit for any tax year other than 2008. The tax credit may not be sold or assigned.

This tax credit can be offset only against Pennsylvania personal income tax liabilities. In order to claim the tax credit, taxpayers must submit a completed *PA-40 Schedule OC-V* with the *PA-40, Individual Income Tax Return.*

12. Keystone Special Development Zone Tax Credit

The Pennsylvania Department of Community and Economic Development (DCED) administers the award of this tax credit. Applications must be submitted to the DCED by Feb. 1 of the year for the previous calendar year. Eligibility is based on businesses that build structures on and then employ additional workers in/on land designated as a special industrial area in the Land Recycling and Environment Remediation Standards Act of 1995. Land must have no permanent vertical structures attached prior to July 1, 2011. Credit is $2,100 for each full-time or full-time equivalent (35 hours or more) new employee working 90 percent within a keystone special development zone over and above each full-time or full-time equivalent employee working prior to Jan. 1, 2012.

Qualified businesses, including pass through entities and individuals, can apply the tax credit against the following Pennsylvania state taxes for tax year beginning 2012:

- Capital stock/foreign franchise tax
- Corporate net income tax
- Bank shares tax
- Mutual thrift institutions tax
- Title insurance and trust company shares tax
- Personal income tax

Guidelines for the Keystone Special Development Zone Tax Credit

- The tax credit can be earned for ten years of a 15-year period beginning July 1, 2012 through June 30, 2026.

- The entity decides if the tax credit will be applied towards corporation tax and/or passed through to its partners, members or shareholders (owners) beginning in 2012.

- The tax credit may be carried forward, sold, or assigned and the tax credit is not refundable.

- Purchased or assigned tax credits may be applied to no more than 75 percent of the tax liability of the purchaser or assignee.

- The purchaser or assignee shall claim the tax credit in the year in which the purchase or assignment is made.

- The entity can pass through in whole or part unused tax credits to its owners. The amount of the tax credit passed through to owners is based on the percentage of income distribution from the entity receiving the tax credit. The owner must use the tax credit in the year it is passed through.

- The applicant/awardee cannot be an employer constructing the improvements in the Keystone Special Development Zone.

- An employer may not claim both Keystone Opportunity Zone and the Keystone Special Development Zone tax credits.

- If the company fails to maintain operations for five years from submission of certificate to the Department of Revenue, the company shall be required to refund the total amount of tax credits granted, with interest and a penalty of 20 percent of the amount of credits granted.

Note. Do not pass through more than is needed to entity owners for this or any other restricted tax credit and do not purchase or assign more than can be used of this tax credit or any other restricted tax credit for purchase or assignment.

For more information, to apply for a Keystone Special Development Zone Tax Credit, visit the Department of Community and Economic Development's website at www.newpa.com or call the DCED Customer Service Center at 1-800-379-7448.

13. Opportunity Scholarship Tax Credit

The Pennsylvania Department of Community and Economic Development (DCED) administers the award of this tax credit to eligible businesses and individuals who contribute to IRC §501(C) scholarship organizations approved by DCED. Scholarship organizations can provide scholarships to eligible students living within the boundary of the lowest-achieving 15 percent of elementary and lowest-achieving 15 percent of secondary schools as published by the Department of Education.

The program will give low- and moderate-income students in low-achieving schools the option to obtain a tuition assistance scholarship to attend a participating public or nonpublic school.

Qualified businesses, including pass-through entities, may apply the credit against the following Pennsylvania state taxes:

- Capital stock/foreign franchise tax
- Corporate net income tax
- Bank shares tax
- Title insurance & trust company shares tax
- Insurance premiums tax (excluding surplus lines, unauthorized, domestic/foreign marine)
- Mutual thrift tax
- Gross receipts tax
- Personal income tax

For more information, to apply for an Opportunity Scholarship Tax Credit, or to pass-through a credit, visit the DCED's website at www.newpa.com, or call the DCED Customer Service Center at 1-800-379-7448.

For tax questions, please contact the Department of Revenue at 717-772-3896.

Guidelines for the Educational Opportunity Scholarship Tax Credit

- The entity decides if the tax credit will be applied towards corporation tax and/or passed through to its partners, shareholders or members.

- The tax credit cannot be sold or assigned.

- Although any unused tax credits may not be carried forward, the entity may elect in writing prior to the due date of the entity's tax return to pass through all or a portion of the tax credit to its owners in the taxable year of the contribution or the taxable year immediately following the year of contributions.

- Credit cannot be applied for any tax withheld by an employer from an employee.

- To make an irrevocable election to pass through an Opportunity Scholarship Tax Credit to partners, shareholders or members, a business should visit the Department of Revenue's website at www.revenue.state.pa.us and complete *REV-1123, Educational Improvement/Opportunity Scholarship Tax Credit Election Form*, which is also used for the Educational Improvement Tax Credit program. The entity must complete a separate REV-1123 each year the tax credit is awarded and not used in whole or in part.

- The election form REV-1123 must be sent to Revenue's Bureau of Corporation Taxes by the tax return filing due date (including extensions) of the entity. However, REV-1123 must be sent separately from the entity's tax return.

- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the tax credit.

- The tax credit may be applied to 100 percent of the entity liability or 100 percent of the entity owners' liabilities.

14. Historic Preservation Incentive Tax Credit

Effective July 1, 2013, this program will provide tax credits for qualified taxpayers to rehabilitate a qualified historic structure that is approved by the PA Historical & Museum Commission. For tax year 2012, only fiscal-year filers can claim this credit.

Qualified taxpayers may apply the credit against the following Pennsylvania state taxes:

- Capital stock/foreign franchise tax

- Corporate net income tax
- Bank shares tax
- Title insurance & trust company shares tax
- Insurance premiums tax (excluding surplus lines, unauthorized, domestic/foreign marine)
- Mutual thrift tax
- Gross receipts tax
- Personal income tax

For more information, to apply for a Historic Preservation Tax Credit or to sell/assign/pass-through a credit, visit the DCED's website at www.newpa.com, or call the DCED Customer Service Center at 1-800-379-7448.

For tax questions, please contact the Department of Revenue at 717-772-3896.

Guidelines for the Historic Preservation Incentive Tax Credit

- The tax credit shall be applied against the qualified entities liability for the current taxable year as of the date on which the tax credit was issued before it can be passed through to its partners, shareholders or members.

- The tax credit can be sold or assigned. Refer to Saleable or Assignable Tax Credits.

- A purchased or assigned tax credit may be applied to 100 percent of the tax liability of the purchaser or assignee.

- The entity may carry forward any unused tax credits to no more than the seven succeeding taxable years.

- The tax credit may not be carried back and is not refundable.

- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the tax credit. The partner, shareholder or member must use the tax credit in the year it is passed through. Refer to Passing Through Tax Credit To Entity Owners.

- The tax credit may be applied to 100 percent of the entity liability or to 100 percent of the entity owners' liabilities.

15. Community-Based Services Tax Credit

The Pennsylvania Department of Community and Economic Development (DCED) administers the award of this tax credit. Effective July 1, 2013, this program will provide tax credits for contributions made by business firms to non-profit providers of community-based services to individuals with intellectual disabilities or mental illness. For tax year 2012, only fiscal-years filers can claim this credit.

Qualified businesses may apply the credit against the following Pennsylvania state taxes:

- Capital stock/foreign franchise tax
- Corporate net income tax
- Bank shares tax
- Title insurance & trust company shares tax
- Insurance premiums tax (excluding surplus lines, unauthorized, domestic/foreign marine)
- Mutual thrift tax
- Gross receipts tax
- Personal income tax

For more information or to apply for a Community-Based Services Tax Credit or to sell/assign/pass-through a credit, visit the DCED's website at www.newpa.com, or call the DCED Customer Service Center at 1-800-379-7448.

For tax questions, please contact the Department of Revenue at 717-772-3896.

Guidelines for the Community - Based Services Tax Credit

- The tax credit shall be applied against the qualified entity's liability for the current taxable year as of the date on which the credit was issued.

- The tax credit cannot be sold or assigned.

- The amount of the tax credit passed through to partners, shareholders or members is based on the percentage of income distribution from the entity receiving the tax credit.

- The tax credit may be applied to 100 percent of the entity's liability.

- Credit cannot be applied for any tax withheld by an employer from an employee.

III. RESIDENT CREDIT FOR A PA S CORPORATION TAXED AS A C CORPORATION

Certain S corporations are not taxed as S corporations (taxed as a C corporation) in other states or countries. In such cases an entity must account for taxes paid to other states or countries in order to claim the correct resident tax credit. A C corporation tax return must be submitted.

Only Pennsylvania resident shareholders can claim credit for taxes paid to other states or countries. To claim a credit for taxes paid by a PA S corporation or a partnership to another state on behalf of Pennsylvania resident shareholders or partners, the Pennsylvania resident must submit a copy of the other state's tax return, a *PA-40 Schedule G-L*, a statement from the partnership or S corporation providing the breakdown of the states with the amounts and classes of income subject to tax in each state and a copy of your PA Schedule(s) RK-1.

The other state's tax return must show the payment of tax by the taxpayer and the PA S corporation, including necessary supporting documentation. The *PA-20S/PA-65 Schedule RK-1* may show the applicable portion of the taxes paid to the other state by attachment of a letter of explanation or making a change in Part III, with the necessary supporting documents. If a consolidated return was filed with the other state, a copy of that return must be submitted with a *PA-40 Schedule G-L*.

Calculate all other states' apportioned income using the Pennsylvania tax rate. The result of this calculation cannot exceed the tax paid to the other state. The Pennsylvania-apportioned income and the other states' apportioned income together cannot exceed 100 percent.

The C corporation from another state that is an S corporation for Pennsylvania reports on Line 5 of the PA-20S/PA-65 Schedule OC the lesser of the amount of tax paid on the apportioned income as compared to the tax rate of Pennsylvania. The entity then distributes the amount reported on Line 5 according to ownership percentage.

EXAMPLE.

Total income from everywhere:	$100,000	
PA-source income	25,000	
Other state's income & tax rate	75,000	x 2.00 percent (0.0200) = $1,500
Other state's income also taxed in PA & PA tax rate	75,000	x 3.07 percent (0.0307) = $2,302
Lesser of the two	= $1,500	

The amount of credit reported on Line 5 is $1,500 because it is less than the amount paid to Pennsylvania.

CHAPTER 19: TAX WITHHOLDING AND ESTIMATED PAYMENTS

WITHHOLDING – REPORTING BLOCK 16.

ESTIMATED PAYMENTS.
Requirements for Making Estimated Payments.
Payment Due Dates.
Form PA-40ES.
Safe Harbor from Pennsylvania Underpayment Penalties.
Penalties.
Interest.

EMPLOYER WITHHOLDING

DIRECTIONS FOR PENNSYLVANIA TAXABLE COMPENSATION
BOX 16 ON FEDERAL FORM W-2

DIRECTIONS FOR COMPLETING
Federal Form W-2

Block 16

"State wages, tips, etc."

This booklet contains information that will help you know what income items must be reported in Block 16 ("State wages, tips, etc.") of your employees' W-2 Wage and Tax Statement. It also contains instructions to help you know which reportable income items are subject to Pennsylvania personal income tax withholding.

Pennsylvania personal income tax rules vary from Federal income tax rules in many ways. This booklet assumes that:

- You have already correctly determined the employment status under Federal income tax rules of each employee and non-employee with Federally taxable "wages."
- You have already correctly computed the amount of each employee's "Block 1" Federal "Wages, tips, etc." but do not know Pennsylvania personal income tax rules.
- Your employee is not a "statutory employee" or "statutory nonemployee" for Federal income tax purposes.
- Your employee is not a post-doctoral research fellow.

The booklet lists each adjustment to the amount of an employee's "Block 1" Federal "wages, tips, etc." that is necessary to compute the correct amount of the employee's "State wages, tips, etc." subject to Pennsylvania personal income tax. Part I lists the items that are taxable for Pennsylvania purposes but not for Federal purposes. The amount of these items must be *added* to the Federal income amount. Part II lists the items that are not taxable for Pennsylvania purposes but are taxable for Federal purposes. The amount of these items must be *subtracted* from the Federal income amount you computed.

Many amounts, of course, are taxable for both Pennsylvania and Federal purposes. If you have correctly computed the employee's Federal "Wages, tips, etc.," no adjustment for these items will be necessary.

This booklet does not contain instructions covering information returns corresponding to Federal Form 1099R or Form 1099-MISC. It also does not contain information concerning non-payroll items such as pensions, annuities, or other payments from any trust described in IRC §401(a) which is exempt from tax under IRC §501(a) at the time of such payment (unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust) and IRAs, military retirement, gambling winnings, and items subject to Federal backup withholding such as interest, dividends, rents, royalties, commissions, and non-employee compensation. The booklet also does not identify which expenses may be deducted on PA Schedule UE. For more information on these matters, consult the PA PIT Guide.

Effective January 1, 1998			
Start with Box 1, Wages, tips, other compensation, of Federal Form W-2, Wage and Tax Statement. The following adjustments are required to determine Box 16, state wages, tips, etc.			
Part A ADD the following items to the Box 1 amount (unless already included) in the circumstances noted:			
Item	**WITHHOLD**	**When**	**Amount**

1	Tuition reimbursement	Yes	All payments made by employers to employees for actual, vouchered educational expenses they incur unless the education is required by law or is required by employer of the employee to retain the specific skills needed for his present position.	Total amount of reimbursements neither used for allowable employee business expenses nor returned to the employer.
2	Educational assistance program	Yes	The education is not required by law or is not required by employer of the employee to retain the specific skills needed for his present position.	All amounts received by an employee for tuition, books, fees, supplies, etc. *less* than the federal exclusion amount ($5,250 for 2000 tax year).
3	Dependent care assistance/day care	YES	All instances other than when: a) Service is provided by employer or co-employee; b) Rights to service were procured beforehand by employer (not by employee); and c) Employee has no option to receive additional cash compensation in lieu of assistance.	Amount paid by employer and/or through employee contributions pursuant to salary reduction agreement or payroll deductions.
4	Employee reimbursements	YES	To the extent that the reimbursement is excluded from federal income but not from Pennsylvania income. Example: payments received under educational assistance plan when the training is not business related.	Amount not included in Box 1 federal wages. Arbitrary or lump sum reimbursements are taxable.
5	Prizes and awards, including length of service or safety achievement	Yes	Winner is required to render services as a condition to receiving prize or award or when awarded in recognition of years of service or safe work record.	To the extent not already included in block 1.

Part B ADD the following items to the Box 1 figure:

ITEM		**Withhold**	**Amount**
1	Elective employee contributions made under a salary reduction agreement or cash or deferred arrangement:		Amount to the extent not already included in block 1.

	a) 401 (k) plan b) 403(b) Pure annuity plan, including plans sponsored by exempt organizations described in IRC § 501(c) c) 403(b) plan plus another deferred plan d) 408(k) Simplified Employee Pension plan e) 457 plan f) A trust established by an employer or other payor to fund Federally nonqualified deferred compensation payments	Yes Yes Yes Yes Yes Yes	Amount to the extent not already included in block 1. Amount to the extent not already included in block 1.[spacing or alignment?]Amount to the extent not already included in block 1. Amount to the extent not already included in block 1. Amount to the extent not already included in block 1. Amount to the extent not already included in block 1.
2	Elective contributions made under a salary reduction agreement or cash or deferred arrangement credited by an employer or other payor toward non-qualified deferred compensation payments	Yes	Amount to the extent not already included in block 1.
3	Elective contributions made under a salary reduction agreement or cash or deferred arrangement credited by an employer or other payor toward the payment of Federally qualified transportation fringes.	Yes	Amount to the extent not already included in block 1.
4	Elective contributions under a cafeteria plan when the employee elects federally excludible non-cash benefit, which is taxable for PA purposes (i.e., dependent care assistance or adoption assistance).	Yes	Amount to the extent not already included in block 1.
5	Treaty exempt income when employee is PA resident	Yes	Amount to the extent not already included in block 1 as a result of federal treaty, unless treaty specifically says "State Tax Exempt."
6	Mustering out pay excludible under IRC § 113 when serviceman is PA resident	Yes	Amount to the extent not already included in block 1.
7	Rental allowance paid to minister (Value of a parsonage is exempt beginning 1/1/98)	Yes	Entire allowance.
8	Peace corps volunteers, basic living allowance	Yes	Entire allowance.
9	Foreign earned income	Yes	Amount not subject to withholding because of federal exclusion.
10	Veterans' bonus, state wages	Yes	Amount of bonus.
11	Employer pickups	Yes	Amount treated as employer contribution for federal purposes pursuant to IRC §414(h)(2)
12	Reimbursements for employee business expenses reimbursed under an accountable plan	Yes	To the extent the item is an allowable deduction for Federal income tax purposes but not for PA purposes. Such items include: a) Job hunting and travel expenses incurred by an individual seeking new employment in the same trade or profession. b) Taxes based on income. c) Commerce or trade association dues, country club dues, etc. d) Fees incurred for seeking or securing new employment or different job with current employer. e) e. Travel expenses incurred for travel between different employments.
13	Educational assistance plan tuition	RESERVED	

14	Education and related travel expenses incurred by an individual seeking new employment	Yes	Amount to the extent not already included in block 1.
15	Difference between FMV of Federal non-qualified stock option at exercise and any amounts paid for the stock or the option when the option had a readily ascertainable value at the time it was granted and there are no substantial limitations or restrictions on transferability or alienability of the stock	Yes	Amount to the extent not already included in block 1.
Part B continued ADD the following items to the Box 1 figure:			
ITEM		**Withhold**	**Amount**
16	Difference between FMV of Federal non-qualified stock option at lapse of limitations or restrictions and any amounts paid for the stock or option when the option had a readily ascertainable value at the time it was granted and there are substantial limitations or restrictions on transferability or alienability of the stock	Yes	Amount to the extent not already included in block 1.
17	Difference between FMV of Federal non-qualified stock option at disposition and any amounts paid for the option when the option had a readily ascertainable value at the time it was granted and the option was disposed of before exercise	Yes	Amount to the extent not already included in block 1.
18	Difference between FMV of incentive stock option at disposition and any amounts paid for the option when the option was disposed of before exercise	Yes	Amount to the extent not already included in block 1.
19	Difference between FMV of incentive stock option at the time it was exercised and the amounts paid for the option when the option was exercised before it was disposed of	Yes	Amount to the extent not already included in block 1
20	Difference between FMV of employee stock purchase plan stock option at the time limitations or restrictions on transferability or alienability of the stock lapse and the amounts paid for the option	Yes	Amount to the extent not already included in block 1.
21	Dues paid for a membership in a business, athletic, country, social, hotel, airline, luncheon or sporting club when the employer elects not to treat the club usage as compensation for Federal income tax purposes, membership is not in the name of the employer, and the club is not used primarily for trade or business	Yes	Amount to the extent not already included in block 1.
22	Reimbursements for home office expenses when the employee has a principal place of work separate from the home office	Yes	Amount to the extent not already included in block 1.

Part C DEDUCT the following items from the Box 1 figures:			
ITEM		**Withheld**	
1	Fair market value of personal use of employer's vehicle	No	Irrespective of whether employer elects not to withhold federal tax.

2	Personal use of company owned or commercial transportation unless already excluded as federal no-additional-cost service	No	
3	Personal use of property belonging to, or held under a lease by, the employer, such as educational or training facilities, housing, clothing, day care facilities, passenger cars and commuter highway vehicles, aircraft or watercraft, construction or recreation vehicles, athletic facilities or equipment, entertainment facilities or equipment, parking facilities, eating facilities, office facilities or equipment, tools, equipment or supplies	No	To the extent taxable for Federal tax purposes.
4	Third party sick payments: a. Third party sick payments when premium is paid by employer under nondiscriminatory plan	No	
	b. Third party sick payments are subject to state withholding if third party is administrator/agent of employer for employer's sick leave plan. (When employer bears insurance risk of extent of payment of benefits)	Yes	
5	Premiums paid by employer for nondiscriminatory term life insurance coverage when they exceed the cost (based on the IRS uniform premium cost tables) of more than $50,000 of group-term life insurance provided by employer If program discriminates in regard to eligibility to participate, coverage or entitlement to benefits, then no adjustment to federal box 1 wages	No	
6	Income in respect of a decedent includible in income for Federal income tax purposes, including after death payments of wages earned through the date of death or for vacation or time off with pay accumulated to date of death	No	
7	Nondiscriminatory split dollar life insurance coverage when the excess of the amount of the one-year term cost of the declining life insurance protection to which the employee is entitled exceeds the amount of the premiums he paid	No	
8	Campus lodging provided to employees of a primary or secondary school, college or university or their dependents if it discriminates in favor of highly compensated employees	No	To the extent not excludible as a de minimis fringe for Federal income tax purposes.
9	Nonqualified stock options (those not governed by IRC §§ 421-424) when amounts are required under the IRC to be included in income upon grant	No	
10	Direct employer contributions to an IRA or SEP when they exceed Federal limitations on employer contributions and not made pursuant to employee election	No	To the extent of the excess.
11	Meals and lodging not provided for the employer's convenience	No	To the extent not excludible as a de minimis fringe for Federal income tax purposes.

Part D. DEDUCT the following items from the Box 1 figure in the circumstances noted:

ITEM		Withheld	When
1	Financial planning assistance	No	Service is purchased directly by the employer or is provided by the employer's own employees.
2	Retirement counseling fees	No	Service is purchased directly by the employer or is provided by the employer's own employees.
3	Other life insurance, including term, whole, under nondiscriminatory plan when premiums paid by employer	No	Except group term life insurance coverage on an employee's dependent.
4	Split dollar life insurance	No	To extent employer pays premiums for life insurance coverage element in policy.
5	Campus lodging	No	Irrespective of whether for employer's convenience (Act 45 of 1998). (If cash allowance, it is subject to withholding.)

6	Meals and lodging not provided for the employer's convenience	No	
7	Amount of tuition reduction or waiver	No	When the reduction or waiver discriminates in favor of highly compensated employees of the primary or secondary school, college or university or the student is a graduate student not engaged in teaching or research activities for the employer – after 1/1/98 (Act 45).
8	Supplemental unemployment benefits paid under nondiscriminatory plan	No	
9	Amount reportable for Federal income tax purposes at grant of nonqualified stock option	No	When the option has a readily ascertainable value.
10	Amount reported for Federal income tax purposes at sale of stock purchased under an employee stock purchase plan	No	
11	Amount reported for Federal income tax purposes at sale of stock purchased under an incentive stock option	No	
12	Federally taxable compensation received while serving as a U.S. serviceman in a combat zone	No	When *NOT* for service in a combat zone or for a month during any part of which serviceman was hospitalized as a result of wounds, disease or injury incurred while serving in a combat zone.
13	Federally taxable compensation received for active duty as a member of the Armed Forces of the U.S. outside PA	No	
14	Dues paid for a membership in a business, athletic, country. Social, hotel, airline, luncheon or sporting club, to extent the employer elects to treat the club usage as compensation for Federal income tax purposes,	No	When the membership is titled in the name of the employer.
15	Moving and relocation expense reimbursements	No	When both of the following apply: 1) The reimbursement would be wholly excludible for Federal income tax purposes but for the fact that the new principal place of work is less than 50 miles farther from the individual's old resident than was his or her former principal place of work; and 2) The new principal place of work is at least 35 miles farther from the individual's old residence than was his or her former principal place of work.

Part E	**NO ADJUSTMENT is made for the following items:**
1	a) Health and accident insurance plan premiums paid by the employer under nondiscriminatory health or accident plan b) Employer contributions to Medical Savings Account, so long as program is nondiscriminatory. If program in a. or b. is discriminatory, add to box 1 wages.
2	Medical reimbursement account. Payments to reimburse the employee for expenses incurred for medical care under self-insured medical reimbursement plan under IRC § 105(h)(6) when employee precluded from receiving unused contributions or carrying benefit to subsequent taxable year.
3	Awards, gifts, prizes and length of service achievement or safety with value in excess of $400 or in excess of $1,600 for qualified plan awards.
4	Periodic sick or disability payments by employer if payment based on nature of sickness, injury or disability and not with reference to employee's absence from work. If in lump sum form or based on employee's rate of compensation, then subject to withholding.

5	Sick pay - employee receives the full amount or a percentage of his regular wages, the amount of leave is earned based on length of service, the employee may receive all or a portion of unused sick leave if he terminates employment after a specified time period, whether in years, days, or the employee can receive the benefits if he takes leave for regular physician or dental visits of for family bereavement.
6	Interest from below market interest rate loans in excess of $10,000.
7	Employer provided facilities for vocations or use of other employer owned or leased property, including off-premises athletic facilities.
8	Meals excludible as a de minimis fringe benefit for federal tax purposes.
9	Meals and lodging provided for the employer's convenience.
10	Uncollected company loans or other advances, discharge of indebtedness constituting compensation.
11	Employee's withholding taxes paid by the employer for: a) Federal Income Tax b) Social Security Tax (OASDI) c) Social Security Tax (Medicare) d) State income tax e) State unemployment tax f) State disability tax g) County, city, borough, township, village, school district, or any other local tax.
12	Tangible personal property awards and prizes.
13	Tuition reimbursement exceeding $5,250 for 2000; course not required by law or for employee to maintain skills needed for present position.
14	Tangible personal property awards and prizes.
15	Employee voluntary or required contributions to: a) IRA/SEP employee only b) IRA/SEP employee plus spousal arrangement.
16	Excess contributions to: a) 401 (k) b) 403(b) annuity contract c) 403(b) (multiple annuity contracts of single employee) e. d. 408(k) or 457 plan.
17	Employer provided country club memberships, season tickets to sporting or other entertainment events (if reimbursement).
18	*ON-SITE DAY CARE OR ATHLETIC FACILITIES.*
19	Standard per diem and federal mileage allowance reporting of employee business expenses.
20	Vacation pay .
21	Property received as compensation.
22	Vacation pay .
23	Scholarship or fellowship grant or award requiring services to the employer unless recipient is a candidate for a degree and the same services are required of all students as prerequisite to receiving degree. If scholarship or fellowship awarded on condition for past or future employment services, then subject to withholding. If recipient is required to apply his skill and training to advance research, creative work or some other project or activity, award is subject to withholding unless the test in the first sentence of this paragraph is met.
24	Qualified employee discounts.
25	No additional cost services.
26	Severance or dismissal pay .
27	Pay in lieu of time off for vocation or other earned absences.
28	Allowance for employee's use of personal vehicle based on: A. Distance employee must drive to perform regular employment duties as required by employer B. Performing regular employment duties on regular day off, legal holiday, Saturday or Sunday.
29	Employee business expenses reimbursed by the employer under accountable plan.
30	Value of parsonage furnished to clergy member.
31	Commissions.
32	Employee discounts, no additional cost services, working condition fringes, de minimis fringes or qualified transportation fringe benefits unless the employee has the choice between cash and the benefit. If so, *e.g.* qualified transportation fringe, the amount the employee could have received as cash compensation or received as a reimbursement for the expense is added to box 1 federal wages.
Part E NO ADJUSTMENT is made for the following items:	
33	Bargain purchases - from employer.

34	Payments received to cancel employment contract with employer.
35	Armed force pay for service performed in Pennsylvania while on federal active duty.
36	Regular pay by non-military employer to employees during period of military service.
37	Group term life insurance coverage for dependents.
38	Cafeteria or flexible benefit plan when employee elects a benefit that is taxable for federal tax purposes.
39	Tuition reductions, (beginning Jan 1, 1998) for employees and their dependents at primary, secondary and post secondary educational institutions for undergraduate courses.
40	Mustering out pay when a Pennsylvania resident separates from active duty following service within Pennsylvania.
41	Golden parachute payments.

Part F OTHER TOPICS that require separate treatment:

	Item	Withheld	Reporting	When	Amount
1	Tips	No Yes	Yes Yes	Received by employee directly from customers & not turned over to employer. Tips received through the employer (i.e. fixed gratuity, service charge transfers, credit card tips or pooled fund tips maintained by employer.)	Report amount listed on federal information return. Total amount of tips.
2	Payments to statutory employees	No	Yes		
3	Health or Accident insurance plan	Yes	Yes	Employee actual cash, deductions or employee's unilateral selection of employer contributions, (this rule does not cover employee contributions to an IRC cafeteria plan or medical or dental reimbursement account (IRC § 105(b) when the employee cannot receive unused benefits as cash or carry them forward to a later tax year).	Amount of cash, deductions, or employer contributions.

4	Long term or short term disability payments under nondiscriminatory plan	No No	No No	If periodic payments from third party insurer under plan established by the employer. **If periodic payments that are not regular wages, which means:** a) Payments have no direct relationship to employee's usual rate of compensation; b) The payments are computed with reference to the nature of the sickness or injury and not based on the employee's job classification o[f]r title; c) The periodic payments would be reduced by payments under workmen's compensation laws, occupational disease acts, Social Security disability benefits or similar legislation by governmental entities; or d) The payments exceed the employee's usual rate of compensation.	Applies if employer pays for the insurance premium and does not bare [?] the risk of extent of payment of benefits.
		Yes	Yes	If plan established by employer and if wage continuation plan. A wage continuation plan is one under which: 1 Employee will receive his regular wages even if he takes sick leave for family bereavement, sickness in the family, regular physician or dental visits; 2 The amount of sick leave earned by the employee is based on length of service with the employer; or 3 The employ[s]ee may receive a portion or all of his unused sick leave if he terminates employment after a stated time period (*e.g.* expressed in years of service) with the employer.	Total amount paid to the employee. Total amount paid to the employee.

NOTE: If an item of compensation is not discussed in this document and is included in Box 1 and a question exists about whether it should be subject to withholding for Pennsylvania Personal Income Tax purposes, consult Departmental regulations (61 Pa. Code § 101.6 &113.1). If an issue and/or transaction is not covered by the regulations, employers may write to the department's Office of Chief Counsel to request a private letter ruling. Send written inquiries to: Pennsylvania Department of Revenue, Office of Chief Counsel, Attn Personal Income Tax, Dept. 281061, Harrisburg PA 17128-1061.

ESTIMATED PAYMENTS.

Requirements for Making Estimated Payments.
Except as explained below, an individual, estate, or trust must make PA estimated tax payments if:

1. Reasonably expecting, after subtracting withholding and credits that the taxpayer expects at least $8,000 of income not subject to withholding by a Pennsylvania employer, and
2. Reasonably expecting the total withholdings and allowable credits to be less than the smaller of:

- Ninety percent of the tax to be shown on the taxpayer's prior year's PA tax return; or
- The product of multiplying the PA taxable income shown on the prior year's PA tax return by the tax rate.

The only exceptions are as follows:

- If a taxpayer expects to obtain at least two-thirds of his, her, or its total estimated gross taxable income from farming for the period, the taxpayer has the option of filing the declaration and paying the estimated tax at any time up to March 1.
- If a taxpayer's total estimated tax is equal to at least the $8,000 multiplied by the annual tax rate, the taxpayer has the option of filing the declaration and paying the estimated tax at any time up to January 15 following the close of the tax year.
- If an individual expects to qualify for 100 percent tax forgiveness in the current year, the Department does not require estimated payments. If during the year the taxpayer realizes he or she no longer qualifies for TAX BACK/Tax Forgiveness, the taxpayer should immediately begin making payments to be spread out over the remaining quarters. Even if not required to make estimated payments due to TAX BACK/Tax Forgiveness, the taxpayer must file a PA tax return.

Caution
Individuals, estates, and trusts cannot use the prior year's tax liability as the current year's estimated tax to avoid underpayment penalty. The estimated tax rules apply to:

- PA-resident and part-year PA-resident individuals, estates, and trusts of Pennsylvania;
- Non-PA resident individuals, estates, and trusts, including residents of other countries, that expect at least $8,000 of taxable income from sources within Pennsylvania; and

Estimated tax is the method used to pay tax on PA taxable income that is not subject to withholding by a Pennsylvania employer. PA taxable income includes wages for domestic service; tips received from customers; wages paid to PA residents working in interstate or intercoastal trade; wages paid to PA residents working in Indiana, Maryland, New Jersey, Ohio, Virginia and West Virginia when PA income tax is not withheld by the employer; earnings and profits from operating a profession, business or farm; gains from the sale, exchange, or disposition of property; interest and dividends; rents and royalties; gambling and lottery winnings (except PA Lottery winnings); and income derived from estates and trusts.

PA-40ES (I) and PA-40ESR (I) Declaration of Estimated Personal Income Tax Forms
If filing declarations for the first time, a taxpayer should use form **PA-40ESR.** Thereafter, the PA Department of Revenue will supply preprinted forms. Failure to receive Department provided forms does not relieve taxpayers from filing and paying the tax.

Joint Declaration
A husband and wife may file a joint return declaration, unless:

1. They are separated under a decree of divorce or separate maintenance; or
2. They have different taxable years; or
3. One spouse is liable for child support

To avoid problems and delays in processing your income tax return, a husband and wife should file in the same manner as they made their estimated installment payments. If the taxpayers made joint estimated payments, they should file a joint PA tax return. If they made separate estimated payments, they should file separate PA tax returns claiming the proper amounts on each return. If a joint declaration is filed, but they decide to file separate annual returns, the taxpayers should use REV-459b, Consent to Transfer, Adjust or Correct PA Estimated Personal Income Tax Account, to divide the estimated payments.

Payment Due Dates
Use the following table to determine the due date and the amount of each installment. A taxpayer may pay all of the estimated tax with the first payment or pay in installments when due. A taxpayer can elect to apply the overpayment from the prior year's PA tax return against the current taxable year's estimated tax liability. If so, the Department will apply an approved overpayment to the first installment, unless the taxpayer notifies the Department in writing to apply the overpayment to another installment.

If you first meet the requirement to make estimated tax payments:	The number of required installments is:	And you pay the following percentages of the estimated tax by the date shown or the next business day if the due date falls on a Saturday, Sunday, or holiday.			
		Apr. 15, 200X	Jun. 15, 200X	Sep. 15, 200X	Jan. 15, 200X
Before April 1, 200X	4	25%	25%	25%	25%
After March 31, 200X and before June 1, 200X	3		50%	25%	25%
After May 31, 200X and before September 1, 200X	2			75%	25%
After August 31, 200X	1				100%

Estates and trusts filing on a fiscal year should adjust the above due dates accordingly.

Farmers
If at least two-thirds of a taxpayer's gross income is from farming, the taxpayer may do one of the following:
- Pay all of the estimated tax by January 15 of the next year; or
- File the current year's PA tax return by March 1 of the following year and paying the total tax due. In this case, PA PIT law does not require current year's estimated tax payments.

Amending Estimated Tax Payments
A taxpayer may have a change in income or credits during the year that requires a change to the estimated payments. To amend the estimated tax, the taxpayer first figures the estimated tax using Parts A and B of the estimated tax worksheet, then subtracts any overpayment from the prior year's PA tax return applied to the current year's estimated account. The taxpayer also subtracts any current year's estimated payments already made, and makes the remaining payments using the instructions for payment due dates.

Safe Harbor from Pennsylvania Underpayment Penalties
An estimated underpayment penalty can be imposed if timely prepayments are not at least:
- 90 percent of the tax as shown on the return or
- For each installment period, 100 percent of the product of multiplying the taxable income shown on the prior year's PA tax return by the current tax year's rate.

Prepayments include PA estimated tax payments, carry-over credit from the prior year's PA tax return, PA tax withheld, nonresident tax withheld as shown on **PA Schedule NRK-1**, TAX BACK/Tax Forgiveness, credit for taxes paid to other states or countries, PA Employment Incentive Payments credit, PA Jobs Creation Tax credit, and PA Research and Development tax credit.

Failure to prepay can result in assessment of interest or penalty against the taxpayer.

PENALTIES

Underpayment Penalty
If a return is filed on time and the tax liability is not paid in full, a five (5) percent underpayment penalty will be imposed on the unpaid balance after the due date of the return.

Late Filed Returns Penalty
If a return is filed after the original due date or the extended due date if an extension was granted, a penalty of five (5) percent of any tax due will be imposed for each month or fraction thereof that the return is late. The maximum penalty is 25 percent of the unpaid balance; the minimum penalty is five dollars ($5). If you do not pay the liability when filing your late return, an additional five (5) percent underpayment penalty will be imposed.

Fraud Penalties
If any part of any underpayment of the tax is due to fraud, 50 percent of the underpayment will be added to the tax.

Additions, Penalties and Fees
If a taxpayer fails to include in taxable income an amount more than 25 percent of the taxable income that was reported by reason of negligence or intentional disregard of rules and regulations but without intention to defraud, there shall be added an amount equal to 25 percent of the amount of underpayment. See Section 352(b)(2).

Any person required to furnish an information return who furnishes a false or fraudulent return shall be subject to a penalty of $50.00 for each failure.

Every PA S Corporation required to file a return that furnishes a false or fraudulent return or fails to file a return shall be subject to a $250 penalty for each failure. See Section 352(f).

If any individual, estate, or trust files a return which does not contain sufficient information to determine the correct liability or which contains information which indicates the liability is significantly incorrect and the return is filed frivolously or to delay or impede the administration of the tax law, the filer shall pay a $500.00 penalty. Section 342(l).

Bad Check Penalty
If a check is returned to the Department of Revenue un-bankable, i.e. it is not honored by the financial institution upon presentment, a 10 percent bad check penalty (minimum $25/maximum $500) along with five (5) percent underpayment penalty will be imposed.

Interest
If the taxpayer does not pay the tax due on or before the due date, simple interest will be computed daily from the date the tax is due to the date of payment. The annual interest rate established by the U.S. Secretary of the Treasury that is in effect on January 1 of each calendar year is the rate of interest in effect when the tax is due and payable. The interest rate on January 1 remains in effect until the tax is paid in full or until December 31 of that year, whichever comes first.

On a bad check, the interest is computed daily on the face amount of the check from the application date of the returned check until the liability is satisfied.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 20: TAX FORGIVENESS

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PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 20: TAX FORGIVENESS

I. SPECIAL TAX PROVISIONS FOR POVERTY - OVERVIEW

In 1974, the Pennsylvania General Assembly determined that certain citizens in the Commonwealth, because of poverty, needed special tax provisions. The General Assembly decided that the imposition of the personal income tax on such persons would deprive them and their dependents of the basic necessities of life. Since poverty is a relative concept, which considers actual income and the number of persons dependent on such income, the General Assembly provided special tax provisions for eligible individuals to relieve their economic burden.

Tax forgiveness is a credit that allows eligible taxpayers to reduce all or part of their Pennsylvania personal income tax liability. Tax forgiveness:

A. Provides a reduction in tax liability, and

B. Forgives some taxpayers of their liabilities even if they have not paid their Pennsylvania personal income tax.

II. CLAIMANT

A. Eligible Claimant

An eligible claimant is a person:

1. Who is subject to the Pennsylvania personal income tax, and

2. Who is not a dependent of another person for the purpose of Internal Revenue Code (IRC) § 151 of the IRC of 1986, except as explained in Part II, Section C of this chapter, and

3. Whose poverty income does not exceed certain eligibility amounts.

4. Who is not a ward of a federal, state or local prison, a patient in a federal or state hospital or student at a federal, state or local residential school for ½ year or more.

B. Nonresident or Part-Year Resident Claimant

Nonresidents and part-year residents of Pennsylvania meeting all of the eligibility requirements described in this chapter may claim tax forgiveness. Such claimants must include in their poverty (eligibility) income all income as described in Part IV of this chapter, whether earned within or outside Pennsylvania. Nonresident and part-year resident claimants who file paper copies of the *PA-40 Individual Income Tax* return must also include a copy of page one of their federal income tax return along with their completed *PA-40 Schedule SP.*

A resident of a reciprocal agreement state with Pennsylvania-taxable income in classes other than compensation must include all Pennsylvania nontaxable income (including the compensation not taxable to Pennsylvania as a resident of a reciprocal agreement state) earned outside Pennsylvania on *PA-40 Schedule SP*.

C. Dependent Child as a Claimant

A dependent child may be eligible to claim tax forgiveness only if he or she is a dependent on the *PA-40 Schedule SP* of his or her parents, grandparents, or foster parents and the child's parents, grandparents, or foster parents are eligible for tax forgiveness. Dependent children whose parents, grandparents, etc. are not required to file a *PA-40 Individual Income Tax Return* but would qualify for tax forgiveness if they were required to file are also eligible for tax forgiveness. The department's instructions allow dependent children to claim tax forgiveness because as the 1974 law identifies the intent of the General Assembly as described above recognized that persons were in need of special provisions because of poverty. Therefore, to impose the Pennsylvania personal income tax on the children of parents that are, because of poverty, eligible for tax forgiveness contradicts the legislative intent. The dependent child with taxable income in excess of $33 must file a *PA-40 Individual Income Tax Return* and a *PA-40 Schedule SP*. The child must also include any child support paid to his/her parent in his/her eligibility income.

D. Deceased Claimant

Pennsylvania law does not specifically exclude a decedent from qualifying for tax forgiveness. The department's instructions allow the executor or other person responsible for the affairs of the decedent to submit a claim on behalf of the decedent. The law does require that the claimant calculate eligibility (poverty) income for an entire taxable year; therefore, the instructions require that the person filing for the decedent with a taxable year of less than twelve months annualize the decedent's income.

E. Annualization of Income

The purpose of the annualization is to ensure that only those decedents who would have qualified for forgiveness had they lived for the entire taxable year, receive tax forgiveness. To that end, the department requires the executor or other person responsible for the affairs of the decedent to annualize decedent's eligibility (poverty) income by determining the amount of income the decedent would likely have earned, received or realized during the entire taxable year had decedent not died and had instead carried on his or her affairs in the ordinary course.

In order to do this, the claimant must first determine the amount of actual, recurring daily/weekly/monthly income the decedent earned, received, or realized during decedent's taxable year for each income class and then multiply each amount by 365/52/12, respectively. If there were any one-time transactions, such as the sale of stock or real property, these amounts should not be considered when determining the daily or monthly income for the decedent when annualizing the income.[1]

The claimant must then add decedent's actual income that was not earned ratably for each class of income.

Finally, the claimant must add the income that decedent would have earned, received, or realized for each income class had decedent lived the entire taxable year and carried on his or her affairs in the ordinary course. For example, if decedent would have been entitled to receive a dividend during the taxable year, but after his or her death, as a result of stock owned by decedent at the time of his death, the dividend income must be included in decedent's annualized income.

Do not include the surviving spouse's income (including one-half of any joint income received prior to the decedent's date of death) in the calculation of the decedent's eligibility income. Likewise, surviving spouses should not include any income in respect of a decedent, income that should be included on the *PA-41 Fiduciary Income Tax* return (estate tax return), or any income of the deceased taxpayer (including the decedent's half of any joint income received prior to the decedent's date of death) in the taxable income or in the calculation of the eligibility income of the surviving spouse.

Report the difference between the total annualized taxable income and the taxable income reported on the tax return on Part C Line 2 of the *PA-40 Schedule SP.*

The following items of income are considered to be earned ratably by day/week/month for number of days/weeks/months during decedent's taxable year unless evidence contra-indicates that the income is not earned ratably.

1. **Compensation** – Exceptions include, but are not limited to, large quarterly, mid-year, or year-end bonuses, new employment at higher pay, loss of employment, or seasonal nature of employment.

2. **Unreimbursed Business Expenses** – Exceptions include, but are not limited to, large one-time expenses incurred during a period.

3. **Interest** – Exceptions include, but are not limited to, large first-time investments made during periods with earnings paid during periods or prior to year end. Income from S corporations and partnerships is reported using the methodology described under net income (loss) from a business, profession or farm for those respective entity types.

[1] The department accepts any reasonable calculation to determine a decedent's eligibility (poverty) income for the entire taxable year, including the prior year's eligibility income, or determining the actual daily/weekly/monthly income the decedent earned, received, or realized while living during the taxable year and multiplying by 365/52/12.

4. **Dividends** – Exceptions include, but are not limited to, large first-time investments made during periods with earnings paid during periods or prior to year end or for year-end mutual fund distributions. Income from S corporations and partnerships is reported using the methodology described under net income (loss) from a business, profession or farm for those respective entity types.

5. **Net Income/Loss from a Business, Profession or Farm** – Consideration must be given to the type of entity earning the income in order to determine the annualized income methodology. Entities and their methodologies are as follows:

   a. **Sole Proprietorship (Schedule C)** – Exceptions include, but are not limited to, large jobs at particular points in periods, seasonal nature of certain businesses, increases in capacity due to expansion, decreases in capacity due to contraction or lay-offs, or sale or discontinuance of business.

   b. **Farm (Schedule F)** – Exceptions include, but are not limited to, sales of crops or livestock in specific periods, seasonal nature of crop or livestock sales, increases in capacity due to expansion, decreases in capacity due to contraction, or sale or discontinuance of farm operations.

   c. **S-Corporation (PA Schedule RK-1 or NRK-1)** – Considered to be earned/allowable ratably for full-year residents by day for number of days during decedent's taxable year. Part-year residents are required to report income (loss) from a PA Schedule RK-1 for their increment of residency and from a PA Schedule NRK-1 for their increment of non-residency based upon the number of days during the period depending upon their residency status during that period.

6. **Net Income/Loss from Rents, Royalties, Patents and Copyrights** – Exceptions include, but are not limited to, investment in rental property during a period, sales of rental property during a period, or periods of vacancy. Income/loss from S corporations and partnerships is reported using the methodology described under net income (loss) from a business, profession or farm for those respective entity types.

7. **Other Deductions** – Exceptions include, but are not limited to, expenses incurred for one time investments or large amounts paid into a tuition account program in one specific period.

F. One Spouse a Dependent (of a Parent, Grandparent, etc.)

Even though married taxpayers meet the income requirements for claiming tax forgiveness when one spouse is a dependent on another person's federal income tax return, they may not claim tax forgiveness jointly. The dependent spouse is not an eligible claimant. The other spouse is eligible, and should complete *PA-40 Schedule SP*. The eligible spouse may not claim his or her spouse as a dependent, because only children are dependents. The eligible spouse must include his or her spouse's eligibility income when calculating total eligibility income on *PA-40 Schedule SP*. In this case, each spouse must file separately.

Example. Scott is a dependent on his parents' federal income tax return and is not eligible for tax forgiveness. His wife, Paula, is not a dependent, and may complete *PA-40 Schedule SP*. Paula may not claim Scott as a dependent, but must include his eligibility income when calculating her total eligibility income. Additionally, if Scott's parents qualify for tax forgiveness, Scott may also qualify if he includes Paula's income in his total eligibility income.

III. DEPENDENT CHILD OF A CLAIMANT

A. Definitions

1. **Dependent** - The definition of dependent is a minor or adult natural child, adopted child, grandchild, or foster child of a claimant who is the dependent of a claimant for purposes of IRC § 151. The department follows the requirements of the IRC.

2. **Full-Time Student** - A full-time student is defined as an individual attending, on a full-time basis for at least five calendar months in a year, a qualified education institution or qualified on-farm training program.

3. **Federal Qualifying Child and Qualifying Relative** - For federal income tax purposes, a taxpayer is allowed to claim an exemption amount for each individual who is a qualifying child or qualifying relative. The federal tests for being considered a qualifying child or qualifying relative are inapplicable for Pennsylvania personal income tax purposes.

B. An individual must satisfy six tests to be considered a "dependent child of a claimant" for SP purposes: the relationship limitation, age limitation, gross income limitation, the support test, married child limitation, and residency requirement. These limitations, tests and requirements are explained in subsections 1 – 6.

1. Relationship Limitation

The individual must bear one of the following relationships to an eligible claimant:

a. A son or daughter (or descendant of a son or daughter),

b. A son or daughter of a claimant's present spouse, or

c. A foster child placed with the claimant by an authorized placement agency or by a decree issued by a court.

The relationship test includes a child legally adopted by an eligible claimant or placed with an eligible claimant pending a final adoption order transferring the rights and responsibilities of the birth parents to the claimant as adoptive parent.

It does not, however, include a birth parent's child if the child is legally placed for adoption where the rights and responsibilities of the birth parents are transferred to an adoption agency pending a final adoption order or to an adoptive parent under a final adoption order.

2. Age Limitation

a. Children who do not satisfy gross income limitations
Children who do not satisfy gross income limitations must not have attained the age of 19 years by the end of the calendar year or must be a full-time student that has not attained the age 24 years by the end of the calendar year.

b. Children who satisfy gross income limitations
Age limitations are suspended for any individual who satisfies gross income limitations.

3. Gross Income Limitation

a. Children who satisfy age limitations
Gross income limitations are suspended for any child who satisfies age limitations.

b. Children who do not satisfy age limitations
The child's gross income for federal tax purposes must be less than the federal personal exemption amount. For example, the child must have less than $3,400 (to increase to $3,500 in 2008) of gross income for the 2007 calendar year. The child must have less than $3,700 of gross income for the 2011 calendar year.

4. Support Test

a. General Rule
The eligible claimant must provide the child with more than one-half of the child's own total support for the year.

b. Exceptions
If an eligible claimant is married, the support requirement is met if the eligible claimant and his spouse file a joint return and jointly provide the child with more than one-half of the child's own total support for the year.

In the case of a child of parents who jointly provide the child with more than one-half of the child's own total support and do not file a joint return, the support requirement is met by a claimant only if:

- The child is in the custody of either or both of the parents for more than half of the year, and
- Either of the following is applicable:
  - ✓ The claimant contributed at least $600 toward the child's support and the divorce or separate maintenance decree, or a written agreement between the parents, provides that he or she is to receive the exemption for dependents for federal tax purposes, or
  - ✓ The claimant provides $1,200 or more of child support (regardless of the number of children) and the other parent does not clearly establish that he or she provided a greater amount of support or had custody of the child for a longer period of time than the claimant.

c. Arrearage Payments
Arrearage payments made in a year subsequent to a calendar year for which there is an unpaid liability shall not be treated as paid either during that calendar year on in the year of payment.

5. Married Child Limitation
A married child may be claimed as a dependent child of a claimant only if neither the child nor the child's spouse would have a tax liability if they were to file separately for federal tax purposes.

6. Residency Requirement
A child may be claimed as a dependent child of a claimant only if the child is a citizen of U.S. or resident of the U.S., Canada, Mexico, Panama or the Canal Zone at some time during the calendar year in which the taxable year of the claimant begins or is an alien child legally adopted by and living with a claimant who is a U.S. citizen as a member of his household for the entire taxable year.

C. A dependent child may not be claimed on PA-40 Schedule SP if:

1. The dependent is not your child, as defined above, or
2. You cannot claim the child on your federal income tax return, or

3. You are unmarried for tax forgiveness purposes, and your former spouse by agreement or court decree can claim your child as a dependent for federal and PA-40 Schedule SP purposes.

You cannot claim any other child or adult as a dependent, even if doing so on a federal income tax return.

IV. POVERTY (ELIGIBILITY) INCOME

A. Poverty (Eligibility) Income

Poverty (eligibility) income includes all income, whether or not it is taxable for Pennsylvania personal income tax purposes that an unmarried claimant or married claimants earn, receive, or realize during the taxable year unless specifically excluded below.

Eligibility income is the total of the taxable income received in the form of cash and property reported on the *PA-40, Individual Income Tax* return and all other income received in the form of cash and property from any other source, unless specifically excluded below. Eligibility income must include the following kinds of income that is not taxable or reportable for Pennsylvania purposes:

1. Interest, dividend, and gain income from exempt direct obligations of the Commonwealth of Pennsylvania,

2. Interest, dividend, and gain income from exempt direct obligations of political subdivisions of the Commonwealth of Pennsylvania,

3. Interest, dividend, and gain income from direct obligations of the U.S. government,

4. The value of employer-paid benefits not included on federal Form W-2,

5. The amount paid for benefits that Pennsylvania law excludes from taxable income such as employee payments to the employer’s cafeteria plan for hospitalization, sickness, disability, or death, supplemental unemployment, or strike benefits,

6. Payments as a foster parent for providing in-home care for foster children,

7. The value of government education grants,

8. Gain excluded from the sale of a personal residence,

9. Gain attributable to the sale of property obtained before June 1, 1971,

10. Alimony,

11. Insurance proceeds,

12. Inheritances, including the value of property inherited,

13. Distributions reported on federal Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., with a distribution code 4 (death benefit) in Box 7,

14. Gifts of cash and property,

15. Awards of cash and property,

16. Prizes of cash or property including winnings from the Pennsylvania Lottery and exempt *Powerball* or *Mega Millions* winnings,

17. Eligibility income earned, received, or realized by nonresidents or part-year residents while residing outside Pennsylvania that is not taxable for Pennsylvania personal income tax purposes,

18. Military pay earned while on federal active duty and federal active duty for training outside Pennsylvania,

19. Cash and property received for a claimant's personal use from family and unrelated persons that live outside the household,

20. Support, but not child support, from a spouse or former spouse that does not live in your household,

21. Educational assistance such as the total value of nontaxable scholarships, fellowships and stipends received unless in the name of the dependent child.

B. Exclusions From Poverty (Eligibility) Income

Poverty (eligibility) income does not include:

1. Periodic payments for sickness and disability received during a period of sickness or disability, other than regular wages,

2. Disability, retirement, or other payments arising under workers' compensation acts, occupational disease acts, and similar legislation by any government,

3. Payments commonly recognized as old age or retirement benefits paid to persons retired from service after reaching a specific age or after a stated period of employment,

4. Payments commonly known as public assistance, or unemployment compensation payments by any governmental agency,

5. Payments to reimburse actual allowable expenses,

6. Payments made by employers or labor unions for programs covering hospitalization, sickness, disability or death, supplemental unemployment benefits, strike benefits, social security and retirement,

7. Any compensation received by members of the Armed Forces serving in a combat or hazardous duty zone, including military differential pay,

8. Civil Service Annuity,

9. Payments for injuries received while working, and damages received, whether by suit or otherwise, for personal injuries,

10. Damage awards and settlements from physical injury or sickness – pain and suffering, emotional distress,

11. Personal use of an employer's owned or leased property and/or services, at no cost or at a reduced cost,

12. Income from contracts of insurance for long-term care that do not have accumulated refundable reserves payable upon lapse or surrender,

13. Economic Stimulus Act of 2008 federal rebates/payments,

14. Any income not consisting of cash or property. Taxable income includes the following items which may not be considered money (cash) or property under state law:

    - Recapture on the sale of property;

    - Phantom gain upon the sale of property securing non-recourse debt;

    - Income recognized upon lapse of substantial risks of forfeiture, where under state property law the taxpayer already has a fixed or vested interest in the property and therefore money or property was considered received in a prior tax year under state property law (*i.e.*, anytime there is a difference in tax law and state property law rights);

- Partners, limited liability company members, beneficiaries, and other persons receiving income from a pass-through entity may receive income based on their distributive share, but may not actually receive money or property in the year the income is recognized;

- Service sharing-type agreements where the taxpayer receives value of services;

- Cancellation of indebtedness;

- Installment sale income where a person recognizes income on the entire amount of the obligation received for Pennsylvania personal income tax purposes, but where the person does not actually receive all payments under the obligation in the year of recognition;

- Constructive dividends where a person has the use of company services or the use of company property;

- Income accrued to an accrual basis taxpayer for which the taxpayer will receive money or property in a subsequent tax year; or

- The income reported by the settlor of a revocable trust who is taxed as the owner on any income, yet who may not actually receive the income in the form of money or property from the trust.

C. Deductions From Poverty (Eligibility) Income

A claimant may deduct allowable business expenses that are usual, customary and reasonable in amount. In determining eligibility income a claimant may deduct:

- Costs and expenses for producing dividends, interest, gambling and lottery winnings; or

- Costs and expenses for producing nontaxable eligibility income.

D. Poverty (Eligibility) Income Determines Amount of Tax Forgiveness

A claimant's poverty (eligibility) income when compared to statutory income limitations determines the amount of tax forgiveness to which the claimant is entitled. The income limits are based upon whether a claimant is single or married and the number of the claimant's dependents. *See* the Eligibility Income Tables. For a single claimant, only the claimant's eligibility income is considered to determine the claimant's tax forgiveness.

For a married claimant, the eligibility income of both the claimant and the claimant's spouse are considered to determine the claimant's tax forgiveness.

Even though a married claimant uses the joint eligibility income of the claimant and the claimant's spouse to determine tax forgiveness, any tax forgiveness to which the claimant is entitled is applied only against the claimant's tax liability. Each spouse's tax forgiveness, if any, must be determined separately.

1. Single Claimant

A claimant is considered single in the following situations:

a. The claimant was unmarried for the entire taxable year.

b. The claimant is married but the claimant and the claimant's spouse file separate income tax returns.

c. The claimant is married but at the end of the taxable year is separated from spouse pursuant to a written agreement.

d. The claimant is married but the claimant and the claimant's spouse lived apart at all times for the last six months of the taxable year.

e. Is divorced or widowed and unmarried at the end of the taxable year.

2. Married Claimant

A claimant is considered married at the end of the taxable year if the claimant is married and is not considered a single claimant.

V. PROOF OF ELIGIBILITY

A. Forms

Claimants must file a *PA-40, Individual Income Tax* return and *PA-40 Schedule SP*. Claimants must submit all required forms, schedules and statements to report Pennsylvania-taxable income on the income tax return. Claimants do not have to submit evidence or supporting documents for income that Pennsylvania law does not tax. However, claimants must maintain sufficient records and evidence to support all the information reported on *PA-40 Schedule SP*. Such records include the claimants' federal income tax returns, federal Forms W-2, W-2P, 1099 and Schedule K-1 or other information returns, and broker statements that evidence income that is not taxable for Pennsylvania purposes.

B. Dependents

If claiming an adult child, adopted child, foster child, or a child with a different last name than the claimant or claimants, the department may ask for a copy of Page 1 of the federal income tax return that the claimant or claimants filed with the Internal Revenue Service.

VI. CLAIMING TAX FORGIVENESS

To claim tax forgiveness, the claimant or claimants must complete and submit *PA-40 Schedule SP* with the *PA-40, Individual Income Tax* return. On *PA-40 Schedule SP*, the claimant or claimants must:

1. Determine the amount of Pennsylvania-taxable income. A single or unmarried claimant determines only his or her own amount of taxable income. Married claimants must determine their own taxable income separately, when filing separately.

2. Determine the claimant's status, single or married, for filing *PA-40 Schedule SP*. *See* Section IV.D.

3. Determine the qualifying dependent or dependents that the claimant or claimants may report.

4. Determine the amount of eligibility income by itemizing the amounts of nontaxable and non-reportable income that the claimant or claimants earned, received, or realized during the entire taxable year. Married claimants must report each spouse's eligibility income, whether filing jointly or separately.

5. Determine the applicable eligibility income limitation table based on the type filer, the number of qualifying dependents, and the eligibility income of the claimant or claimants.

6. Determine the percentage and amount of forgiveness.

7. Properly complete the *PA-40, Individual Income Tax* return.

VII. ELIBIILITY INCOME TABLES

A. Eligibility Income Tables for Tax Years 2004 and later for Unmarried, Separated, or Deceased Taxpayers.

Eligibility Income Tables										
Eligibility Income Table 1. Unmarried, Separated or Deceased Taxpayers										
If your Eligibility Income from PA-40 Schedule SP, Line 11 does not exceed:										
You ⇨	$6,500	$6,750	$7,000	$7,250	$7,500	$7,750	$8,000	$8,250	$8,500	$8,750
⇩ Dependent Children										
1	$16,000	$16,250	$16,500	$16,750	$17,000	$17,250	$17,500	$17,750	$18,000	$18,250
2	$25,500	$25,750	$26,000	$26,250	$26,500	$26,750	$27,000	$27,250	$27,500	$27,750
3	$35,000	$35,250	$35,500	$35,750	$36,000	$36,250	$36,500	$36,750	$37,000	$37,250
4	$44,500	$44,750	$45,000	$45,250	$45,500	$45,750	$46,000	$46,250	$46,500	$46,750
5	$54,000	$54,250	$54,500	$54,750	$55,000	$55,250	$55,500	$55,750	$56,000	$56,250
6	$63,500	$63,750	$64,000	$64,250	$64,500	$64,750	$65,000	$65,250	$65,500	$65,750
7	$73,000	$73,250	$73,500	$73,750	$74,000	$74,250	$74,500	$74,750	$75,000	$75,250
8	$82,500	$82,750	$83,000	$83,250	$83,500	$83,750	$84,000	$84,250	$84,500	$84,750
9	$92,000	$92,250	$92,500	$92,750	$93,000	$93,250	$93,500	$93,750	$94,000	$94,250
	Then your Percentage of TAX BACK and the Decimal Equivalent is:									
	100%	**90%**	**80%**	**70%**	**60%**	**50%**	**40%**	**30%**	**20%**	**10%**
	1.0	.90	.80	.70	.60	.50	.40	.30	.20	.10

B. Eligibility Income Tables for Tax Years 2004 and later for Married Taxpayers.

Eligibility Income Tables										
Eligibility Income Table 2. Married Taxpayers										
If your Eligibility Income from PA-40 Schedule SP, Line 11 does not exceed:										
You & ⇨ Spouse	$13,000	$13,250	$13,500	$13,750	$14,000	$14,250	$14,500	$14,750	$15,000	$15,250
⇩ Dependent Children										
1	$22,500	$22,750	$23,000	$23,250	$23,500	$23,750	$24,000	$24,250	$24,500	$24,750
2	$32,000	$32,250	$32,500	$32,750	$33,000	$33,250	$33,500	$33,750	$34,000	$34,250
3	$41,500	$41,750	$42,000	$42,250	$42,500	$42,750	$43,000	$43,250	$43,500	$43,750
4	$51,000	$51,250	$51,500	$51,750	$52,000	$52,250	$52,500	$52,750	$53,000	$53,250
5	$60,500	$60,750	$61,000	$61,250	$61,500	$61,750	$62,000	$62,250	$62,500	$62,750
6	$70,000	$70,250	$70,500	$70,750	$71,000	$71,250	$71,500	$71,750	$72,000	$72,250
7	$79,500	$79,750	$80,000	$80,250	$80,500	$80,750	$81,000	$81,250	$81,500	$81,750
8	$89,000	$89,250	$89,500	$89,750	$90,000	$90,250	$90,500	$90,750	$91,000	$91,250
9	$98,500	$98,750	$99,000	$99,250	$99,500	$99,750	$100,00 0	$100,250	$100,500	$100,750
	Then your Percentage of TAX BACK and the Decimal Equivalent is:									
	100%	**90%**	**80%**	**70%**	**60%**	**50%**	**40%**	**30%**	**20%**	**10%**
	1.0	.90	.80	.70	.60	.50	.40	.30	.20	.10

Note: Add $9,500 for each additional dependent in Tables A and B.
Eligibility income tables for each taxable year may be found in the *PA-40 Individual Income Tax* return instructions booklet available at www.revenue.state.pa.us.

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CHAPTER 21: AMENDED RETURNS

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CHAPTER 21: AMENDED RETURNS

I. WHEN TO FILE AN AMENDED RETURN

A. Refunds From Amended Returns

An amended Pennsylvania return can be filed and a refund requested if a taxpayer over-reported income or did not claim allowable credits or deductions. The taxpayer must complete and file an amended return within three years from the original due date or extended due date.

B. Refund Limitations

If a taxpayer over-reported income or is entitled to credits or deductions not claimed and seeks a refund, the taxpayer must complete and file an amended return within three years from the original or extended due date. Filing an amended return to seek a personal income tax refund is appropriate in situations where a taxpayer is simply correcting a routine error, and when the three-year deadline for filing the amended return is not imminent. Additionally, filing an amended return does not stop the statute of limitations for filing tax refund petitions. If an amended return seeking a refund is denied or not acted upon by the department, a petition for a refund will only be considered by the Board of Appeals so long as it is filed within three years of the payment due date.

To pursue a personal income tax refund near the end of the three-year period from the payment due date or in a more complex scenario – any involving complicated factual, legal or policy issues that may require further documentation – taxpayers are encouraged to timely file a petition for refund with the Board of Appeals. A petition for refund must be filed within three years of the date the tax was paid, (generally the original due date of the return, unless tax was paid with a late filing or paid with the extended filing of the return) in order to be considered. See Pennsylvania Department of Revenue e-Services – Board of Appeals Online Petition Center for additional information or to file a refund petition electronically at **http://boardofappeals.state.pa.us.**

Refer to Miscellaneous Tax Bulletin 2008-01 Practice before the Board of Appeals (Board) pursuant to Article 27 of the Tax Reform Code (Act 119 of 2006).

C. Underreported Income

If after a return is filed a taxpayer discovers the income was under-reported, credits were erroneously claimed, or deductions were not allowed, the taxpayer must correct the error within 30 days by completing and filing an amended return and paying the additional tax, plus penalty and interest. A summary of interest rates is available on *REV–1611, Notice of Interest Calculations*.

II. HOW TO FILE AN AMENDED RETURN

A. PA-40 Individual Income Tax Return

If after filing the PA-40 Individual Income Tax Return the taxpayer discovers an incorrect Pennsylvania tax return has been submitted to the department, the taxpayer must correct the return by filing an amended PA-40 Individual Income Tax Return.

To file an amended PA-40 Individual Income Tax Return use the appropriate return for the tax year you are correcting and clearly print *"AMENDED RETURN"* at the top. For the year 1997 and later, be sure to fill-in the amended oval at the top of the front side of the *PA-40, Individual Income Tax return* or *PA-40 EZ, Individual Income Tax return*. For all tax years, amended returns can be filed using a paper *PA-40, Individual Income Tax return*, regardless of the method used for filing the original return. However, for current tax years, amended returns can also be filed using padirectfile or state only efile through the date of the October filing deadline regardless of the method of filing the original return. After the October filing deadline, all amended returns must be filed using a paper *PA-40, Individual Income Tax return*, regardless of the method of filing the original return until the next tax year's returns are able to be received by the department.

Beginning with tax year 2011, *Schedule PA-40X,* must be submitted with an amended PA-40, Individual Income Tax return. Schedule PA-40X provides the taxpayer and the department with information about the amended return including the specific line changes, amounts of the changes and reason for the changes. Schedule PA-40X is not a return and cannot be filed without the amended PA-40, Individual Income Tax return.

As a result of the new schedule, the instructions for filing an amended return are different than those for earlier tax years. The instructions to file an amended return for tax years beginning in 2011 are as follows–

1. Fill in the Amended Return oval, and write *"AMENDED RETURN"* at the top of the PA-40 individual Income Tax Return.

2. Complete the Schedule PA-40X. Enter the amended amounts from Schedule PA-40X per the PA-40X instructions.

3. Calculate Line 11 amended total Pennsylvania-taxable income.

4. Calculate Line 12 amended Pennsylvania tax liability.

5. Enter Line 24 amended total payments and credits.

6. Complete Line 27 to report any adjusted penalty and interest to be included on the return.

7. **Do not** complete Lines 28 and 29. The department will properly calculate your amended total payment due or overpayment.

8. Complete Lines 30 through 36 to notify the department how to disperse your overpayment.

The department will take your original refund or payment into account when reviewing the amended PA-40, Individual Income Tax return. Be sure to sign your amended return and mail it with all explanations and attachments. Include only those schedules or statements that were amended. Do not include the original return or original schedules.

The instructions to file an amended return for tax years 2010 and prior are as follows–

1. Enter the amounts from the original return that you are not amending.

2. Enter the amended amounts. Explain the reason an amended return is being filed and include only the amended forms or schedules supporting the amended amounts.

2. Calculate the amended total Pennsylvania-taxable income.

4. Calculate the Pennsylvania tax liability. If a refund was received on the original return, add that amount to the Pennsylvania tax liability.

5. Calculate the total credits and payments. If tax was paid with the original return, add that payment to the total credits and payments.

6. Calculate the amended tax due or overpayment. If an overpayment, be sure to complete the lines designating the application of said overpayment.

The department will take the original refund or payment into account when reviewing the amended return. The amended return must be signed.

Amended returns should be mailed to one of the following addresses depending upon the type of return it is–

If you owe tax:
PA DEPT OF REVENUE
PAYMENT ENCLOSED
1 REVENUE PLACE
HARRISBURG PA 17129-0001

If you overpaid:
PA DEPT OF REVENUE
REFUND OR CREDIT REQUESTED
3 REVENUE PLACE
HARRISBURG PA 17129-0003

If you neither owe nor overpaid:
PA DEPT OF REVENUE
NO PAYMENT OR NO REFUND
2 REVENUE PLACE
HARRISBURG PA 17129-0002

III. WHO MAY NOT FILE AN AMENDED RETURN

You may not file an amended return after the department issued an assessment if the amendment relates to the same taxable year and the same item of income or gain, deduction or loss involved in the assessment. In this case, you must either–

A. File a timely petition for reassessment with the Board of Appeals within 90 days of the mailing date of the assessment, or

B. Pay the assessment and file a petition for refund with the Board of Appeals within six months of the mailing date of the notice of assessment, billing notice, or other departmental document.

C. You may file the petition electronically by logging on to https://www.boardofappeals.state.pa.us or the taxpayer may order the petition form, *REV–65, Board of Appeals Petition Form* by calling the forms ordering telephone number. The *REV–65, Board of Appeals Petition Form* is also available on the department's website at www.revenue.state.pa.us.

Refer to Miscellaneous Tax Bulletin 2008-01 Practice before the Board of Appeals (Board) pursuant to Article 27 of the Tax Reform Code (Act 119 of 2006).

IV. ORIGINAL RETURN FILED USING FED/STATE E-FILE, TELEFILE or PA DIRECT FILE

For the current tax year, amended returns may be e-filed through October 15 through the Fed/State e-File program. For non-current tax years, taxpayers must file a paper amended return, even if the taxpayer filed his or her original Pennsylvania tax return using Fed/State e-File, TeleFile, or pa.direct.file.

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CHAPTER 23: NATURAL RESOURCES

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CHAPTER 23: NATURAL RESOURCES

I. FEDERAL INCOME TAX TREATMENT OF DEPLETION

A. Depletion – Overview

Section 611(a) of the Internal Revenue Code provides, in part, that in the case of mines, oil and gas wells, other natural deposits and timber, there will be allowed as a deduction in calculating taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary.

There are two methods for calculating depletion, cost and percentage. The taxpayer must take the greater deduction of the two methods. Both methods are on a property-by-property basis. The cost depletion method is essentially a units-of-production method. For the taxpayer to receive the benefit of a cost depletion deduction, the taxpayer must have basis available in the property. The percentage depletion deduction is based on a percentage (currently 15 percent) of gross income from the property.

Internal Revenue Code (IRC) Section 613A(c)(6), amended by the Revenue Reconciliation Act of 1990, increases the percentage depletion with respect to marginal production properties for tax years beginning after Dec. 31, 1990. The increase is 15 percent, plus 1 percentage point for each whole dollar that the "reference price" for crude oil [for the immediately preceding calendar year] is less than $20 per barrel. The amount of the percentage depletion deduction is limited to 50 percent (or 100 percent after 1990) of the net income of the property, performed on a property-by-property basis, and 65 percent of the taxpayer's taxable income. The allowable depletion deduction is the greater of the two methods.

B. Federal Statute

Section 613(a) provides, in part, that in the case of the mines, wells and other natural deposits listed in subsection (b), the allowance for depletion under Section 611 will be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. In no case will the allowance for depletion under Section 611 be less than it would be if calculated without reference to this Section.

Section 613(c)(1) provides that the term "gross income from the property" means, in the case of a property other than an oil or gas well and other than a geothermal deposit, the gross income from mining.

Section 613(d) states that, except as provided in Section 613A, in the case of any oil or gas well, the allowance for depletion will be calculated without reference to §613.

Section 613(e)(1) provides that in the case of geothermal deposits located in the United States or in a possession of the United States, for purposes of subsection (a)–

1. Such deposits will be treated as listed in subsection (b), and

2. 15 percent will be deemed to be the percentage specified in §613(b).

C. Economic Interest

A taxpayer must have an economic interest in the property to claim a deduction for depletion; with the exception of production payments treated as loans and installment bonuses under IRC Section 636. The law further limits the taxpayers entitled to a percentage depletion deduction to entities that qualify as independent producers and certain royalty owners.

A taxpayer has an economic interest when it has acquired any interest in a mineral in place, by any form of legal relationship, and has vested rights to the income from the extraction of the mineral that is looked to for a return of capital. A person who has no capital investment in the mineral deposit does not have an economic interest merely because the taxpayer gains an economic or monetary advantage from production through a contractual relationship. The contractual right to purchase oil or gas after it has been produced is an example of an economic advantage. Such an economic advantage is not an economic interest sufficient to claim a deduction for depletion. *See* Revenue Ruling 68-330, 1968-1 C.B. 291.

D. Cost Depletion

The cost depletion deduction assures the owner of an oil and gas producing property a tax deduction equal to the investment in the mineral property as the reserves are depleted. The basis for cost depletion is defined under IRC Section 612. “The basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in Section 1011.”

E. Units Sold

In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as barrels of oil or Mcf (1000 cubic feet) for gas. Some taxpayers convert barrels of oil to Mcf of gas, or gas to barrels, by reference to the value of each. Thus, both oil and gas enter into the calculation, although Treasury Regulation Section 1.611-2(a) indicates only one should be used. This usually results in an equitable deduction. Any adjustment to the method usually is small and insignificant.

For a cash basis taxpayer, units sold include only units for which payment was received during the period. For an accrual basis taxpayer, the units sold shall be determined from the taxpayer's inventories kept in physical quantities and in a manner consistent with his or her method of inventory accounting under IRC Section 471 or Section 472. No units should be included for which depletion was allowed in a prior period.

If the taxpayer received prior period price adjustments and included the barrels or Mcf in the current period the "units sold" for cost depletion are excluded.

F. Adjusted Basis of Property

An allowable deduction for depletion (cost or percentage) will reduce the basis of a property, as determined under IRC Section 1011, for the cost depletion calculation. Cost depletion is limited to the adjusted basis of the property, whereas percentage depletion can exceed it. Taxpayers should maintain accounts, which have accumulated all the capitalized costs and allowable depletion (percentage and cost) by property. If costs exceed the depletion reserve (accumulated depletion), the difference is the remaining basis. The effect of this is that an addition to capital of any asset may be fully offset by previously allowed percentage depletion, so that immediately after a substantial capitalization, the taxpayer's remaining basis may be zero. *See* Revenue Ruling 75-451, 1975-2 C.B. 330 and Treasury Regulation §1.614-6 (a)(3), Example 1.

G. Reserves

The reserves to be included in the calculation of cost depletion for federal income tax purposes include proved and probable reserves in accordance with Treasury Regulation Section 1.611-2(c). Regulations indicate probable or prospective reserves are to be included only if they are extensions of known deposits or are new bodies of mineral whose existence is indicated by a high degree of probability.

H. Gross Income from the Property

Gross income per the tax return and gross income per the depletion schedule will generally not be the same. Various adjustments must be made to determine gross depletable income. Examples of oil and gas revenues per the general ledger may be gas sales, oil sales, condensate sales, plant products, royalty gas sales, royalty oil sales, and royalty condensate sales. Plant products are not gross depletable income. Examples of accounts not included in depletable income are plant operating income (for example, propane, butane, and ethane sales), marketing income, truck rentals, pipeline fees and consulting fees.

There are several adjustments to book income to determine income subject to depletion-

1. **Transportation Costs**
   These costs must be isolated from production income.

2. **Lease Bonus Exclusion**
   Gross income is reduced by a portion of the bonus payment to arrive at depletable income.

3. **Royalty Income**
   If paid by the working interest owner, it must be excluded from depletable income.

4. **Advanced Royalties**
Gross income is reduced by a portion of the advanced royalty payment to arrive at depletable income.

5. **Delay Rentals**
When received by the landowner, delay rentals are not payments for production of oil and gas and are not subject to depletion.

6. **Taxes**
The amount received by a producer is usually net of production and severance taxes; this amount received generally needs to be grossed up by the amount of the taxes for depletion purposes.

I. Net Income of the Property

Percentage depletion is calculated on a property-by-property basis. Taxable income from the property is important because the percentage depletion deduction is limited to a percentage of taxable income from the property, calculated without regard to depletion allowance, per IRC Section 613(a). For taxable years beginning before Jan. 1, 1991, the net income limitation is 50 percent. For taxable years beginning after Dec. 31, 1990, the net income limitation has been increased from 50 percent to 100 percent of net taxable income in the case of oil and gas properties. The increased limitation, 100 percent, is applicable only to oil and gas properties.

J. Expense of the Property

The taxpayer can claim various expenses (for example, lease operating, severance taxes, production taxes, depreciation, overhead, *etc.*) to calculated each property's net income. These expenses will be directly attributable to the property or the taxpayer will be required to use an allocation method.

K. Overhead Allocation

Expenses must be separated between direct and indirect. Each separate activity should draw a portion of the overhead that is incurred.

L. Passive Activity Loss Limitation

Internal Revenue Code Section 469(a) denies any net losses or tax credits from passive activities. Losses and credits from passive activities may only reduce income from other passive activities. The excess is carried forward to subsequent years to offset passive activity income arising in those years.

The passive activity loss limitation is applied after the percentage depletion limitations. The portion of the percentage depletion deduction carried over to a subsequent year due to the 65 percent of taxable income limitation is allowed without regard to the application of IRC Section 469 in that year.

M. Various Percentage Depletion Rates

The various percentage depletion rates are contained in IRC Section 612(b). The rates range from a high of 22 percent for sulphur and uranium to 5 percent for gravel, peat, pumice, sand, certain shale and stone. Oil shale, gold, silver, copper and iron ore are at 15 percent.

II. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF DEPLETION

A. Overview

Pennsylvania Regulation Section 125.51, Allowance of deduction for cost depletion provides in part -

> "In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in calculating income a reasonable allowance for depletion. In any case which it is ascertained as a result of operations or development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.
>
> Recoverable units - Recoverable units are the number of units (*e.g.*, tons, pounds, ounces or barrels) of minerals, oil or gas in the ground and economically worth extracting, estimated according to the best available information and industry standards.
>
> Basis for depletion - The basis on which depletion is to be allowed in respect of any property shall be the adjusted basis for the purpose of determining the gain upon the sale or other disposition of such property."

B. Pennsylvania Personal Income Tax Treatment of Federal Percentage Depletion

The allowance of deductions for percentage depletion is **not** generally acceptable by standards of the accounting profession and constitutes an unconstitutional item of tax preference under the *Pennsylvania Constitution* after the cost of recoverable units has been fully recovered. Effective for taxable years beginning on or after Jan. 1, 2005, a deduction for percentage depletion shall be allowed **only** in the following set of circumstances -

1. It is allowable as a deduction in computing federal taxable income.
2. Insufficient information is available to estimate the amount of recoverable units in accordance with industry standards.
3. The cost of the recoverable units is fixed and certain.
4. The cost of the recoverable units has not been fully recovered.

(Adopted- Effective Nov. 9, 2004)

The taxpayer must have un-recovered basis in the property in order to receive the benefit of a deduction for percentage depletion.

C. Classification and Adjustments

Classification and adjustments are required to the respective Pennsylvania personal income tax reporting base to account for annual differences between the taxpayer's federal depletion deduction and the taxpayer's allowable Pennsylvania personal income tax depletion deduction.

III. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF ROYALTIES AND RENTS

A. Taxable Royalties

Article III of the Tax Reform Code of 1971 (Tax Reform Code) provides that every resident individual, estate or trust shall pay (be taxed on each dollar of income) for the privilege of receiving each of the classes of income from all sources, and that every nonresident individual, estate, or trust shall pay (be taxed on each dollar of income) from Pennsylvania sources (*i.e.*, compensation earned for services performed in Pennsylvania). The Tax Reform Code provides the following eight classes of taxable income: 1) Compensation; 2) Interest; 3) Dividends; 4) Net income or [Loss] from the operation of a business, profession or farm; 5) Net gain or [loss] from sale, exchange or disposition of property; 6) Net income or [loss] from rents, royalties, patents and copyrights; 7) Estate and trust income; and, 8) Gambling and lottery winnings. *See* 72 P.S. §§7302, 7303.

Royalties are not defined under the Tax Reform Code. However, in *Tygart Resources, Inc. v. Com.*, 134 Pa. Comwlth. 168, 578 A.2d 86 (Pa. Cmwlth. 1990) the Commonwealth Court of Pennsylvania stated --

> "Section 1903(a) of the Statutory Construction Act of 1972, 1 Pa. C.S. §1903(a) provides that words shall be construed according to their common and approved usage, but technical words shall be construed according to their peculiar and appropriate meaning."
>
> *Webster's Third New International Dictionary 1982 (1986)* pertinently defines royalty as follows:
>
> > "A share of the product or profit of property reserved by the owner when the property is sold, leased, or used or a payment (a percentage of the amount of property used) to the owner for permitting another to exploit or market such property (as natural resources, patents, or copyrights) which is often subject to depletion with use."

Residents are subject to Pennsylvania personal income tax on income from all sources. Only nonresidents of Pennsylvania allocate royalty income, since only their Pennsylvania source income (portion allocable to Pennsylvania) is subject to Pennsylvania personal income tax.

B. Taxable Rental Income

Taxable rental income consists of income the taxpayer receives for the use of real or tangible property. Royalty income is income the taxpayer receives upon the extraction of coal, oil, gas or other minerals, or for the use of a patent or copyright. Gross rents and royalties include all items of gross income or receipts from rents, royalties, patents, copyrights, secret processes, formulas, good will, trademarks, trade brands, franchises and similar property derived in the form of rents and royalties. However, gross rent and royalties does not include -

1. Income or receipts from the sale, exchange or other disposition of rental property, royalty rights, copyrights, secret processes, patents, formulas, good will, trademarks, trade brands, franchises and similar property;

2. Income or receipts from operating oil, gas, or mineral interests includable in the calculation of net profits from a business, profession or farm, or otherwise derived in the ordinary course of and from the operation of a business; and

3. If the taxpayer retains an economic interest in the coal, oil, gas or other minerals after being extracted (*i.e.* will receive a percentage of future sales), then the proceeds received would constitute net gains or income derived from royalties. In computing net gain or income from royalties, taxpayer is permitted to offset ordinary and necessary expenses incurred in receiving this royalty gain or income. [*See* Section 631 of the Internal Revenue Code.]

IV. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF TIMBER

A. Net Profits; Net Gains or Income from Disposition of Property; and Net Gains or Income Derived From or in the Form of Rents, Royalties, Patents and Copyrights Defined

Pennsylvania's Tax Reform Code of 1971, as amended, contains eight separate classes of income. Three of the items of income are defined as -

1. **Net profits**
The net income from the operation of a business, profession or other activity after provision for all costs and expenses incurred in the conduct thereof ... determined in accordance with accepted accounting principles and practices but without deduction of taxes based on income.

2. **Net gains or income from disposition of property**
   Net gains or net income, less net losses, derived from the sale, exchange or other disposition of property, including real or personal, whether tangible or intangible as determined in accordance with accepted accounting principles and practices.

3. **Net gains or income derived from or in the form of rents, royalties, patents and copyrights**. This income is reportable on *PA-40 Schedule E – Rents and Royalty Income (Loss)*. *See* 72 P.S. §7303(a)(2), (3) and (4).

B. PA-40 Schedule D – Gain (Loss) Defined

For Pennsylvania personal income tax purposes, timber products are treated as "property" for purposes of taxation and the income is properly classifiable as proceeds from the disposition of property. The income from such disposition is reportable on *PA-40 Schedule D – Sale, Exchange or Disposition of Property* unless the sale of the timber is part of a commercial enterprise.

C. Commercial Enterprise Defined

Pennsylvania courts have held that the essential element of a commercial enterprise is the rendering of goods and services to others in a marketplace. *Wettach v. Com.*, 620 A.2d 730 (Pa. Cmwlth. 1993); *Morgan v. Com.*, 400 A.2d 1384 (Pa.Cmwlth. 1979).

In order to classify the proceeds from the sale of trees (timber products) as business income it must be shown that the timber is marketed to customers on a commercial basis and without limitation or exclusivity (*i.e.* it is sold to the general public and not to an exclusive number of customers). Additionally, the marketing activity must be conducted with the manifest objective of achieving profitable operations and it must be conducted with regularity and continuity.

D. PA-40 Schedule D – Gain (Loss) and Resident Credit

For Pennsylvania personal income tax purposes, if the taxpayer’s timber sales were not the result of a commercial enterprise or net gains derived from royalties then the timber products are treated as “property” and the income would be classifiable as Schedule D, gain (loss). The gain is the difference between the amount realized and taxpayers’ basis in the timber. The income from such disposition is reportable on *PA-40 Schedule D – Sale, Exchange or Disposition of Property*.

A resident is subject to tax on the net gain from making a disposition of property irrespective of whether the property is located inside or outside of the Commonwealth. To avoid the double taxation of income, however, the statute also includes a resident tax credit provision.

E. Income From Pay-As-Cut Contract Classified as Royalties

Income from the sale of timber outside a commercial enterprise is generally classified as net gains or income from the disposition of property. However, the fact that a sale was made under a pay-as-cut contract changes the classification of the income.

The IRS Announcement 1990–129, indicates that timber sales under a pay-as-cut contract are royalties. Royalties are not defined under the Tax Reform Code. However, as discussed previously in *Tygart Resources, Inc. v. Commonwealth*, the Commonwealth Court of Pennsylvania stated -

> "Section 1903(a) of the Statutory Construction Act of 1972, 1 Pa. C.S. §1903(a) provides that words shall be construed according to their common and approved usage, but technical words shall be construed according to their peculiar and appropriate meaning."

F. Taxpayer Retains An Economic Interest in the Timber After Being Cut

If the taxpayer retains an economic interest in the timber after being cut (*i.e.* will receive a percentage of future sales), then the proceeds received would constitute net gains or income derived from royalties. In computing net gain or income from royalties, taxpayer is permitted to offset ordinary and necessary expenses incurred in receiving this royalty gain or income. This income is reportable on *PA-40 Schedule E – Rents and Royalty Income (Loss)*.

V. FEDERAL INCOME TAX – S CORPORATION CONSIDERATION

A. Allowance for Depletion Calculated Separately for Each Shareholder

Section 613A(c)(11)(A) of the Code provides that, in the case of an S corporation, the allowance for depletion with respect to any oil or gas property shall be calculated separately by each shareholder.

Section 613A(c)(11)(B) of the Code provides that the S corporation will allocate to each shareholder his pro rata share of the adjusted basis of the S corporation in each oil or gas property held by the S corporation. The allocation will be made as of the later of the date of acquisition of the property by the S corporation or the first day of the first taxable year of the S corporation to which the Subchapter S Revision Act of 1982 applies. Each shareholder will separately keep records of his share of the adjusted basis in each oil or gas property of the S corporation, adjust each share of the adjusted basis for any depletion taken on the property, and use the adjusted basis each year in the computation of the cost depletion or in the computation of the gain or loss on the disposition of such property by the S corporation. In the case of any distribution of oil or gas property to its shareholders by the S corporation, the corporation's adjusted basis in the property will be an amount equal to the sum of the shareholders' adjusted basis in the property, as determined under this subparagraph.

B. Basis Consideration

A shareholder's S corporation stock basis is increased by the shareholder's portion of the excess of the corporation's depletion deductions over the basis of the property subject to depletion.

However, no increase in basis may be made for any pass through item of corporate gross income unless that increase is, in fact, reported on the shareholder's tax return.

Stock basis is then decreased (but not below zero) for the shareholder's portion of the depletion deduction for any oil or gas wells held by the S corporation to the extent that this deduction does not exceed the shareholder's proportionate share of the adjusted basis of the property.

C. Accumulated Adjustments Account Consideration

The accumulated adjustments account (AAA) (*See* IRC Section 1368(e)) is used to calculate the tax effect of distributions made by an S corporation with earnings and profits. The balance of the accumulated adjustments account is zero at the beginning of the tax year when the corporation first elects S corporation status.

The accumulated adjustments account is increased for the excess of depletion deductions over the basis of property subject to depletion (except certain oil and gas property).

VI. PENNSYLVANIA PERSONAL INCOME TAX – S CORPORATION CONSIDERATION

The deduction for depletion is calculated at the S corporation level. Pennsylvania personal income tax rules do not allow a deduction for depletion in excess of basis in the property. If the taxpayer's basis is negative, then the taxpayer must adjust the capital account.

See Pennsylvania Personal Income Tax Guide Chapter 16, Pass Through Entities.

VII. FEDERAL INCOME TAX – PARTNERSHIP CONSIDERATION

A. Separately Stated Items

While a partnership's income is generally calculated like that of an individual, there are certain exceptions. As stated above, a number of items must be separately stated. *See* IRC Section 703(a)(1). Furthermore, several deductions are not permitted in computing partnership income since these deductions will be made instead at the partner level. The impermissible deductions include the IRC Section 611 deduction for oil and gas well depletion.

IRC Section 613A(c)(7)(D) provided in part that in the case of a partnership the depletion allowance shall be calculated separately by the partner and not by the partnership. The partnership allocates to each partner his or her proportionate share of the adjusted basis of each partnership's oil and gas property.

B. Basis Adjustments

This initial partner basis in the partnership interest is adjusted over time as follows --

1. Basis is increased by the sum of the partner's distributive share for the tax year and prior tax years for the excess of the deductions for depletion over the basis of the property subject to depletion.

2. Basis is also decreased, but not below zero, by the amount of the partner's deduction for certain oil and gas well depletion. *See* IRC Section 705(a)(3).

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VIII. PENNSYLVANIA PERSONAL INCOME TAX – PARTNERSHIP CONSIDERATION

All partnership elections are applicable equally to all partners but any election made by the partnership will not apply to any partner's other income or gain outside the partnership. The deduction for depletion is calculated at the partnership level. Pennsylvania personal income tax rules do not allow a deduction for depletion in excess of basis in the property. If the taxpayer's basis is negative, then the taxpayer must adjust the capital account.

See Pennsylvania Personal Income Tax Guide Chapter 16, Pass Through Entities.

IX. FEDERAL INCOME TAX TREATMENT OF INTANGIBLE DRILLING COSTS

A. Intangible Drilling Costs – Overview

There are many costs incurred in developing an oil and gas well. For federal income tax purposes, these costs are classified into two groups: intangible drilling costs (referred to as IDC) and tangible equipment costs. The distinction between these two costs is very important; they are treated differently for tax purposes.

Intangible drilling costs are expenditures for drilling wells or developing wells (preparing them to produce) which are intangible, or which have no salvage value in themselves. Pursuant to Treasury Regulation Section 1.612-4(a), intangible drilling costs are expenditures made by an operator for wages, fuel, repairs, hauling, supplies, *etc.*, incident to and necessary for the drilling of wells and the preparation of the well for the production of oil and gas. Treasury Regulation Section 1.612-4(a) provides for the option with respect to intangible drilling and development costs.

Intangible drilling costs are all costs, which are the intangible or non salvageable costs of drilling up to and including the cost of installing a system of pipes, valves and fittings. The term "Christmas tree" in the oil and gas industry refers to the pipes, valves, and fittings that are used to regulate the flow of oil and gas from the wellhead. The physical arrangement of these pipes and valves resemble a "Christmas tree." The cost of casing and the physical components of the "Christmas tree" are not intangible drilling costs, but equipment costs that are capitalized and depreciated.

A working interest owner in an oil or gas property has the option to elect to currently deduct intangible drilling cost. This option, granted by Treasury Regulation Section 1.612-4(a), is exercised by claiming intangible drilling cost as a deduction on the taxpayer's federal income tax return for the first taxable year in which the taxpayer pays or incurs such costs. No formal statement is necessary. If the owner of the lease is a partnership, the election must be made at the partnership level. Once the election is made, it is irrevocable and binding for all subsequent taxable years. A taxpayer who fails to claim the expenses on the first return as a deduction is deemed to have elected to capitalize the costs.

If a taxpayer fails to deduct intangible drilling cost as an expense on the first return, the taxpayer is deemed to have elected to capitalize such costs. Recovery of costs will be done through depletion, to the extent that they are not represented by physical property, and through depreciation, to the extent that they are represented by physical property. *See* Treasury Regulation Section 1.612-4(b).

The option to expense or capitalize domestic intangible drilling cost is available to all taxpayers, both individuals and corporations, with one exception. Integrated oil companies can deduct only 70 percent of their domestic intangible drilling cost currently.

B. Federal Tax Treatment– Intangible Drilling Costs

As discussed above, the costs of developing oil, gas, or geothermal wells are ordinarily capital expenditures. Taxpayer can usually recover them through depreciation or depletion. However, taxpayer can choose to deduct intangible drilling costs as a current business expense. These are certain drilling and development costs for wells in the United States in which a taxpayer holds an operating or working interest. Taxpayer can deduct only costs for drilling or preparing a well for the production of oil, gas, or geothermal steam or hot water.

Taxpayers can choose to deduct only the costs of items with no salvage value. These include wages, fuel, repairs, hauling, and supplies related to drilling wells and preparing them for production.

Taxpayer’s cost for any drilling or development work done by contractors under any form of contract is also an intangible drilling cost.

Taxpayers can also choose to deduct the cost of drilling exploratory bore holes to determine the location and delineation of offshore hydrocarbon deposits if the shaft is capable of conducting hydrocarbons to the surface on completion. It does not matter whether there is any intent to produce hydrocarbons.

Taxpayers elect to deduct intangible drilling costs as a current business expense by taking the deduction on your income tax return for the first tax year you have eligible costs. No formal statement is required. If taxpayer files federal Schedule C (Form 1040), enter these costs under "Other expenses."

For oil and gas wells, taxpayer’s choice is binding for the year it is made and for all later years. For geothermal wells, the filing of an amended return on which you do not take the deduction can revoke your choice.

If taxpayer capitalizes his or her intangible drilling costs, a taxpayer has another option if the well is nonproductive. Taxpayers can deduct the intangible drilling costs of the non-productive well as an ordinary loss. Taxpayers must indicate and clearly state their choice on the tax return for the year the well is completed. Once made, the choice for oil and gas wells is binding for all later years. Taxpayers can revoke his or her choice for a geothermal well by filing an amended return that does not claim the loss.

C. Exploration Costs

The costs of determining the existence, location, extent, or quality of any mineral deposit are ordinarily capital expenditures if the costs lead to the development of a mine. Taxpayer recovers these costs through depletion as the mineral is removed from the ground. However, taxpayers can choose to deduct domestic exploration costs paid or incurred before the beginning of the development stage of the mine (except those for oil, gas, and geothermal wells).

Taxpayers elect to deduct exploration costs by taking the deduction on their income tax return, or on an amended income tax return, for the first tax year for which you wish to deduct the costs paid or incurred during the tax year. Taxpayer must adequately describe and identify each property or mine, and clearly state how much is being deducted for each one. The choice applies to all later tax years.

Each partner, not the partnership, chooses whether to capitalize or to deduct that partner's share of exploration costs.

X. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF INTANGIBLE DRILLING COSTS

A. Intangible Drilling Costs Amortized, Not Deductible

Intangible drilling costs associated with the creation of wells are not deductible. As long as the taxpayer or entity is engaged in the active conduct of a business and business activities have begun (beyond the exploration stage), and the drilling costs are reasonable in amount, the expenses may be amortized over the life of the wells.

B. Write-Off Remaining Un-amortized Cost of Unproductive Wells

An entity can write off the remaining un-amortized cost as a loss when the well proves unproductive. This loss is similar to a federal capital loss not subject to current expensing. Pennsylvania personal income tax rules require the loss to be recorded as a loss on the sale, exchange or disposition of property.

C. Pennsylvania Personal Income Tax Classification and Adjustment

Pennsylvania personal income tax classification and adjustment must be made to account for Pennsylvania personal income tax difference from federal tax treatment.

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CHAPTER 24: CANCELLATION OF DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES

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CHAPTER 24: CANCELLATION OF DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES

I. OVERVIEW OF CANCELLATION OF DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES

A. In General

The federal income tax treats the income that is derived from the discharge of indebtedness (DOI) as a separate and distinct class of gross income. The Pennsylvania personal income tax, however, treats a discharge of indebtedness either as a form of payment or as a reduction in cost, not as a separate and distinct class of gross income. Thus, a cancellation of a genuine, uncontested and enforceable obligation for less than its face value can have varying Pennsylvania personal income tax effects, depending upon whether the debtor is insolvent after such discharge, the cancelled debt constitutes the unpaid balance of a purchase price or the discharge is ordered under the Bankruptcy Act. The effects may also vary depending upon the identity of the parties to the transaction and other factors. Accordingly, special Pennsylvania personal income tax rules apply when a debtor is legally discharged from primary liability for a debt and it is probable that the debtor will not be required to make future payments as guarantor of the debt.

If the liabilities of a partnership are decreased, thereby decreasing each partner's share of the liabilities, each partner's decrease is treated as a distribution of money to the partner by the partnership and if a decrease in liabilities exceeds the partner's basis in his partnership interest, the excess is reported as gain on PA Schedule D.

B. When Cancellation of Debt Occurs

Indebtedness is cancelled only on the occurrence of an identifiable event indicating that the debt will never have to be repaid. There are seven identifiable events:

1. Discharge~~s~~ of indebtedness in bankruptcy;
2. Discharge~~s~~ of indebtedness in receivership;
3. Expiration of the statute of limitations for collecting the indebtedness;
4. Cancellation of debt (COD) arising from the creditor’s election to pursue foreclosure which statutorily extinguishes its right to pursue further collection;
5. Extinguishment of a debt under a probate proceeding;
6. Discharge pursuant to an agreement between the creditor and debtor for less than full consideration;
7. Discharge according to a decision by the creditor, and under a defined policy of the creditor, to discontinue collection activity and discharge the debt.

A liability is not forgiven or cancelled merely because it is temporarily uncollectible or unenforceable. However, it is the position of the department that, when a 36-month testing period during which there has been no payment made expires, the 36-month period provides a rebuttable presumption that the indebtedness has been cancelled.

C. Classifying Income from Cancellation of Debt for Pennsylvania Personal Income Tax Purposes

Cancellation of debt generally occurs:

1. Under Generally Accepted Accounting Principles (GAAP), the debt forgiven was considered a liability;

2. Where the debt forgiven constitutes a *quid pro quo* or incentive that would be taxable under Pennsylvania personal income tax law if it had been paid to the debtor in cash or in property.

Taxpayers report taxable debt forgiveness in the class of income for which the debt was cancelled. For example:

1. If the cancellation of debt relates to rent, royalty, patent or copyright income, it is reported in that class;

2. If the cancellation of debt relates to an employee/employer relationship, it is reported as compensation;

3. If the cancellation of debt relates to the sale, discontinuation or abandonment of a business or segment thereof, it is reported on PA Schedule D as gain on the sale of property.

D. Cancellation of Debt Incurred In Business, Profession or Farm Income

If the debt forgiveness was related to business, profession or farm income in the past, then the income is reported in that class of income.

E. Cancellation of Debt Incurred in Rent and/or Royalty Business Activity

Rent or royalty income can result if the taxpayer's indebtedness is cancelled and the indebtedness was incurred in the rent and/or royalty activity.

F. Cancellation of Debt Incurred in Investment Activity

Interest or dividend income constitutes reportable income if the cancellation of debt resulted from the purchase of assets used in the investment activity.

G. Cancellation of Debt Incurred in Compensation Income

Compensation income constitutes reportable income if the indebtedness is cancelled in exchange for services rendered.

H. Pennsylvania Personal Income Tax Insolvency Provision

1. Solvent Taxpayer

If the taxpayer is solvent, the amount of indebtedness is generally reported as income. Solvent taxpayers would report the amount of indebtedness forgiven or discharged with the associated class of income.

2. Insolvent Taxpayer

Insolvent taxpayers not filing for bankruptcy recognize cancellation of debt as income. The reportable amount is the lesser of:

a. The amount of indebtedness forgiven or discharged, or

b. The excess over the taxpayer's fair market value of assets (net worth) immediately after the cancellation.

If an insolvent taxpayer is not rendered solvent by the cancellation of debt, no income is recognized.

I. Basis Adjustment

The basis of an insolvent debtor's property must be reduced but not below its fair market value (FMV). Basis reductions for amounts cancelled shall be allocated in any manner that has the effect of reducing the difference between the fair market value and the adjusted basis of the properties. Requisite basis adjustments are required as a result of a bankruptcy discharge and to the extent that income was not reported as a result of the Pennsylvania personal income tax insolvency provision.

J. Individuals filing for Bankruptcy

Unless the case is dismissed, an individual bankruptcy filed under Chapters 7, 11, or 12 of the Bankruptcy Act leads to the creation of a bankruptcy estate and no income shall be considered to have been realized by reason of discharge of indebtedness under bankruptcy laws.

II. REPORTABLE INCOME IN THE EIGHT CLASSES OF INCOME FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES

A. Eight Classes of Income that are Subject to Pennsylvania Personal Income Tax

1. Compensation
2. Interest
3. Dividends
4. Net Income (loss) from the operation of a business, profession or farm
5. Net gain (loss) from the sale, exchange or disposition of property
6. Net income (loss) from rents, royalties, patents and copyrights
7. Income from estates or trusts
8. Gambling and lottery winnings.

B. Pennsylvania Personal Income Tax Statute Does Not Conform To Internal Revenue Code Sections 61(a)(12) and 108 Relating To Cancellation of Debt

The Pennsylvania personal income tax statute does not conform to the following Internal Revenue Code Sections relating to cancellation of debt:

IRC Section 61(a)(12) – Income from discharge of indebtedness; and

IRC Section 108 – Income from discharge of indebtedness.

For a taxpayer in a Title 11 Bankruptcy, income is not realized by the estate debtor or a successor to the debtor by reason of a discharge of indebtedness in bankruptcy except to the extent such income is subject to tax under the Internal Revenue Code. As a result, Section 108 is only operative for Pennsylvania personal income tax reporting purposes in determining whether "such income is subject to tax under the Internal Revenue Code."

For taxpayers not in a Title 11 Bankruptcy case, Pennsylvania does not follow Section 108.

C. Internal Revenue Code Section 61(a)(12) Does Not Define Reportable Income for Pennsylvania Personal Income Tax Purposes

Reportable income for Pennsylvania personal income tax purposes consists of eight classes of income. Cancellation of **debt** is only taxable if it falls under one of the listed classes of income. *See* Eight Class of Income.

D. Cancellation of Debt Incurred in a Business Activity is Generally Reportable Income for Pennsylvania Personal Income Tax Purposes

Cancellation of debt for a debt incurred in a business activity (business, profession or farm), is generally taxable.

E. Cancellation of Debt Incurred in an Investment Activity is Generally Reportable Income for Pennsylvania Personal Income Tax Purposes

Cancellation of debt for a debt incurred in an investment activity is generally taxable if the debt was used to purchase investments generating interest or dividend income.

F. Cancellation of Debt Incurred in an Exchange for Employee Services is Generally Reportable as Compensation Income for Pennsylvania Personal Income Tax Purposes

Cancellation of debt for a debt incurred of an employee or subcontractor in exchange for services rendered is compensation income to the employee or subcontractor.

G. Pennsylvania Personal Income Tax Insolvency Provision

1. Application to partnerships and PA S corporations

a. Applied at the partner level
b. Applied at the PA S corporation level

2. Insolvency is determined immediately before the transaction

a. At the partner level to determine whether that partner is insolvent immediately before the cancellation of indebtedness transaction.

b. At the PA S corporation level to determine whether that PA S corporation is insolvent immediately before the cancellation of indebtedness transaction.

3. Recognition of Reportable Income for Pennsylvania Personal Income Tax Purposes

Recognition of reportable income for Pennsylvania personal income tax purposes to the extent that:

a. The partner is made solvent as a result of the transaction
b. The PA S corporation is solvent as a result of the transaction

4. Required Basis Adjustment Relating to Cancellation of Debt Not Reported for Pennsylvania Personal Income Tax Purposes

Required basis adjustment relating to cancellation of debt transaction not reported for Pennsylvania personal income tax purposes:

a. First reducing the insolvent partner's Pennsylvania personal income tax adjusted basis in the entity. Any excess requires applicable adjustment at the partnership level for partner's percentage share of assets.

b. Reducing PA S corporation Pennsylvania personal income tax adjusted basis in its assets.

H. Pennsylvania Personal Income Tax Treatment in Bankruptcy Cases

"Section 346 of the Bankruptcy Code is amended to generally follow the same provisions that apply for federal income tax purposes. Considerable conflicts existed between state and local taxes and federal taxes. Congress indicated at the time the Bankruptcy Reform Act of 1978 became law that the state and local tax issues would be changed when the Congress passed the federal bankruptcy tax laws. A few years later Congress passed the Bankruptcy Tax Act of 1980 and no action has been taken to eliminate the tax problems that arise because of the differences between the two federal laws.

To correct these problems, the amendment to section 346 of the Bankruptcy Code conforms Section 346 to that of Section 1398, etc…."

"Section 346 of the Bankruptcy Code contains a series of detailed provisions that mandate a uniform outcome at the state and local level with respect to a variety of bankruptcy tax matters, both substantive and procedural. For example, Section 346(g)(1)(c) provides that, for state and local tax purposes, neither gain nor loss shall be recognized on a transfer that qualifies as a bankruptcy reorganization for federal income tax purposes. Section 346(j) provides a comprehensive series of rules governing the state and local tax consequences of discharge of debt in bankruptcy. Other, more specialized tax rules appear in Chapter 762 and Chapter 11.63. Under the Act, Section 346 is completely rewritten, and the provisions previously housed in Section 728 and Sections 1146(a) and (b) are largely transferred to Section 346. Among other things, the new rules require uniformity among federal, state and local tax administrative rules by:

1. preventing a bankruptcy filing from resulting in the creation of a new taxable estate (or the termination of the debtor's taxable year) for federal purposes but not for state and local purposes (or *vice versa*);

2. conforming the federal, state and local tax consequences of property transfers from the debtor to the estate (or *vice versa*);

3. preventing state or local tax from being imposed on discharge of debt income unless that income is also subject to tax under the Internal Revenue Code; and

4. generally requiring states and localities to reduce tax attributes to reflect untaxed discharge of debt income following the same rules applicable for federal purposes.

I. Bankruptcy Code Section 346. Special Provisions Related to the Treatment of State and Local Taxes

Section 346 provides in part:

> Whenever the Internal Revenue Code of 1986 provides that a separate taxable estate or entity is created in a case concerning a debtor under this title, and the income, gain, loss, deductions and credits of such estate shall be taxed to or claimed by the estate, a separate taxable estate is also created for purposes of any state and local law imposing a tax on or measured by income and such income, gain, loss, deductions and credits shall be taxed to or claimed by the estate and may not be taxed to or claimed by the debtor. The preceding sentence shall not apply if the case is dismissed. The trustee shall make tax returns of income required under any such state or local law.
>
> To the extent that any state or local law imposing a tax on or measured by income provides for the carryover of any tax attribute from one taxable period to a subsequent taxable period, the estate shall succeed to such tax attribute in any case in which such estate is subject to tax under subsection (a).
>
> After such a case is closed or dismissed, the debtor shall succeed to any tax attribute to which the estate succeeded under paragraph (1) to the extent consistent with the Internal Revenue Code of 1986.

For purposes of any state or local law imposing a tax on or measured by income, income is not realized by the estate, the debtor or a successor to the debtor by reason of discharge of indebtedness in a case under this title. Except to the extent, if any, that such income is subject to tax under the Internal Revenue Code of 1986.

Whenever the Internal Revenue Code of 1986 provides that the amount excluded from gross income in respect of the discharge of debt in a case under this title shall be applied to reduce the tax attributes of the debtor or the estate, a similar reduction shall be made under any state or local law imposing a, tax on or measured by income to the extent such state or local law recognizes such attributes. Such state or local law may also provide for the reduction of other attributes to the extent that the full amount of income from the discharge of indebtedness has not been applied.

For federal tax purposes, the provisions of this section are subject to the Internal Revenue Code of 1986 and other applicable federal non bankruptcy law.

As stated above, the changes to Section 346 conform state and local income tax administrative practices to those under the Internal Revenue Code in several important respects including: the "split year" for filing returns in the year of the bankruptcy filing, the division of tax liabilities and responsibilities between the bankruptcy estate and the debtor, tax consequences with respect to partnerships and transfers of property, and the taxable period of a debtor. The section does not, however, conform to state and local tax rates.

J. Pennsylvania Personal Income Tax Reduction in Tax Attributes Relating To a Discharge in a Title 11 Bankruptcy

Pennsylvania personal income tax reduction in tax attributes relating to a discharge in a Title 11 Bankruptcy proceeding:

1. Partners

a. First reducing the partner's percentage or any carryover of Pennsylvania personal income tax credits;

b. Adjusted basis in the entity which is not liquidated;

c. Adjusted basis in the entity's assets for any excess to the extent of the partner's share of the partnership assets;

d. Adjusted basis in any property received in liquidation.

2. PA S Corporations

Reduction in adjusted basis in PA S corporation Pennsylvania personal income tax assets is required at the entity level.

III. PENNSYLVANIA PERSONAL INCOME TAX REPORTING BASE CONSIDERATIONS

A. Federal Taxable Income (Loss)

If federal taxable income (loss) per the taxpayer's filed federal tax return is the Pennsylvania personal income tax reporting base, then classification and/or adjustments are required to account for amounts excluded under Sections 108 and/or 111. Adjustments are also required to account for differences in either of the application of the Pennsylvania personal income tax insolvency calculation, Pennsylvania personal income tax purchase price reduction provision, or Pennsylvania personal income tax attribute reduction amount.

B. Accepted Accounting Principles and Practices for Book Income (Loss)

If accepted accounting principles and practices are used in the Pennsylvania reporting base, then adjustments are required to account for certain Pennsylvania personal income tax adjustments which require the application of the bankruptcy rules. Adjustments are also required to account for differences in the application of the Pennsylvania personal income tax insolvency calculation, Pennsylvania personal income tax purchase price reduction provision, or Pennsylvania personal income tax attribute reduction amount.

C. Requisite Pennsylvania Personal Income Tax Adjustment to Reflect Reduction to Adjusted Basis Calculations to Reflect Associated Reductions in Tax Attributes

Requisite adjustment must be made to reflect requisite Pennsylvania personal income tax reduction to Pennsylvania personal income tax adjusted basis calculations to reflect associated reductions in Pennsylvania personal income tax attributes.

IV. TREATMENT OF CANCELLATION OF INDEBTEDNESS OF RECOURSE DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES

A. No Bifurcation for Pennsylvania Personal Income Tax Purposes

There is no required bifurcation between PA Schedule D gain and other Pennsylvania personal income tax reportable income for Pennsylvania personal income tax purposes.

For federal income tax purposes, a bifurcation is required based on the relationship between fair market value of the property and adjusted basis. If the collateral encumbered by recourse debt is transferred, foreclosed or abandoned to the creditor, then the gain is reported on PA Schedule D.

B. Net Profit (Loss) From a Business, Profession or Farm

If the collateral is not transferred, foreclosed or abandoned, but the indebtedness is reduced, business income generally occurs if the debt was incurred in the business activity.

C. Rental or Royalty Business Income or Losses

If the collateral is not transferred but the indebtedness is reduced, rental or royalty income generally occurs if the debt was incurred in the rental or royalty activity.

D. Cancellation of Recourse Debt in a Title 11 Bankruptcy Proceeding

The cancellation of recourse debt in a Title 11 Bankruptcy proceeding is covered by the Bankruptcy Code provisions. *See* Bankruptcy Code Section 346.

E. Cancellation of Recourse Debt for Solvent Debtor with Seller Purchase Price Reduction

The cancellation of recourse debt for a solvent debtor associated with a purchase price reduction by the seller does not constitute reportable income for Pennsylvania personal income tax purposes. Rather, Pennsylvania personal income tax basis in the property is reduced as a result of the purchase price reduction.

F. Cancellation of Recourse Debt that is Personal in Nature is not Reportable Income for Pennsylvania Personal Income Tax Purposes

The cancellation of recourse debt that is personal in nature does not constitute reportable income for Pennsylvania personal income tax purposes.

V. TREATMENT OF CANCELLATION OF INDEBTEDNESS OF NONRECOURSE DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX

A. Pennsylvania Personal Income Tax Schedule D Gain on Pennsylvania Personal Income Tax Reportable Cancellation of Debt

1. Calculating Pennsylvania Personal Income Tax Schedule D Gain If Property Is Transferred to Lender or Foreclosed By Lender

Collateral transferred, foreclosed or abandoned in exchange for cancellation of debt is always treated as Pennsylvania Schedule D gain and not business income, rental or royalty income or as interest and/or dividend income. The Pennsylvania Schedule D gain is calculated as follows:

Adjusted issue amount of the debt
<u>Pennsylvania personal income tax adjusted basis</u>
Pennsylvania Schedule D gain

2. Collateral Is Not Transferred for Net Profit (Loss) From a Business, Profession or Farm

If the collateral is not transferred, foreclosed or abandoned, business income generally occurs if the debt proceeds were incurred in a business activity.

3. Collateral Is Not Transferred for Rental or Royalty Business Income (Loss)

If the collateral is not transferred, foreclosed or abandoned, then rental or royalty income generally occurs if the debt proceeds were incurred in the rental or royalty activity.

4. Constructive Cash Distributions Pass Through to Owners

The treatment of nonrecourse debt discharged in a Title 11 Bankruptcy proceeding is governed by the bankruptcy Code Section 346.

5. Nonrecourse Debt Discharged By Seller in a Purchase Price Reduction

The discharge of indebtedness of nonrecourse debt by a seller in a purchase price reduction for a solvent debtor is determined under the Pennsylvania personal income tax purchase price reduction provisions.

6. Discharge of Personal Nonrecourse Debt Is Not Reportable Income for Pennsylvania Personal Income Tax Purposes

The discharge of nonrecourse indebtedness that is personal in nature does not constitute reportable income for Pennsylvania personal income tax purposes.

7. Discharge of Investment Activity Nonrecourse Debt Is Reportable as Interest or Dividend Income for Pennsylvania Personal Income Tax Purposes

The discharge of nonrecourse indebtedness associated with an investment activity where the funds were used to purchase assets generating interest and dividend income, constitutes reportable interest or dividend income for Pennsylvania personal income tax purposes.

VI. PENNSYLVANIA PERSONAL INCOME TAX APPLICATION TO PARTNERS – CANCELLATION OF INDEBTEDNESS

A. Pennsylvania Personal Income Tax Follows Federal Bankruptcy Code Section 346 if Taxpayer Is In Bankruptcy

Pennsylvania personal income tax treatment will follow federal bankruptcy Code Section 346 for determining Pennsylvania personal income tax reportable income if the taxpayer is in bankruptcy.

B. Discharge of Debt for Insolvent Taxpayer Not In Bankruptcy

The cancellation of debt for a taxpayer who is insolvent and not in bankruptcy before the transaction is nontaxable to the extent that the taxpayer is still insolvent after the transaction. A taxpayer will recognize gain to the extent the taxpayer was made solvent after the transaction.

C. Discharge of Debt for Solvent Taxpayer Accounted for as a Purchase Price Reduction

The cancellation of debt associated with a purchase price reduction by the seller, for a solvent taxpayer, is accounted for as a purchase price reduction.

D. Discharge of Debt Incurred in Business or Commercial Activities is Generally Taxable

The cancellation of debt incurred in the following activities is generally taxable if the debt was incurred in-

1. A business, profession or farm;
2. Rental or royalty income activity;
3. Investment activity.

E. Discharge of Debt by Partnership Employee or Subcontractor is Included In Compensation

The cancellation of debt owed by an employee or subcontractor is included in the employee's or contractor's compensation.

F. Cancellation of Personal Debt or Student Loans is not Taxable For Pennsylvania Personal Income Tax Purposes

The cancellation of personal debt, including student loans, is not taxable for Pennsylvania personal income tax purposes. However, employer paid student loans constitutes taxable employee compensation.

G. Application of Insolvency Rules Based on State Law

The insolvency calculation is determined under Pennsylvania law. The insolvency is determined at the individual partner level. To the extent that an amount of the cancellation of debt is excluded as a result of the insolvency exclusion, a requisite reduction in the partner's Pennsylvania personal income tax adjusted basis is required. If an excess amount remains a respective percentage of the partnership property that the partner owns is reduced for that partner by the partnership. The partnership would make a special allocation to the partner to account for the reduced depreciation.

H. Partnership Transfers Collateral to Lender

If the collateral is transferred by the partnership to the lender, then the partnership will report gain on *PA–20S/PA–65 Schedule D* and on the associated *PA-20S/PA-65 Schedules RK–1 and NRK–1*.

I. Pennsylvania Personal Income Tax Reporting of Debt Reduced or Discharged If Partnership Retains Collateral

If the partnership retains the collateral but the debt is reduced or discharged, the amount is reported as follows:

1. As business income if the debt was incurred in a business activity;

2. As rental or royalty income if the debt was incurred in a rental or royalty activity;

3. As interest or dividend income if the debt was incurred to purchase interest or dividend portfolio assets.

J. Reduction in Liability Decreases Partner's Pennsylvania Personal Income Tax Basis – Increase Pennsylvania Personal Income Tax Basis For Inclusion of Additional Income

A partner receives a basis increase for the inclusion of additional income. The partner's basis is then decreased by any associated constructive cash distribution. The effect on Pennsylvania personal income tax adjusted basis is as follows:

1. Reduction in liabilities for constructive cash distribution decreases Pennsylvania personal income tax basis.

2. Increase in Pennsylvania personal income tax adjusted basis for either:

   a. Reportable business income;
   b. Reportable rental or royalty income;
   c. Reportable interest or dividends.

K. Classify Accrued But Unpaid Expenses to Arrive at Partnership Pennsylvania Personal Income Tax Reportable Income

Accrued but unpaid expenses are recorded as income in the respective class of income where the accrued expense was taken in arriving at Pennsylvania personal income tax reportable income.

VII. PENNSYLVANIA PERSONAL INCOME TAX APPLICATION TO PA S CORPORATION SHAREHOLDERS WITH A CANCELLATION OF DEBT

A. For Pennsylvania Personal Income Tax Purposes Cancellation of Debt Is Also Determined at PA S Corporation Shareholder Level

For Pennsylvania personal income tax purposes, a cancellation of indebtedness for PA S corporation shareholders is treated as follows:

1. Under Title 11 Bankruptcy – The Bankruptcy Code provisions are applicable as they apply to PA S corporations;

2. Not taxable to the extent the PA S corporation is still insolvent immediately after the discharge. The determination of insolvency is based on Pennsylvania law;

3. The PA S corporation must be insolvent before the transaction;

4. Not taxable to the extent the cancellation of debt relates to a purchase price reduction made by the seller for a solvent PA S corporation;

5. Generally taxable to the extent the debt was incurred:

   a. in a business activity (net profit from a business, profession or farm);

   b. in a rental or royalty activity;

c. in an investment activity where funds were borrowed to purchase portfolio assets used in an investment activity.

Note. An investment activity is not a commercial activity.

6. Not taxable to the extent that the debt discharge relates to personal debt including student loans.

7. Taxable to the extent the debt forgiven was exchanged for compensation.

B. For Pennsylvania Personal Income Tax Purposes Internal Revenue Code Section 108 Only Applies in Title 11 Bankruptcy Case

IRC Section 108 is not applicable in determining whether Pennsylvania personal income tax income is reportable except in a Title 11 Bankruptcy case.

C. Application of Insolvency Rule Based on State Law

The Pennsylvania personal income tax insolvency rule discussed above is not based on Section 108 of the Internal Revenue Code. Pennsylvania personal income tax has a parallel provision. For purposes of applying this rule, insolvency is determined at the PA S corporation level. Insolvency is determined immediately before the discharge occurs. The PA S corporation will report Pennsylvania personal income tax reportable income where the PA S corporation is solvent after the transaction.

D. PA S Corporation Reports Pennsylvania Schedule D Gain If Collateral is Transferred or Foreclosed

If the collateral is transferred or foreclosed, the PA S Corporation will report PA Schedule D gain on the PA–20S/PA–65 Information Return. The gain is calculated based on the following:

Adjusted Issue amount of debt
Pennsylvania personal income tax adjusted basis
Pennsylvania Schedule D gain

The PA Schedule D gain should be reflected on the respective PA-20S/PA-65 Schedules RK-1 or NRK–1.

E. Collateral Not Transferred

If the collateral is retained but the associated debt is forgiven, the PA S Corporation will report the following where applicable:

1. As business income if the indebtedness cancelled was incurred in a business, profession or farm activity;

2. As rental or royalty income if the indebtedness cancelled was incurred in a rental or royalty activity;

3. As interest or dividend income to the extent the indebtedness cancelled related to the purchase of investment assets.

F. Discharge of Debt by PA S Corporation Employee or Subcontractor is Included in Compensation

If the PA S corporation cancels an employee's or subcontractor's outstanding loan amount, then the amount of the cancellation is included in the employee's or subcontractor's compensation.

G. Classify Accrued but Unpaid Expenses to Arrive at Reportable Income of a PA S Corporation for Pennsylvania Personal Income Tax Purposes

Accrued but unpaid expenses are recorded as income in the respective class of income where the accrued expense was taken in arriving at reportable income for Pennsylvania personal income tax purposes.

H. Application of the Pennsylvania Personal Income Tax "Tax Benefit" Rules

For coordination with the application of the Pennsylvania personal income tax "tax benefit" rules when the entity is liquidated or discontinued. *See* the *Pennsylvania Personal Income Tax Guide* on the utilization of losses.

VIII. CANCELLATION OF DEBT CONCERNING ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES

A. Troubled Debt Restructuring

Troubled debt restructuring is defined in Statement of Financial Accounting Standards (SFAS) 15, "*Accounting for Debtors and Creditors in a Troubled Debt Restructuring*", and expanded upon in various Emerging Issues Task Force (EITF) issues. EITF 02-04, "*Determining Whether a Debtor's Modification or Exchange of Debt Instruments is within the scope of FASB Statement No. 15*", requires that debtor companies apply these special rules upon a restructuring when:

1. Debtors are "experiencing financial difficulties" – Among the factors to consider when assessing whether a company is experiencing financial difficulties include whether the company (i) is in default on its debt, (ii) has either filed or will soon file for bankruptcy, (iii) is able to continue as a going concern, (iv) projections indicate that cash flows will be insufficient to satisfy its contractual debt obligations, (v) has outstanding securities that have been de-listed, or (vi) has limited access to capital due to deteriorating creditworthiness.

2. Creditors grant a concession in the restructuring – To determine whether a "qualifying" concession has occurred, the company must determine that the renegotiated interest rate has been reduced due to the company's financial difficulties, rather than a decline in prevailing market interest rates,

IX. APPLICATION OF ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES CONCERNING PENNSYLVANIA PERSONAL INCOME TAX CANCELLATION OF DEBT TREATMENT

A. Financial Accounting Implications

The financial accounting for a particular troubled debt restructuring transaction depends in large part on what the creditor receives in exchange for any concessions granted. If no assets are transferred and the transaction simply modifies the company's cash flow either by delaying or reducing outstanding principal or interest the company cannot recognize a gain on the transaction date. The only exception is if the aggregate of all renegotiated future payments is less than the carrying amount of the debt. In all other instances, the company simply reports a reduced interest charge in future income statements. That interest charge will be the discount rate that equates the present value of the future cash payments to the carrying amount of the debt.

When companies extinguish troubled debt obligations by transferring assets or making equity grants to their lenders, they can record an accounting gain equal to the difference between the amount of debt appearing in their financial statements and the fair value of the consideration exchanged. They must also record a gain or loss equal to the difference between the fair value and carrying amount of the assets transferred.

Hybrid troubled debt restructurings are employed, which combine an asset or equity transfer with modified loan terms. In these cases, the company must first reduce the carrying amount of its financial statement debt or the fair value of the assets or equity transferred. It can then determine whether it must record a gain on the transaction date by comparing the newly adjusted book value of the debt instrument with the renegotiated value of its aggregate cash flows.

The tax consequences of a troubled debt restructuring hinge on whether it simply cancels indebtedness, or whether there is also cash flow modifications combined with an exchange of assets or equity. Generally, companies have to assess whether the troubled debt restructuring triggers cancellation of debt income, as well as whether any asset or equity transfers generate other taxable gains or losses. Cancellation of debt income is recognized if the present value of the restructured payments is less than the total future payments due pursuant to the original terms of the debt. Furthermore, the original issue discount provisions of the Internal Revenue Code may force limitations on the future deductibility of interest. A cancellation of debt tax gain can be avoided when the company is deemed insolvent for tax purposes (tax basis liabilities are greater than the fair market value of its assets) or is in bankruptcy. In this instance, the cancellation of debt income will not trigger a current tax liability, but rather would be applied to reduce tax attributes such as net operating losses, tax credits or tax basis of assets.

B. Examples of Troubled Debt Restructuring Disclosure

Transfer of Assets in Full Settlement.	At [date of transfer], the amount due to the supplier exceeded the fair market value of the assets transferred, and accordingly a gain of $xx,xxx has been included in income in 20x2.
Transfer of Equity in Full Settlement.	At [date of transfer], the amount due to debenture holders exceeded the aggregate market value of the shares transferred, and accordingly a gain of $xx,xxx has been included in income in 20x2.
Modification of Terms – Carrying Value of Debt Exceeds Future Cash Payments.	The bank has agreed to accept [reduced amount] at no interest over the same period. Accordingly, the amount of the note has been reduced by $xx,xxx, and a gain of $xx,xxx has been included in operations in 20x2.
Modification of Terms – Future Cash Payments Exceed Carrying Value of Debt.	The bank has agreed to accept [reduced amount] in 20x7 and to reduce the interest rate to x% on the new balance. The modifications have resulted in an effective interest rate of x percent, and interest expense through 20x7 will be reduced accordingly.
Partial Settlement and Modification of Terms – Carrying Value of Debt Exceeds Future Cash Payments.	The fair market value of the [description of assets] exceeded their book value by $xx,xxx at [date of transfer], and accordingly a gain of $xx,xxx has been included in operations in 20x2. The amount of the note payable has been further reduced by $xx,xxx, and a gain of $xx,xxx has also been included in operations in 20x2.
Partial Settlement and Modification of Terms – Future Cash Payments Exceed Carrying Value of Debt.	The fair market value of the [description of assets] exceeded their book value by $xx,xxx at [date of transfer], and accordingly a gain of $xx,xxx has been included in operations for 20x2. The modifications have resulted in an effective interest rate of x percent, and interest expense through 20x6 will be reduced accordingly.

Partial Settlement and Modification of Terms – Carrying Value of Debt Exceeds Future Cash (and Contingent) Payments.	The supplier has agreed to accept xx,xxx shares of the company's $x par value common stock and to reduce the annual payments to (reduced amount). In addition, the supplier will receive an additional $xx,xxx annual payment for each year in which the company's earnings exceed $xxx,xxx. These modifications have resulted in a reduction of the maturity value of the note and a gain of $xx,xxx in 20x2.
Disclosure Required in Subsequent Years When Modification of Terms Includes Contingent Payments.	At [date of financial statements], 20x2 and 20x1, the aggregate amounts contingently payable included in the carrying value of the notes were $xx,xxx and $xx,xxx, respectively.

X. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF BANKRUPTCY DISCHARGE

Pennsylvania personal income tax treatment conforms to federal law as defined under Section 346 of the Bankruptcy Code.

A. Internal Revenue Code Sections 108(a), 108(b) and 108(g) are Applied at the Partner Level

Sections 108(a), 108(b) and 108(g) are applied at the partner level. Section 108(a)(1)(A) provides for an exclusion from gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs in a Title 11 Bankruptcy case. Section 108(a)(2)(A) provides that a Title 11 exclusion takes precedence.

Section 108(b) provides for a reduction in tax attributes which includes amounts excluded under subparagraph (A). See Internal Revenue Code Section 108(a)(1)(A).

Both Sections 108(a)(1)(A) and 108(b) are applied at the partner level.

Section 346 of the Bankruptcy Code provides in part:

> "For purposes of any state or local law imposing a tax on or measured by income, income is not realized by the estate, debtor, or a successor to the debtor by reason of discharge of indebtedness in a case under this Title except to the extent, if any, that such income is subject to tax under the Internal Revenue Code."

B. Requisite Reduction in Pennsylvania Personal Income Tax Attributes Required as Result of Bankruptcy Discharge

A requisite reduction in Pennsylvania personal income tax attributes is also required as a result of the bankruptcy discharge.

Section 346 of the Bankruptcy Code also provides in part.

"For purposes of any state law imposing a tax on or measured by income, income is not realized."

Whenever the Internal Revenue Code provides that the amount excluded from gross income in respect of the discharge of indebtedness in a case under this Title shall be applied to reduce the tax attributes of the debtor or the estate, a similar reduction shall be made under any state or local law imposing a tax on or measured by income to the extent such state or local law recognizes such attributes.

Such state or local law may also provide for the reduction of other attributes to the extent that the full amount of income from the discharge of indebtedness has not been applied.

C. Internal Revenue Code Sections 108(a) and (b) Applied at the PA S Corporation Level

Internal Revenue Code Sections 108(a) and (b) apply at the PA S corporation level. Section 108(a)(1)(A) provides for an exclusion from gross income by reason of the discharge (in whole or in part) of the indebtedness of the taxpayer if the discharge occurs in a Title 11 case.

Section 108(a)(2)(A) provides that a Title 11 exclusion takes precedence.

Section 108(d)(7) provides for the special rules for PA S corporations. Subsections (a), (b), (c), and (g) shall be applied at the corporate level. Subsection (c) relates to the treatment of discharged of qualified real property indebtedness.

D. Internal Revenue Code Sections 108(a)(1)(B), 108(a)(1)(C), and 108(a)(1)(D) Not Operative For Pennsylvania Personal Income Tax Reporting Purposes

The following are not operative for Pennsylvania personal income tax reporting purposes:

1. 108(a)(1)(B) – Discharge occurs when taxpayer is insolvent

2. 108(a)(1)(C) – Discharge is qualified farm indebtedness

3. 108(a)(1)(D) – Discharge is qualified real property indebtedness

E. Federal Precedence Rule for Internal Revenue Code Section 108(a)(2)

According to Internal Revenue Code Section 108(a)(2), the exclusions from income resulting from discharge of indebtedness have an order of priority which must be followed. Exclusion under bankruptcy has precedence over the other exclusions listed under IRC Section 108. Therefore, exclusions for debt discharged to insolvent taxpayers, discharged qualified farm indebtedness and discharged qualified real property indebtedness are not applicable to a debt that is discharged in a bankruptcy situation. In turn, when a taxpayer is insolvent and has income resulting from discharged qualified real property business indebtedness, the exclusion for qualified real property business indebtedness only applies to the extent the taxpayer is not able to exclude income under the insolvency exception.

F. Precedence Rule for Pennsylvania Personal Income Tax

The following Internal Revenue Code Sections are not operative – 108(a)(1)(B), 108(a)(1)(C), 108(a)(1)(D). The Pennsylvania personal income tax insolvency rule is operative. The Pennsylvania personal income tax insolvency rule is applied at the partner and PA S corporation level.

XI. NONTAXABILITY OF CANCELLATION OF DEBT INCOME FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES

A. Personal Indebtedness

Discharge of indebtedness income is not specifically mentioned in any of the eight classes of taxable income. However, the department has consistently taken the position that a discharge of indebtedness is only taxable when it represents a direct substitute for one of the eight classes of taxable income as provided for in the Tax Reform Code. For example, if there is a discharge of indebtedness in exchange for an employee performing services for the obligee, that discharge would be considered taxable compensation.

B. Student Loans

Forgiveness of student loans would not qualify as a substitute for any of the eight classes of taxable income. Rather, this discharge of indebtedness amounts to an incentive from your nursing school to encourage its students to practice public interest nursing regardless of the extent of their nursing school debt.

C. Other [Reserved]

XII. APPLICATION OF OTHER FEDERAL RULES CONCERNING CANCELLATION OF DEBT – PENNSYLVANIA PERSONAL INCOME TAX REPORTING BASIS – FEDERAL TAXABLE INCOME (LOSS) – [Reserved]

A. Acquisition of Related Party Debt
B. Debt for Stock
C. Debt for a Partnership Interest
D. Tax Benefit Rule

XIII. OVERVIEW OF FEDERAL INCOME TAX STATUTORY PROVISIONS

A. Federal Statutes for Internal Revenue Code Sections 61(a)(12), 108, 111

If a debt is cancelled or forgiven, other than as a gift or bequest, the debtor generally must include the cancelled amount in gross income for tax purposes. A debt includes any indebtedness for which the debtor is liable or which attaches to property the debtor holds. The applicable federal statutes are Internal Revenue Code Sections 61(a)(12), 108, 111.

B. Gross Income Defined for Internal Revenue Code Section 61(a)(12)

Gross Income Defined – Internal Revenue Code Section 61(a)(12):

1. Net operating losses and net operating loss carryovers;

2. General business credits under Section 38;

3. Alternative minimum tax credits;

4. Net capital losses and capital loss carryovers;

5. The basis of depreciable property (to the extent the basis exceeds remaining liabilities);

6. Passive activity losses and credit carryovers; and

7. Foreign tax credits and carryovers.

C. Required Reduction in Attributes

1. Reduction in Attributes

The reduction in attributes occurs after the determination of tax for the year of the discharge. Attributes are reduced dollar-for-dollar, except for tax credits, which are reduced 33 1/3 cents for each dollar. A taxpayer may instead elect to first reduce the basis of depreciable property. The reduction in basis is limited to the taxpayer's adjusted basis of depreciable property held at the beginning of the taxable year following the taxable year in which the debt is discharged. (The reduction in basis is not limited to the excess of the basis in depreciable property over remaining liabilities.)

2. Basis Reduction

The required basis reduction generally applies to depreciable real property held by the taxpayer at the beginning of the taxable year following the taxable year in which the debt is discharged. If the taxpayer disposes of real property (in the transaction that gave rise to the discharge or otherwise) prior to the first day of the next taxable year, then the reduction in basis of such property is made immediately before the disposition.

Taxpayers may not make the election available under present law to treat as depreciable real property real estate held primarily for sale to customers. When depreciable real property, the basis of which has been reduced, is disposed of, then for purposes of determining the amount of ordinary income depreciation recapture under Section 1250; (i) the basis reduction is treated as an allowance for depreciation, and (ii) the determination of depreciation under the straight line method is made as if there had been no reduction. Accordingly, the amount of ordinary income depreciation recapture is reduced over time as the taxpayer forgoes depreciation deductions.

D. Exclusion from Gross Income for Internal Revenue Code Section 108

1. Exceptions and Exclusions

There are several exceptions and exclusions from the inclusion of cancelled debt in income. The exceptions include:

a. The cancellation of a student loan for a student required to work for certain employers.

b. The cancellation of debt that would have been deductible if paid.

c. The reduction of a debt by the seller of property if the debt arose from the purchase of the property.

2. Exclusions

Taxpayers do not include a cancelled debt in gross income if any of the following situations apply:

a. The cancellation takes place in a bankruptcy case under the U.S. Bankruptcy Code.

b. The cancellation takes place when a taxpayer is insolvent, and the amount excluded is not more than the amount by which he or she is insolvent.

c. The cancelled debt is qualified farm debt (debt incurred in operating a farm).

d. The cancelled debt is qualified real property business indebtedness (certain debt connected with business real property).

3. Order of Exclusions

If the cancellation of debt occurs in a Title 11 bankruptcy case, the bankruptcy exclusion takes precedence over the insolvency, qualified farm debt, or qualified real property business indebtedness exclusions.

To the extent that the taxpayer is insolvent, the insolvency exclusion takes precedence over qualified farm debt or qualified real property business indebtedness exclusions.

4. Bankruptcy Case Exclusion

A bankruptcy case is a case under Title 11 of the United States Code, but only if the debtor is under the jurisdiction of the court and the cancellation of the debt is granted by the court or occurs as a result of a plan approved by the court.

None of the debt cancelled in a bankruptcy case is included in the taxpayer's gross income in the year cancelled. Instead, certain losses, credits and basis of property must be reduced by the amount of excluded income (but not below zero). These losses, credits and basis in property are called tax attributes.

E. Tax Benefit Approach for Internal Revenue Code Section 108(e)(2)

Under the Internal Revenue Code Section 108(e)(2), taxpayers can exclude discharge of indebtedness income to the extent that the payment of the liability would have given rise to a deduction by the debtor. *See* Internal Revenue Code Section 108(e)(2).

The effect of Section 108(e)(2) is that there is no debt discharge income where a trade account payable of a cash basis taxpayer is discharged.

F. Gifts

Courts have allowed taxpayers to exclude discharge of indebtedness income in situations involving gifts and overall loss transactions. Under the gift exception, if the creditor intends to cancel all or part of the debt, expecting nothing in return, there is no discharge of indebtedness income. However, there must be donative intent, making this exception inapplicable in the commercial setting.

G. Student Loan

Complete or partial cancellations of some student loans do not generate forgiveness of indebtedness income. For this exception from debt discharge income to apply, the loan cancellation must be conditioned on the student working in a certain profession for a certain period of time for any of a broad class of employers. For student loans to qualify for this exception, which include loans from qualified educational organizations or other tax-exempt entities that refinance qualified student loans, the loans must also help students attend qualified educational organizations.

H. Purchase Price Reduction

When a lender reduces a buyer's purchase money debt, the debt relief is treated as an adjustment to the purchase price requiring reduction of the property's basis, instead of as discharge of indebtedness income. This rule applies only if the bankruptcy or insolvency exclusions do not, and only if the reduction otherwise would have given rise to discharge of indebtedness income.

To qualify for this exclusion, the debt must run from the buyer to the seller and not to either's transferee (even if related) or to a third-party holder of the debt. A debt reduction by a third-party lender can be treated as a purchase price adjustment only if it is based on an infirmity that clearly relates back to the original price, such as the seller's inducement of a higher purchase price by misrepresentation of a material fact or by fraud where a debt discharge was part of a larger transaction resulting in a transfer of ownership (from debtor to a third party), the tax court found a sale or exchange of an asset. However, the Internal Revenue Service (IRS) has privately ruled that when a sole shareholder sold all of the stock in his old company for cash and debt to a newly formed corporation, and after the new corporation was merged into the old company the shareholder agreed to reduce the amount of debt due him from the sale, the old company had a purchase price reduction rather than forgiveness of indebtedness income.

The debt reduction is not treated as a purchase price adjustment if it is directly the result of dealings between the buyer and seller, such as the running of the limitations period. *See Senate Committee Report to P.L. 96-589* (1980), S. Rep. No. 96-1035,16.

This treatment can apply to a partnership even if it is insolvent or bankrupt. However, it applies only if no partner in the partnership takes a position that is not consistent with the partnership's treatment of the discharge as a purchase price adjustment.

XIV. INTERNAL REVENUE CODE SECTION 61(a)(12)

A. General Application

In general, a taxpayer must include in gross income the amount of any debt that is cancelled. *See* Internal Revenue Code (IRC) §§108 and 61 (a)(12). Generally, this includes accrued original issue discount (OID). *See* I.R.C. §163(e)(3), Treasury Regulation §1.61-12(c)(3). For example, a taxpayer/debtor recognizes cancellation of indebtedness income where it acquires its own indebtedness for less than the face amount.

Under Section 108(e)(4), a taxpayer/debtor is treated as acquiring its own indebtedness and therefore may recognize cancellation of debt income when its indebtedness is acquired by a person "related" to the taxpayer/debtor, within the meaning of IRC Section 267(b) or Section 707(b)(1). Under Section 267(b)(3), two corporations which are members of the same controlled group (as defined in Section 267(f)) are related. Section 267(f) provides that the term "controlled group" has the same meaning as in Section 1563(a) (without regard to Section 1563(a)(4)) (insurance companies) and Section 1563(e)(3)(C) (no attribution of stock owned by qualified employee's trust), except that "more than 50 percent" is substituted for "more than 80 percent." Thus, for purposes of Section 108(e)(4), members of the same controlled group are "related," control being defined as owning more than 50 percent of vote and value.

B. Internal Revenue Service Reporting Requirements

An applicable entity that discharges $600 or more of the debt of any person generally must file an information return showing the person's name, address and taxpayer identification number (TIN), the date and amount of discharge, and any other information required by the IRS. This requirement applies whether the discharge is total or partial.

The required information must be filed on *Form 1099-C, Cancellation of Debt*, by February 28 of the year following the year in which the discharge occurred. The due date for electronically filing Form 1099-C is March 31 of the year following the year of discharge. In addition, the debtor must be given a written statement showing the Form 1099-C information, and any information required by current revenue procedures, by January 31 of the year after the discharges.

A discharge of indebtedness for information return purposes is one of eight identifiable events as defined in Internal Revenue Service Regulation Section 1.6050P-1:

1. Chapter 11 Bankruptcy;

2. A cancellation or extinguishment of debt that renders it unenforceable in a receivership, foreclosure or similar proceeding in a federal or state court, other than a bankruptcy proceeding;

3. A cancellation or extinguishment of debt resulting from expiration of the statute of limitations for collecting the debt. However, this type of cancellation arises only when a debtor's affirmative statute of limitations defense is upheld in a final judicial proceeding and the time for appeal has expired;

4. A cancellation or extinguishment of debt arising from a creditor's election of foreclosure remedies that statutorily extinguishes or bars his right to collection. However, reporting is required only when local law bars a mortgage lender or holder from pursuing a deficiency judgment or note collection proceeding after exercise of a power of sale contained in the mortgage or deed of trust;

5. A cancellation or extinguishment of debt rendering it unenforceable under a probate or similar proceeding;

6. A discharge under an agreement with an applicable entity to reduce the debt for less than full consideration. The last act needed to effect the agreement must occur;

7. A discharge under a creditor's decision, or the application of a defined policy of the creditor, to discontinue collection activity. A defined policy can be either a written or established business practice; or

8. The expiration of a nonpayment testing payment period. There is a presumption that a discharge has occurred if a creditor has not received a payment on a debt during the nonpayment testing period. The nonpayment testing period is a 36 month period, increased by the number of months during all or part of which collection was stayed by bankruptcy or similar state or local law. However, the presumption of discharge can be rebutted by significant, bona fide collection activity during the 12 months preceding expiration of the period, or by the facts and circumstances existing as of January 31 of the calendar year following expiration. Significant collection activity does not include merely nominal or ministerial action, such as an automated mailing. Facts and circumstances showing no discharge include the existence of a lien against the debtor, or the sale or packaging for sale of the debt.

XV. INTERNAL REVENUE CODE SECTION 108

A. Title 11 Bankruptcy Discharge of Unpaid Tax

Debts are divided into two categories: dischargeable and non–dischargeable. Dischargeable debts are those that the debtor is no longer personally liable to pay after the bankruptcy proceedings are concluded. Non–dischargeable debts are those that are not cancelled because of the bankruptcy proceedings. The debtor remains personally liable for their payment.

As a general rule, there is no discharge for a taxpayer as an individual debtor at the termination of a bankruptcy case for the second and eighth priority taxes, or for taxes for which no return, a late return (filed within two years of the filing of the bankruptcy petition), or a fraudulent return was filed. However, claims against a taxpayer for other taxes predating the bankruptcy petition by more than three years may be discharged.

B. Discharge When Taxpayer is Insolvent and Not in Bankruptcy

Gross income does not include income from discharge of indebtedness of an insolvent taxpayer. The amount excludable from gross income by an insolvent taxpayer is limited to the amount by which the taxpayer is insolvent. A taxpayer is considered insolvent if the liabilities of the taxpayer immediately preceding the discharge of the debt exceed the fair market value of the taxpayer's assets.

Liabilities – In *Revenue Ruling 92-53*, the Internal Revenue Service stated that, in determining solvency it will ignore nonrecourse debt in excess of the value of the property securing that debt (except where that excess nonrecourse debt itself is being forgiven). Commentators have asserted it is unclear as to whether contingent liabilities should be valued and included in liabilities.

Assets – In determining solvency, exempt assets under state law are not included in the taxpayer’s assets. To value partnership interests, the taxpayer should evaluate the partnerships assets and liabilities. If there is equity in the partnership interest, then the partner should apply an appropriate marketability discount.

C. Insolvency

1. If a partner is insolvent, then he or she may exclude cancellation of debt income to the extent insolvent (IRC section 108(a)(1)(B) and IRC section 108(a)(3). If the cancellation of debt removes a partner from insolvency, the partner must recognize income to the extent made solvent. That is, to the extent the fair market value of the partner's assets exceeds his or her liabilities immediately after the cancellation.

2. Insolvency is determined immediately before discharge of debt (IRC section 108(d)(3)).

3. The amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to

what extent, a taxpayer is insolvent, but only to the extent that the excess non–recourse debt is discharged. *See Revenue Ruling 92-53*.

4. The fair market value of assets that are exempt under state law are not excludable in determining insolvency.

5. Contingent liabilities (guarantees) are not included in the insolvency calculation. *See Merkel*, 109 T.C. 463 (1997), *affd*, [99-2 U.S.T.C. ¶50,848], (9th Cir. 1999).

6. The burden of proving insolvency is on the taxpayer. *See Bressi*, T.C. Memo. 1991-651.

7. Federal Insolvency Calculation:

Fair Market Value of Assets (less selling costs)

a. Cash

b. IRAs/Pensions

c. Life insurance (cash surrender value)

d. Personal property

e. Real property

f. Stocks, Bonds, & Other Securities

g. Business interests (Partnerships, S-Corporations, LLCs, etc.)

h. Accounts/Notes Receivable

Less: Liabilities

a. Recourse Debt

b. Nonrecourse Debt

= (Insolvency) – Solvency

D. Qualified Farm Indebtedness

Farmers can exclude a limited amount of income that would otherwise be included as a result of the discharge of indebtedness if the indebtedness discharged is qualified farm indebtedness and tax attributes are reduced accordingly. This exclusion applies to solvent farmers. If the farmer is insolvent, the insolvency exclusion takes precedence to the extent the farmer is insolvent. However, the exclusion for qualified real property business indebtedness does not. A farmer is insolvent if his liabilities exceed the fair market value of assets.

E. Qualified Real Property Business Indebtedness

Taxpayers other than C corporations can elect to exclude income realized from the discharge of qualified real property business indebtedness. Qualified real property business indebtedness is debt that ' incurred or assumed on real property used in a trade or business, and that is secured by this real property. It cannot have been incurred or assumed after December 31, 1992, unless it is qualified acquisition indebtedness used to refinance pre-1993 qualified real property business indebtedness. Qualified acquisition indebtedness is debt used to acquire, construct, reconstruct, or substantially improve the property. Debt used to refinance qualified real property business indebtedness does not qualify to the extent that it exceeds the amount of debt being refinanced. Qualified real property business indebtedness does not include qualified farm indebtedness.

F. Stock-for-Debt

The stock-for-debt exception has been repealed. For purposes of determining the income of a debtor attributable to the cancellation of indebtedness, a debtor that issues a debt instrument in satisfaction of indebtedness is treated as having satisfied the indebtedness with an amount of money equal to the issue price of that debt instrument (Code Sec. 108(e)(10)). For this purpose, the issue price of the new obligation is determined under the general rules applicable to debt instruments issued for property (Code Sections 1273(b) and 1274). For debt instruments subject to interest on deferred payments (Code Sec. 483), the issue price, determined under Code Sec. 1273(b)(4), is reduced to exclude unstated interest for purposes of determining income from cancellation of debt.

A corporation that issues its own stock to a creditor in satisfaction of outstanding debt realizes income from discharge of indebtedness to the extent that the principal of the debt exceeds the value of the stock or any other property transferred (Code Sec. 108(e)(8)). There is no insolvency or bankruptcy exception to recognition of discharge of indebtedness income when a corporation exchanges its outstanding stock for debt; recognition can be avoided only by reduction of tax attributes.

XVI. REDUCTION OF TAX ATTRIBUTES FOR INTERNAL REVENUE CODE SECTION 108(b)

A. Amount of Reduction – Insolvency Exclusion

Taxpayers are insolvent when, and to the extent, their liabilities exceed the fair market value of their assets. Taxpayers determine liabilities and the fair market value of their assets immediately before the cancellation of debt to determine whether or not they are insolvent and the amount by which they are insolvent.

Taxpayer can exclude from gross income debt cancelled when a taxpayer is insolvent, but only up to the amount by which he or she is insolvent. However, taxpayers MUST use the amount excluded to reduce certain tax attributes.

B. Reduction of Tax Attributes

If a debtor excludes cancelled debt from income because it is cancelled in a bankruptcy case or during insolvency, he or she MUST use the excluded amount to reduce certain "tax attributes." Tax attributes include the basis of certain assets and the losses and credits listed next. By reducing these tax attributes, tax on the cancelled debt is in part postponed instead of being entirely forgiven. This prevents an excessive tax benefit from the debt cancellation.

If a separate bankruptcy estate was created, the trustee or debtor–in–possession must reduce the estate's attributes (but not below zero) by the cancelled debt.

C. Order of Reduction

Generally, use the amount of cancelled debt to reduce the tax attributes in the order listed below. However, taxpayers may choose to use all or a part of the amount of cancelled debt to first reduce the basis of depreciable property before reducing the other tax attributes.

1. Net Operating Loss (NOL) – First, reduce any net operating loss for the tax year in which the debt cancellation takes place and any net operating loss carryover to that tax year.

2. General Business Credit Carryovers – Second, reduce any carryovers, to or from the tax year of the debt cancellation, of amounts used to determine the general business credit.

3. Minimum Tax Credit – Third, reduce any minimum tax credit that is available as of the beginning of the tax year following the tax year of the debt cancellation and any capital loss carryover to that year.

4. Basis – Fourth, reduce the basis of property as described under basis reduction, later. This reduction applies to the basis of both depreciable and non-depreciable property.

5. Passive Activity Loss and Credit Carryovers – Fifth, reduce any passive activity loss or credit carryover from the tax year of the debt cancellation.

6. Foreign Tax Credit – Last, reduce any carryover, to or from the tax year of the debt cancellation, of an amount used to determine the foreign tax credit or the Puerto Rico and possessions tax credit.

D. The Required Reductions

The required reductions in tax attributes occur after figuring the tax for the tax year of the debt cancellation. In reducing net operating losses and capital losses, first reduce the loss for the tax year of the debt cancellation, and then any loss carryovers to that year in the order of the tax years from which the carryovers arose, starting with the earliest year. Make the reductions of credit carryovers in the order in which the carryovers are taken into account for the tax year of the debt cancellation.

E. Basis Reduction

If any amount of the debt cancellation is used to reduce the basis of assets, the following rules apply to the extent indicated:

1. Taxpayers make the reduction in basis at the beginning of the tax year following the tax year of the debt cancellation. The reduction applies to property held at that time.

2. Bankruptcy and Insolvency Reduction Limit – The reduction in basis because of cancelled debt in bankruptcy or in insolvency cannot be more than the total basis of property held immediately after the debt cancellation, minus the total liabilities immediately after the cancellation. This limit does not apply if an election is made to reduce basis before reducing other attributes.

3. Exempt Property Under Title 11– If debt is cancelled in a bankruptcy case under Title 11 of the United States Code, make no reduction in basis for property that the debtor treats as exempt property under Section 522 of Title 11.

4. Election to Reduce Basis First – Taxpayers (the estate in the case of an individual bankruptcy under Chapters 7 or 11) may choose to reduce the basis of depreciable property before reducing any other tax attributes. However, this reduction of the basis of depreciable property cannot be more than the total basis of depreciable property held at the beginning of the tax year following the tax year of the debt cancellation.

F. Depreciable Property

Depreciable property means any property subject to depreciation, but only if a reduction of basis will reduce the amount of depreciation or amortization otherwise allowable for the period immediately following the basis reduction. Taxpayers may choose to treat as depreciable property any real property that is stock in trade or is held primarily for sale to customers in the ordinary course of a trade or business.

Taxpayers must generally make this choice on the tax return for the tax year of the debt cancellation, and, once made, taxpayers can only revoke it with IRS approval. However, if taxpayers establish reasonable cause, they may make the choice with an amended return or claim for refund or credit.

1. Making Elections

Make the election to reduce the basis of depreciable property before reducing other tax attributes as well as the election to treat real property inventory as depreciable property, on Form 982, reduction of tax attributes due to discharge of indebtedness (and Section 1082 basis adjustment).

2. Recapture of Basis Reductions

If any basis in property is reduced under these provisions and is later sold or otherwise disposed of at a gain, the part of the gain that is from this basis reduction is taxable as ordinary income. Figure the ordinary income part by treating the amount of this basis reduction as a depreciation deduction and by treating any such basis-reduced property that is not already either Section 1245 or Section 1250 property as Section 1245 property.

In the case of Section 1250 property, make the determination of what would have been straight line depreciation as though there had been no basis reduction for debt cancellation.

G. Federal Tax Election to Apply Reduction First Against Depreciable Property

1. Partnership or PA S Corporation Level Election

With respect to partnerships and PA S corporations, the determination of whether the debt is qualified real property indebtedness is made at the entity level. For partnerships the election to exclude income and reduce the basis of property is made by the partner. For PA S corporations the election is made by the PA S corporation, not by its shareholders. Partners who are C corporations are not eligible to make the election. If a partner makes the election, basis is reduced in the partner's interest in the partnership to the extent of the partner's proportionate interest in the depreciable real property held by the partnership. The partnership's basis in depreciated real property with respect to such partner is correspondingly treated. It appears that a partner may reduce the basis of depreciable real estate held outside the partnership if the partner's share of partnership depreciable basis is insufficient. However, this may give rise to partnership tax problems.

2. Tax Attribute Reduction for Insolvent and Bankrupt Partners

If cancelled debt is excluded under IRC Section 108 because a partner is bankrupt or insolvent, he or she must use the excluded amount to reduce net operating losses, capital losses, basis, suspended passive losses, and other tax attributes.

3. Qualified Real Property Business Indebtedness

Solvent partners, other than C corporations, may exclude cancellation of qualified real property business indebtedness (referred to as "QRPBI") income if certain requirements are met (IRC Section 108(c)).

a. The determination of whether cancelled debt is QRPBI is made at the partnership level. The debt cancelled must be secured by real property used in the trade or business and incurred before January 1, 1993, or be qualified acquisition indebtedness.

b. The excluded cancellation of debt income cannot exceed the partner's share of the difference between the outstanding principal amount of debt (before discharge) and the fair market value of the real property (reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property); and the partner's total adjusted bases of depreciable real property. The outstanding principal amount includes prior year accumulated accrued and unpaid interest (Final Treasury Regulation Section 1.108-6(a)).

4. Partner Must Timely Elect to Reduce Basis of Depreciable Real Property

The partner must make a timely election to reduce the basis of his or her depreciable real property

Note. Depreciable real property does not include land, furniture and fixtures, equipment or intangible assets.

A partnership interest is considered depreciable real property to the extent of the partner's share of depreciable real property. To make the election, the partner uses *Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness* in the year cancellation of debt income is received. The partner must attach a detailed description, by property, identifying any reduction in basis under IRC Section 1017.

For the partner's basis in his or her partnership interest to be reduced the partnership must make a corresponding reduction in the partner's share of depreciable real property on its books. If the partnership does not make the reduction, then the partner may not exclude the cancellation of debt income (*See* Treasury Regulation Section 1.1017-1(g) (2) for general rules and exceptions).

The partnership must consent to the reduction of partner's share of inside basis if:

a. The partner owns (directly or indirectly) more than 80 percent interest in the capital and profits of the partnership, or

a. Five or fewer partners own (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership (See Treasury Regulation Section 1.1017-1(g)(2)(ii)(C)).

XVII. GENERAL RULES FOR FEDERAL RULE DISCHARGE OF INDEBTEDNESS INCLUDING DISCHARGES NOT IN TITLE 11 BANKRUPTCY CASES OR INSOLVENCY

A. General Rules on Recognition of Cancellation of Debt Income

1. Cancellation of Debt Income May Be Recognized Even If the Debt Is Not Actually Cancelled

Cancellation of debt income may be recognized even if the debt is not actually cancelled. A change in the terms of a debt instrument can trigger cancellation of debt income to the debtor or creditor. This result may occur if the debt is either replaced by new debt or the terms of the debt are materially modified.

2. Replacement of Existing Debt

If a debtor replaces an existing debt with new debt, the debtor will be treated as having satisfied the old indebtedness with an amount of money equal to the issue price (determined under Sections 1273 and 1274) of the new debt. Therefore, if the issue price of the new debt is less than the adjusted issue price of the old debt, the debtor will realize cancellation of debt income.

The new debt instrument may also contain original issue discount (OID) that would provide the debtor with interest deductions, however, the deductions will be spread over the term of the debt instrument. Because of the time value of money, the deductions will not fully offset any recognized cancellation of debt income.

3. Significant Modification in the Terms of a Debt Instrument

Treasury Regulations §1.1001 were issued in response to the Supreme Court decision in *Cottage Savings Association v. Commissioner*. The regulations expand the scope of circumstances under which cancellation of debt income may be triggered in a negotiated workout. Under Treasury Regulations §1.1001, any "significant modification" in the terms of a debt instrument will be considered an exchange. A modification of a debt instrument is defined as any alteration in any legal right or obligation of the issuer or holder unless the modification occurs by operation of the original terms of the instrument.

The final regulations state that the following modifications are considered significant:

a. General Rule – A modification is significant only if, based upon all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant;

b. A change in the yield to maturity of more than 25 basis points or 5% of the annual yield of the unmodified instrument.

B. Special Rules on the Discharge Of Indebtedness

1. No Other Insolvency Exception
2. Income Not Realized to Extent of Loss Deductions
3. Adjustments for Unamortized Premium and Discount
4. Acquisition of Indebtedness by Persons Related to Debtor
5. Purchase Money Debt Reduction for Solvent Debtor Treated as a Price Reduction
6. Indebtedness Contributed to Capital
7. Indebtedness Satisfied by Corporate Stock or Partnership Interest
8. Indebtedness Satisfied by Issuance of Debt Instrument
9. Other Rules.

XVIII. FEDERAL CANCELLATION OF DEBT INCOME PROVISIONS ARE APPLIED AT PARTNER LEVEL

A. Applicable Internal Revenue Code Sections 108(a)(b)(c) and (g)

B. Application to Partners

1. When A Debt Modification Causes Cancellation of Debt Income at the Partnership or Partner Levels

A debt modification that does not cause cancellation of debt income at the partnership level nevertheless may give rise to income at the partner level under the following provisions.

The determination of bankruptcy or insolvency and the reduction of tax attributes are made at the partner rather than the partnership level.

Therefore, items of income related to the discharge of debt should be separately stated on the partnership return to allow individual partners to make this determination on their own behalf. IRC Section 108 also allows taxpayers who are not bankrupt or insolvent to elect to exclude income from the discharge of “qualified real property business debt” with regard to debt discharged after December 31, 1992, in tax years ending after that date.

The first question that arises in a partnership setting is whether the discharge of partnership debt results in income. This is determined at the partnership level. While discharge of debt generally produces partnership income, no income arises from the discharge of debt which, if paid, would give rise to a deduction. Nor does income arise from a reduction or discharge of purchase money debt owed by the partnership purchaser to the seller of property if the purchaser is not insolvent and the reduction does not occur as part of a bankruptcy proceeding. Such a discharge is treated as a purchase price adjustment. *Revenue Procedure 92-92 1992-2 CB 505*, states that the IRS will not challenge a partnership's treatment of cancellation of purchase money debt as a purchase price adjustment simply because the partnership is bankrupt or insolvent.

When a partner files bankruptcy and his share of a partnership debt is discharged, there is no income from discharge of indebtedness under IRC Section 61(a)(12). The court ordered debt discharge applies only to that partner and does not reduce or eliminate the partnership's recourse debt. The debt that the partner is discharged from is assumed by the other partners, thereby creating a deemed distribution under IRC Section 752(b) to that partner.

2. Distribution in Excess of Basis – Internal Revenue Code Section 731(a)(1)

A partner's basis in his or her partnership interest includes the partner's share of partnership liabilities. The basis is decreased by any decrease in the partner's share of partnership liabilities, which is treated as a distribution of money. If a partner receives a distribution of money from a partnership (including a deemed distribution under Section 752(b) caused by a reduced share of liabilities) and the amount distributed exceeds the partner's basis in the partnership interest, the partner will recognize gain to the extent of the excess. A constructive cash distribution occurs when debt is paid down, forgiven, or debt is reallocated to another partner pursuant to Section 752 and the Regulations thereunder.

Debt can be reallocated pursuant to Section 752 when it is converted from nonrecourse to recourse, or if it is converted from nonrecourse to partner nonrecourse by virtue of a partner guaranteeing the debt or a lender becoming a partner. Under Section 731(a)(1) the test for determination of gain is to be made immediately before the distribution. However, in *Revenue Ruling 92-97*, the IRS stated that where debt was forgiven in mid-year, the test for debt relief will be made at year end and the earlier distribution will be treated like a partnership draw.

Otherwise income could be triggered twice since the cancellation of indebtedness is not allocated to the partners until year end to increase their tax bases.

3. Minimum Gain Chargebacks Under Internal Revenue Code Section 704(b) and Associated Affect with Internal Revenue Code Section 108(c)

When partners take losses based on nonrecourse liabilities they increase their share of partnership minimum gain. If there is a net decrease in partnership minimum gain for any year, the Treasury Regulations require that the partners be allocated items of gross income as a minimum gain chargeback to reflect such decrease. There are limited exceptions to this minimum gain chargeback, such as (i) where a partner has become personally liable on what was nonrecourse debt, or (2) has contributed money to the partnership to the extent of the reduction or (3) the chargeback would cause a distortion to the economic deal of the parties through its impact on capital accounts. A partner's election under new Section 108(c) to reduce basis beyond his or her share of the partnership's basis of depreciable real property could trigger gain under a minimum gain chargeback.

4. The Determination of the Existence or Amount of Cancellation of Debt Income and the Amount of Sale, Exchange, Gain (Loss) are Both Made at the Partnership Level

The Determination of the Existence or Amount of Cancellation of Debt Income and the Amount of Sale, Exchange, Gain (Loss) are Both Made at the Partnership Level.

5. When Debt Discharge Does Not Result in Cancellation Of Debt Income Under Internal Revenue Code Section 108(e)(2)

If debt is discharged and the payment of the debt would have given the taxpayer a deduction, then the taxpayer does not realize cancellation of debt income under IRC section 108(e)(2). For example, when a cash basis taxpayer's obligation to pay an expense is cancelled no cancellation of debt income is recognized.

6. Purchase Price Reduction Is Not Cancellation Of Debt Income Under Internal Revenue Code Section 108(e)(2)

If seller financed debt is reduced for a solvent taxpayer, the reduction is treated as a purchase price reduction. It is not considered cancellation of debt income. IRC section 108 (e)(5).

7. Partner’s Share of Cancellation of Debt Income and Net Gain (Loss) from the Sale, Exchange or Disposition of Property Separately Stated on PA Schedules RK-1 and NRK-1

Each partner’s distributive share of cancellation of debt income and net gain (loss) from the sale, exchange or disposition of property is separately stated on PA Schedules RK-1 and NRK-1.

8. Taxability of Cancellation of Debt Income and Exception Determined at the Partner Level

Partners must include cancellation of debt income in taxable income unless an exception applies (IRC section 61(a)(12)). The taxability of cancellation of debt income is determined at the partner level (IRC sections 108(d)(6) and 6231(a)(5)).

9. Conditions Apply to Partner Exclusion of Cancellation of Debt Income Under Internal Revenue Code Section 108

A partner may exclude cancellation of debt income under IRC section 108 if-

a. Partner is bankrupt (Title 11 discharge);

b. Partner is insolvent (limited to level of insolvency);

c. Qualified farm indebtedness is cancelled.

C. Amendments to Internal Revenue Code Section 108 by the Bankruptcy Tax Act of 1980

In _Babin_, 6th Cir. 1994, the Sixth Circuit affirmed a Tax Court decision holding that cancellation of debt income not taken into income because of an individual partner's insolvency does not increase the partner's basis in the partnership. The specific issue in _Babin_ was the proper calculation of the partner's basis in his partnership interest pursuant to §705.

"The _Babin_ decision involved a 1978 tax year, which predates amendments to 108 by the Bankruptcy Tax Act of 1980 ("1980 Act"). The Service has concluded that the _Babin_ decision does not apply to partnership transactions commencing after Dec. 31, 1980. The Committee Reports to the 1980 Act specifically address the basis increase issue:

"The bill provides that the rules of exclusion from gross income and reduction of tax attributes in Section 108 of the Code (as amended by the bill) are to be applied at the partner level and not at the partnership level. Accordingly, income from discharge of a partnership debt is not excludable at the partnership level under amended Section 108. Instead, such income is treated as an item of income which is allocated separately to each partner pursuant to Section 702(a) of the Code…

This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (Section 705). At the same time, the reduction in the partner's share of partnership liabilities caused by the debt discharge results in a *deemed distribution* (under Section 752), in turn resulting in a reduction (under Section 733) of the partner's basis in the partnership. The *Section 733 basis reduction, which offsets the section 705 basis increase, is separate from any basis reduction pursuant to the attribute reduction rules of the bill*. [Emphasis added]…

See S. Rep. 96-1035, 96th Cong., 2d Sess. 21 (1980) provides in part:

"Accordingly, for cancellation of partnership debt occurring after Dec. 31, 1980, the amount of cancellation of debt income allocated to a partner, whether solvent or insolvent, will result in an increase in that partner's partnership basis…

Under the facts in this case, cancellation of debt income from the discharge of Partnership's indebtedness was not excludable at the partnership level pursuant to §108(d)(6). Instead, the cancellation of debt income was treated as an item of income that was allocated separately to each partner, including Taxpayer, pursuant to §702(a). This allocation of an amount of cancellation of debt income to each partner, including Taxpayer, resulted in that partner's basis in the partnership being increased by the amount under §705(a)(1)(A). At the same time, the reduction in any partner's share of partnership liabilities caused by the debt discharge resulted in a deemed distribution under §752, which in turn resulted in a reduction of that partner's basis in the partnership under §733. The tax treatment of the cancellation of debt income allocated to each partner, including Taxpayer, depended on that partner's own circumstances, such as insolvency, and should not affect the basis increase under §705(a)(1)(A)."

D. Separate Determination of Income for Each Partner

If a partnership realizes cancellation of debt income, whether such income must be recognized is determined separately for each partner. A bankrupt or insolvent partner would not recognize taxable income currently but would reduce other tax attributes and would have the opportunity to elect to reduce the basis of depreciable property. A partner's interest in depreciable property includes the basis of partnership interests to the extent of the partner's proportionate interest in the partnership depreciable property if there is a corresponding reduction in the partnership's basis in the property with respect to such partner.

A solvent partner would recognize taxable income unless the exclusion for qualified real property business indebtedness (discussed below), the qualified farm indebtedness exception, or the purchase price adjustment exception applies.

Where the debtor is a partnership, the purchase price adjustment is made at the partnership level. Where the partnership is bankrupt or insolvent, but the partners are solvent, the IRS stated in *Revenue Procedure 92-50* that it would not challenge the partnership's use of the purchase price adjustment provided that all of the partners use consistent income tax reporting.

E. Basis Reduction Elections at the Partner Level

Two special partner–level attribute reduction elections are available under IRC Sections 108(b)(5) and 1017. Instead of reducing tax attributes in the order prescribed, the partner that is excluding debt discharge income under the exceptions for bankruptcy, insolvency, or qualified farm indebtedness can elect under IRC Section 108(b)(5) to first reduce the basis of depreciable assets. Debt discharge income in excess of the reduction in basis of depreciable assets is then used to reduce other attributes according to the normal ordering procedure.

This special "basis reduction" election can be beneficial to taxpayers with NOL or credit carryovers that will be utilized in the near future and depreciable property that will be held for the long term. An election can also be made at the partner level under IRC Section 1017 to treat real property inventory as described in IRC Section 1221(1) as depreciable property for purposes of the election to first reduce the basis of depreciable property before reducing other tax attributes.

F. Timing of Partner Attribute Reduction

When a bankrupt or insolvent partner's tax attributes are reduced because of excluded debt discharge income, the required attribute reductions are deemed to occur after determination of the partner's taxable income for the year of discharge. This rule allows the partner to use any NOL, capital loss, or credit carryovers in the year of discharge to offset other taxable income for that year before the carryovers are reduced for debt discharge income occurring in that year. Furthermore, the partner can depreciate or amortize the full tax basis of property in determining taxable income for the year of discharge before reducing tax basis because of excludable debt discharge income in that year. The attribute reductions are deemed to occur on the first day of the tax year after the debt discharge occurs.

Revised Regulation 1.1017-1 indicates that partnership interests are treated as depreciable property if an election is made under IRC Section 108(b)(5) to reduce the basis of depreciable property before reducing other tax attributes or under IRC Section 108(c) for qualified real property indebtedness.

XIX. SPECIAL RULES FOR PA S CORPORATIONS

A. Applicable Federal Internal Revenue Code Sections 108(a)(b)(c) and (g) Statute Applied at the Corporate Level

1. The cancellation of debt of a PA S corporation may cause a PA S corporation to recognize discharge of indebtedness income. However, under Internal Revenue Code (IRC) Section 108, the discharge of some debts is not a taxable event. As discussed previously, Section 108 provides that gross income does not include discharge of indebtedness income occurring in connection with bankruptcy proceedings or with respect to an insolvent taxpayer.

   A PA S corporation’s excluded cancellation of debt income does not pass through. Income from the cancellation of debt of a PA S corporation that is excluded from the PA S corporation’s income because the corporation is bankrupt or insolvent is not a pass through item and does not increase the basis of any shareholder’s stock. See IRC Section 108(d)(7)(A).

   IRC Section 108(d)(7)(A), which denies pass through treatment of such excluded cancellation of debt income, generally applies to discharges of indebtedness after Oct. 11, 2001.

2. A bankrupt or insolvent taxpayer who does not recognize income under IRC Section 108 however, must reduce certain of its tax attributes, such as net operating losses, net operating loss carryovers, credit carryovers, capital loss carryovers and the basis of property he owns. In the Subchapter S context, Section 108(a) and (b) apply at the corporate level. Therefore, the bankruptcy or insolvency of a PA S corporation, not its shareholders triggers the application of Section 108.

3. In addition Section 108(d)(7)(B) provides that any loss suspended under the basis limitation of IRC Section 1366(d)(1) at the shareholder level for the year of the discharge is treated as a net operating loss of the corporation for purposes of Section 108.

4. IRC Section 108(d)(7)(B) limits the treatment of losses suspended under Section 1366(d)(1) as net operating losses to losses disallowed for the taxable year of the discharge. After the tax is determined for the year, the Section 108 attribute reduction rules are applied. This means that suspended losses may be used to reduce income arising during the year of the discharge of debt. Also, losses or deductions suspended under the at-risk, passive loss, or investment interest limitations are not subject to reduction under this rule.

5. Under Section 108(b), the debtor is required to reduce future tax benefits in the following order:

   a. net operating loss carryovers;

   b. general business credits;

   c. capital loss carryovers; and

   d. the basis of the property held by the taxpayer immediately after the discharge, but only to the extent such basis exceeds the taxpayer's remaining liabilities.

   The reduction is dollar-for-dollar of excluded cancellation of indebtedness income for non-credit items. For credit items, the reduction is 33 1/3 cents for each dollar. Section 108(b)(4)(B) provides that net operating losses are reduced first "for the taxable year of the discharge and then in carryovers to such taxable year in the order of the taxable years from which each such carryover arose. Because the treatment of losses suspended under Section 1366(d)(1) as net operating losses under Section 108(b) is limited to losses disallowed for the taxable year of the discharge, those net operating losses are treated as arising in the taxable year of the discharge.

6. Section 108(b)(5) provides that a taxpayer having cancellation of indebtedness income resulting from tax attribute reduction under Section 108(b)(1) may elect under Section 1017, to reduce the depreciable basis of its assets before reducing other tax attributes. One means of avoiding the reduction of losses suspended under Section 1366(d)(1) would be to elect under Section 108(b)(5). Unfortunately, the Section 108(b)(5) election is available only to the corporation, which must elect to reduce the basis of its depreciable assets. Thus, if a shareholder is required to reduce the basis of debt owed to that shareholder by a PA S corporation, that adjustment is ignored when determining a PA S corporation's income from discharge of debt owed to that shareholder.

7. Section 108(e)(6) provides that discharge of corporate debt owed to a shareholder results in gross income to an PA S corporation only to the extent that the face amount of the debt exceeds the shareholder's adjusted basis in the debt. For purposes of applying this rule, Section 108(d)(7)(C) provides that the corporation ignores the reduction in the basis of the debt attributable to the pass-through of an PA S corporation's losses.

8. Section 108(e)(5) provides that a reduction of a purchase money debt owed by an PA S corporation that is solvent and has not filed a bankruptcy petition is a reduction in basis, not cancellation of indebtedness income, if the adjustment is made between the original buyer and seller of the property. The settlement of a liability by a PA S corporation that is on the cash method, or the cancellation of a contested or contingent liability, does not give rise to cancellation of indebtedness income under Section 108.

B. Discharge of Qualified Real Property Indebtedness

Section 108(c) constitutes an exception to the cancellation of indebtedness income inclusion rules. It provides that a taxpayer, other than a C corporation, may elect to exclude from gross income what would otherwise constitute includible cancellation of indebtedness income arising from the discharge of qualified real property business indebtedness (QRPBI). The exclusion is elective and it applies only after the bankruptcy or insolvency exceptions apply.

The exception applies to the discharge of indebtedness secured by real property used in a trade or business. If such indebtedness was incurred after 1992, it must be incurred in the acquiring or refinancing of such property. The cancellation of indebtedness income excluded from income through the operation of the qualified real property business indebtedness rules reduces the basis of the taxpayer's depreciable real property.

Under IRC Section 108(d)(7)(A), the qualified real property business indebtedness rules are applied at the corporate level in the Subchapter S corporation context. This rule has important consequences for the PA S corporation and its shareholders because the income to be excluded cannot exceed the basis of certain depreciable real property and reduces the basis of that property. The amount excludible under this provision may not be more than the excess of the outstanding principal amount of such debt immediately before the discharge over the fair market value immediately before the discharge of the business real property that is security for the debt. For this purpose, the property's fair market value is reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by the property immediately before the discharge. Under Section 108(a)(20), the qualified real property business indebtedness exclusion does not apply to the extent that the taxpayer is insolvent or in bankruptcy under Title 11. The election to exclude income and reduce depreciable basis is available only to a PA S corporation, not is shareholders. Therefore, even if a shareholder had depreciable real property basis outside of the corporation, the shareholder cannot use the depreciable basis to offset such income passed through to him.

Once a PA S corporation has reduced its depreciable real property basis under the qualified real property business indebtedness rules, there would be no reason to reduce losses suspended under Section 1366(d)(1) as a further tax attribute reduction. Section 108(d)(7)(B) explicitly provides that any loss or deduction that is disallowed because it exceeds the shareholders basis in stock and debt is a net operation loss for the tax year of the discharge and is subject to the tax attribute reduction rules.

Most debt is secured by property. If the property is transferred to the lender as part of a loan workout involving recourse debt, the Internal Revenue Service treats the debtor as recognizing gain or loss in an amount equal to the difference between the fair market value of the property transferred and the adjusted basis of the property; if the indebtedness exceeds the fair market value of the property, the debtor recognizes discharge of indebtedness income. If nonrecourse indebtedness is involved, the gain or loss recognized as the transfer of the property to the lender equals the difference between the amount of the debt and the adjusted basis of the property. The Internal Revenue Service also takes the position that the reduction in nonrecourse debt, without relinquishment of the property, results in discharge of indebtedness income. These rules are important because the indebtedness exclusion rules of Section 108(a) only apply with respect to discharge of indebtedness income.

C. PA S Corporation Losses Pass Through to Its Shareholders Even Though It Is In Bankruptcy

A PA S corporation can continue to pass through losses to its shareholders under IRC Section 1374 even though it is in bankruptcy. Section 1374 allows a shareholder in a Subchapter S corporation to deduct his portion of the corporation's net operating loss from his gross income. Section 1374(c) limits the amount of the deduction to the sum of the adjusted basis of the shareholder's stock in the corporation and the adjusted basis of any indebtedness of the corporation to the shareholder. In *Estate of Leavitt*, the Tax Court held that there must be an "economic outlay or a realization of income by the shareholder in order to increase basis in the stock in a Subchapter S corporation." For Section 1374(c) purposes, the term "basis" is defined in Section 1012, which provides that the basis of property shall be the cost of such property. Regulation Section 1.1012-1(a) defines "cost" to mean the amount paid for property in cash or other property.

Thus, the existence of Section 1374 is very important in determining whether or not a shareholder has realized any income in order to increase basis.

D. Debt Cancellation Transaction May Not Produce Cancellation of Debt Income – Relationship of the Parties

Even if a debt is cancelled, the transaction may not produce cancellation of debt income if the transaction may be characterized differently because of the relationship of the parties.

1. Gift - If the parties are related, the transaction may constitute a gift instead of a loan.

2. Compensation - If an employer cancels his employee's debt, the transaction could be re–characterized as compensation. The employer would be responsible for employment taxes and withholding on the amount canceled. The transaction would be viewed as if the employer paid compensation to the employee and then the employee used the compensation to repay the loan.

3. Dividend – Cancellation of a debt owed by a shareholder to its corporation may be treated as a dividend or distribution followed by repayment of the debt by the shareholder.

4. Contribution to Capital – Cancellation of a debt owed by a corporation to its shareholder may be treated as a contribution to capital by the shareholder followed by repayment of the debt by the corporation. The shareholder is treated as contributing to the corporation an amount of money equal to his basis in the indebtedness. Thus, if basis is less than the face amount, the corporation could still recognize cancellation of debt income.

E. Shareholder Basis in PA S Corporation Stock is not Increased

In the case of PA S corporations, some of the rules for excluding discharge of indebtedness income are applied at the corporate level. Corporate-level application affects the rules for reducing tax attributes in Title 11 bankruptcy cases, insolvency cases, and cases where the discharged indebtedness is qualified farm indebtedness or qualified real property business indebtedness. (Code Section 108(d)(7)).

In *Gitilitz*, the Supreme Court held that income from the discharge of indebtedness of a S corporation that is excluded under Section 108(a) increased a shareholder’s basis in his or her stock.

Congress has passed legislation reversing the Supreme Court’s decision in *Gitilitz*. Income from the discharge of indebtedness of a PA S corporation that is excluded from the corporation’s income under Code Section 108(a) is not taken into account as an item of income that flows through to any shareholder under Code Section 1366(a) (Code Section 108(d)(7)(A)). Thus, a shareholder’s basis in PA S corporation stock does not increase and the corporation’s suspended loss does not pass through to the shareholder.

The tax consequences now reflect the economics of the situation and a PA S corporation shareholder will no longer be allowed to deduct a loss that it did not economically incur.

Any loss or deduction that is disallowed because it exceeds the shareholder's basis in stock and indebtedness of the corporation is treated as a net operating loss that is reduced by amounts excluded from gross income arising from the discharge of indebtedness.

If a debt is contributed to a PA S corporation's capital, corporate income does not result to the extent that the basis of the debt has previously been reduced by the pass through of losses from the corporation.

XX. RECOVERY OF TAX BENEFIT ITEMS FOR FEDERAL INCOME TAX

A. Overview of Federal Tax Benefit Rule

Certain items that were deducted in one year may need to be included in income in a later tax year if an event occurs in the later year that is inconsistent with the original grounds for the deduction and makes the deduction improper. The amount that must be included in income is limited to the amount of the tax benefit that resulted from the deduction (Code Sec. 111).

B. Inclusionary Component

The federal tax benefit rule is a judicially developed doctrine that "ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction." (*Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 372 (1983)). It has two components, the inclusionary component and the exclusionary component. (*Hudspeth v. Commissioner*, 914 F.2d 1207, 1212 (9th Cir. 1980), *rev'd* and remanding on another issue T.C. Memo. 1985-628; *Frederick v. Commissioner*, 101 T.C. 35, 40-41 (1993)). The exclusionary component is partially codified in I.R.C. §111(a), but does not become an issue unless, and until, the inclusionary component of the rule is first satisfied. The inclusionary component provides that an amount deducted from gross income in one year is included in income in a subsequent year if an event occurs in the subsequent year that is fundamentally inconsistent with the premise on which the deduction had previously been based.

C. Inclusion in Gross Income

An amount must be included in gross income in the current year if, and to the extent that:

1. the amount was deducted in a year prior to the current year;

2. the deduction resulted in a tax benefit;

3. an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based; and

4. a non–recognition provision of the Internal Revenue Code does not prevent the inclusion in gross income.

A current event is considered fundamentally inconsistent with the premises on which the deduction was originally based when the current event would have foreclosed the deduction if that event had occurred within the year that the deduction was taken.

D. Amounts Previously Deducted

The federal tax benefit rule is not limited to "recoveries", but requires the inclusion of amounts previously deducted if the deductions are inconsistent with later events. As the Supreme Court noted in *Hillsboro National Bank*, "it has long been accepted that a taxpayer using accrual accounting who accrues and deducts an expense in a tax year before it becomes payable and who for some reason eventually does not have to pay the liability must then take into income the amount of the expense earlier deducted."

Revenue Ruling 67-200, 1967-1 C13 15 provides in part: "An accrual basis taxpayer had deducted, but not paid, interest accrued on his indebtedness. On a later forgiveness of the debt, the taxpayer was permitted to exclude the amount of interest forgiven which did not give rise to a tax benefit (Code Sec. 111). That portion not excluded under Code Sec 111 could be excluded under Code Sec. 108 provided the consent to a basis adjustment was filed. However, any portion of the forgiven interest which exceeded the basis to be adjusted was includible in income."

XXI. FEDERAL INCOME TAX TREATMENT – RECOURSE DEBT

A. Property Dispositions

Cancellation of debt income may be realized when property that is security for recourse debt is disposed or sold. If recourse debt cancelled is more than the fair market value/sales price of the property, the difference is treated as cancellation of debt income. If recourse debt is equal or less than the fair market value/sales price of the property, no cancellation of debt income is realized. The difference between the fair market value/sales price and adjusted basis of the property will be treated as gain (loss) on sale or disposition of property (IRC section 1001(a)).

B. Debt Cancellation – Calculation of Gain

1. Property Dispositions

Cancellation of debt income may be realized when property that is security for recourse debt is disposed or sold. If recourse debt cancelled is more than the fair market value/sales price of the property, the difference is treated as cancellation of debt income. If recourse debt is equal or less than the fair market value/sales price of the property, no cancellation of debt income is realized.

2. Example

Calculation

Fair Market Value	$100,000	Debt Owed	$200,000
Recourse Debt	$200,000	Fair Market Value	$(100,000)
Adjusted Basis	$ 75,000	Cancellation of Debt Income	$100,000

Calculation

		Fair Market Value Amount	
		Realized	$100,000
		Adjusted Basis	$ 75,000
		Taxable Gain	$ 25,000

C. Property Retained Debt Reduced

If the debtor retains the property and the creditor reduces debt, cancellation of debt income will be realized.

Recourse Debt Before Cancellation	$200,000
Recourse Debt After Cancellation	$100,000
Cancellation of Debt Income (IRC Section 61(a)(12))	$100,000

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

XXII. FEDERAL TAX TREATMENT – NONRECOURSE DEBT

A. Property Dispositions (Foreclosures, Abandonments, Sales, etc.)

Cancellation of debt income is not realized when property that secures nonrecourse debt is disposed or sold (that is, sale, foreclosure, deed-in-lieu of foreclosure, abandonment, etc.). The nonrecourse obligation is considered the amount realized (that is, sales proceeds) (*Tufts v. Commissioner*, 461 U.S. 300 and IRC section 7701(g)). It does not matter that the fair market value is equal to or less than the amount of the debt.

B. Example, Sale, Foreclosure, or Deed–in–Lieu of Foreclosure

Sales Price of Property	$100,000
Adjusted Basis	$50,000
Nonrecourse Liability	$200,000

Calculation of Gain

Amount Realized (Nonrecourse Debt)	$200,000
Adjusted Basis	$(50,000)
Gain on Sale/Exchange	$150,000

C. Collateral Retained and Nonrecourse Debt Reduced

If the debtor retains the property and the creditor reduces nonrecourse debt, cancellation of debt income will be realized. (*Gershkowitz v. Commissioner*, 88 T.C. 984 (1987) and Rev. Rul. 91-31).

Nonrecourse Debt Before Cancellation	$200,000
Nonrecourse Debt After Cancellation	$100,000
Cancellation of Debt Income (IRC Section 61(a)(12))	$100,000

D. Property Sold and Debt Discharged

The following sequence of events is considered part of one overall sales transaction:

1. Partnership sells a building subject to nonrecourse debt to a third party.

2. The sales proceeds go to the lender.

3. The lender discharges the difference between the debt and the sales proceeds.

4. The lender settles a partner's personal guarantee for a lesser amount.

E. Sale Transaction – Foreclosure of Property

The amount realized will equal the amount of the nonrecourse debt less the amount required to be paid by the guarantor. (*2925 Briarpark, Ltd.*, T.C. Memo. 1997-298, *affd.* 99-1, ¶50,209, (5th Cir.)).

"A foreclosure constitutes a "sale or exchange" for purposes of federal income taxation. (*Helvering v. Hammel* [41-1 USTC ¶9169], 311 U.S. 504 (1941); *Allan v. Commissioner* [Dec. 42,9801], 86 T.C. 655 (1986); *Middleton v. Commissioner* [Dec. 38,124], 77 T.C. 310 (1981), *affd. per curiam* [82-2 USTC ¶9713], 693 F.2d 124 (11th Cir. 1982); *Freeland v. Commissioner* [Dec. 37,1271], 74 T.C. 970 (1980)). The amount realized on such a sale includes the balance of the nonrecourse mortgage debt. (*Crane v. Commissioner* [47-1 USTC ¶9217], 331 U.S. 1 (1947)). That is true even if the nonrecourse mortgage debt exceeds the fair market value of the mortgaged property. (*Commissioner v. Tufts* [83-1 USTC ¶9328], 461 U.S. 300, 317 (1983); *Millar v. Commissioner* [Dec. 34,206], 67 T.C. 656, 600 (1977), *affd.* on this issue [78-2 USTC ¶9514], 577 F.2d 212, 214-216 (3d Cir. 1978); *Woodsam Associates, Inc.* v. Commissioner [Dec. 18,178], 16 T.C. 649, 654-655 (l9xx), *affd.* [52-2 USTC ¶351] (2d (Ar. 1952); *Mendham Corp. v. Commissioner* [Dec. 16,004], 9 T.C. 320, 323-325 (1947))."…

F. Sale Transaction – Transfer of Property

The Courts have held that abandonments and voluntary re-conveyances likewise constitute sales or exchanges. *See* *Middleton v. Commissioner* [Dec. 38,124], 77 T.C. 310 (1981), *affd. per curiam* [82-2 USTC ¶9713], 693 F.2d 124 (11th Cir. 1982); *Freeland v. Commissioner* [Dec. 37,127], 74 T.C. 970 (1980).

G. Insolvency of the Partnership Is Immaterial

It is immaterial whether or not the partnership was or is insolvent, since any determination of insolvency would be made at the partner, not the partnership, level. (*Gershkowitz v. Commissioner* [Dec. 43,857], 88 T.C. 984 (1987); *Slavin v. Commissioner* [Dec. 45,679(M)], T.C. Memo. 1989-221).

CHAPTER 30. PENNSYLVANIA DEPARTMENT OF REVENUE PERSONAL INCOME TAX POLICY GUIDANCE.

CHAPTER 30. Table Of Contents.

I. Personal Income Tax Statement of Policy 2004 – 01 Issued November 9, 2004

DEPLETION. Title 61 Pa. Code Section 125.

1. Section 125.51. Allowance of deduction for cost depletion.

(a) General Rule.

In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing income a reasonable allowance for depletion. In any case which it is ascertained as a result of operations or development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

(b) Recoverable units.

Recoverable units are the number of units (e.g., tons, pounds, ounces or barrels) of minerals, oil or gas in the ground and economically worth extracting, estimated according to the best available information and industry standards.

(c) Special rules.

(i) Leases.

In the case of a lease, the deduction under this section shall be apportioned between the lessor and lessee in accordance with Federal income tax requirements.

(ii) Life tenant and remainderman.

In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

(iii) Property held in trust.

In the case of property held in trust, the deduction under this section shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

(iv) Property held by estate.

In the case of a decedent's estate, the deduction under this section shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

(v) Basis for depletion.

The basis on which depletion is to be allowed in respect of any property shall be the adjusted basis for the purpose of determining the gain upon the sale or other disposition of such property.

2. Section 125.52. Percentage depletion.

The allowance of deductions for percentage depletion is not generally acceptable by standards of the accounting profession and constitutes an unconstitutional item of tax preference under the Pennsylvania Constitution after the cost of recoverable units has been fully recovered. Effective for taxable years beginning on or after January 1, 2005, a deduction for percentage depletion shall be allowed only in the following set of circumstances:

(1) It is allowable as a deduction in computing Federal taxable income;

(2) Insufficient information is available to estimate the amount of recoverable units in accordance with industry standards;

(3) The cost of the recoverable units is fixed and certain;

(4) The cost of the recoverable units has not been fully recovered.

3. Reporting Method.

The Pennsylvania Department of Revenue will develop a schedule to assist taxpayers in computing the appropriate deduction amounts.

II. Personal Income Tax Bulletin 2005 – 01 Issued November 23, 2005

Treatment of Certain Amounts Paid to Section 170(c) Organizations under Certain Employer Leave-Based Donation Programs

In view of the extreme need for charitable relief in the aftermath of Hurricane Katrina, employers may have adopted or may be considering adopting leave-based donation programs to aid victims of this hurricane. Under these programs employees elect to forgo vacation, sick, or personal leave in exchange for cash payments an employer makes to organizations described in §170(c) of the Internal Revenue Code (§170(c) organizations) for the relief of victims of Hurricane Katrina. This Bulletin provides guidance on the treatment of these cash payments for personal income and withholding tax purposes. This guidance is provided in view of the extraordinary damage and destruction caused by Hurricane Katrina and the announcement of the Internal Revenue Service published at Notice 2005-68 I.R.B. 2005-40 (September 8, 2005).

The Department of Revenue joins with the Internal Revenue Service in its support of leave-based donation programs to aid victims of Hurricane Katrina. The Department also will not assert that cash payments an employer makes to §170(c) organizations in exchange for vacation, sick, or personal leave that its employees elect to forgo constitute compensation of the employees if the payments are: (1) made to the §170(c) organizations for the relief of victims of Hurricane Katrina; and (2) paid to the §170(c) organizations before January 1, 2007. Similarly, the Department of Revenue will not assert that the opportunity to make such an election results in constructive receipt of compensation for employees. Moreover, the Department will not assert that an employer is not permitted to deduct these cash payments as an ordinary business expense.

For further information, please contact the Taxpayer Service and Information Center at (717) 787-8201.

III. Personal Income Tax Bulletin 2005 – 02 Issued December 15, 2005

Gain or Loss Derived From The Disposition Of A Going Concern.

1. Section 1. Intangible personal property.

For purposes of this Bulletin, the term “intangible personal property” includes only:

- Good will employed in a going concern,
- Going concern value of assets employed in a going concern,
- Working capital employed in a going concern,
- Workforce in place of a going concern, including its composition and terms and conditions (contractual or otherwise) of its employment,
- Business books and records of a going concern,
- Operating systems or any other information base (including lists or other information with respect to current or prospective customers) used in a going concern,
- Patents, copyrights, formulas, processes, designs, patterns, know-how, format or other similar items employed in a going concern,
- “Customer-based intangibles” as defined at IRC §197(d)(2),
- “Supplier-based intangibles” as defined at IRC §197(d)(3),
- Licenses, permits or other rights granted by a governmental unit or an agency or instrumentality thereof that is employed in a going concern, or
- Covenants not to compete entered into in connection with an acquisition of an interest in a going concern.

The term does not include corporate stock, notes, bonds, debentures or other evidences of indebtedness, interest rate, currency or equity notional principal contracts, foreign currencies or interests (or derivative financial interest instruments) in commodities held solely for investment or to trade for the account of the holder.

2. Section 2. Income from sources within this Commonwealth.

A. The gain derived from a disposition of a proprietary interest in a corporation, investment company or investment partnership, a partner’s interest in a partnership, a member’s interest in a limited liability company, or a shareholder’s share in a Pennsylvania S corporation or business trust does not constitute income from sources within this Commonwealth for a nonresident.

B. Gain from a disposition of a sole proprietor’s proprietary interest in a going concern is earned, received or acquired from sources within this Commonwealth if the gain is attributable to the disposition of—

- Real or tangible personal property sited in this Commonwealth, including inventoriable or operational items.
- Intangible personal property employed in the trade, profession, occupation or

business carried on by the sole proprietor in this Commonwealth.

- Unless the taxpayer uses an accrual method of accounting, accounts or notes receivable from sales of products or services sold in the ordinary course of business operations in this Commonwealth.

3. Section 3. Computation of Income from sources within this Commonwealth.

A. If the nonresident carries on a trade or business, profession, or occupation wholly within Pennsylvania as described in 61 PA Code §109.3, his gain from the disposition of intangible personal property employed therein and receivables from sales of products or services sold in the ordinary course of business operations shall be wholly allocated to this Commonwealth as income from sources within this Commonwealth.

B. If the nonresident carries on a trade or business, profession, or occupation both within and without Pennsylvania, his gain from the disposition of intangible personal property employed therein and receivables from sales of products or services sold in the ordinary course of business operations shall be allocated by multiplying the net gain therefrom by the average of the property, payroll, and sales percentages of the proprietorship determined under 61 PA Code §109.5(c) for the 365-day period preceding the disposition.

C. Gain attributable to real or tangible personal property sited in this Commonwealth is wholly allocable to Pennsylvania, whether or not employed in a trade or business, profession or occupation.

D. If not transferable or not separately dealt with as a separate item in a bona fide sale of a going concern, no gain shall be attributed to goodwill.

E. Gains that represent the incremental value attaching to property as a result of being an integral part of a going concern shall be allocated in the same manner as the affected property.

F. Losses incurred in connection with the disposition of a trade or business carried on entirely outside this Commonwealth shall not be recognized.

G. Losses incurred in connection with the disposition of a trade or business carried on partially within this Commonwealth shall be recognized only in proportion to the average of the property, payroll, and sales percentages of the trade or business as determined under 61 PA Code §109.5(c) for the 365-day period preceding the disposition.

H. Losses incurred in connection with the disposition of a trade or business carried on partially within this Commonwealth in excess of those allowable under paragraph G shall not be recognized.

I. Income from sources within this Commonwealth shall be computed without regard to a member's, partner's or shareholder's distributive share of any loss described in paragraph F or paragraph H.

J. For nonresident estates, trusts or beneficiaries, income from sources within this Commonwealth shall be computed without regard to any loss described in paragraph F or paragraph H.

4. Section 4. Partnerships, PA S corporations, trusts or estates.

A. The gains of a partnership, PA S corporation, trust or estate that is disposing of its proprietary interest in a going concern from sources within this Commonwealth shall be determined in the same manner as the gains of a nonresident individual sole proprietor.

B. For purposes of this bulletin, the term “partnership” includes limited partnerships, limited liability companies, business trusts or any other entities that, for Federal income tax purposes, are classified as a partnership.

5. Section 5. Burden of proof.

A. The burden of proving income is not from sources within this Commonwealth shall be upon the taxpayer.

B. The burden of proving losses or deductions are from sources within this Commonwealth shall be upon the taxpayer.

IV. Personal Income Tax Bulletin 2005 – 03 Issued: October 12, 2005 (Revised: December 22, 2005)

Deferred Compensation Under Nonqualified Plans.

1. Part I. Overview.

(a) Receipt of compensation.

Taxpayers are required to include in the income they report on their tax returns income that is "received" by the taxpayer during the returnable period. The tax accounting rules for determining when income is received and thus must be taken into account for purposes of income tax reporting vary depending upon:

- The method of financial accounting used by the taxpayer.
- Whether overriding rules are set by statute or regulations to operate independently of the taxpayer's financial accounting method.

For example, in the absence of overriding statutory provisions, cash would become reportable as income only when actually received in hand under the cash receipts and disbursements method of financial accounting or when all the events fixing the right to receive it has occurred under the accrual method of financial accounting.

Examples of where the Internal Revenue Code sets overriding rules for determining when income is to be reported that operate independently of the taxpayer's financial accounting method include:

(1) IRC §83 (relating to the inclusion in income of beneficial ownership interests acquired in connection with the performance of services).

(2) IRC §409A (relating to the inclusion in income of deferred compensation under nonqualified deferred compensation plans).

(3) IRC §451 (relating to the general rule for determining the taxable year of inclusion).

(4) IRC §457 (relating to the inclusion in income of deferred compensation under deferred compensation plans of governmental and tax exempt entities.

Each of these Code sections supersedes or overrides any otherwise applicable financial accounting principle or practice relating to the recognition of income. Moreover, where inconsistent, IRC §§409A, and 457 also supersede or override IRC §§83 and 451.

Prior to the enactment of Act 2005-40, the personal income tax had no statutory provisions comparable to these Code sections. Consequently, for personal income tax purposes, there were only a few instances where the determination of when compensation is to be reported operated independently of the taxpayer's financial accounting method. They included instances in which the constructive receipt doctrine, economic benefit doctrine or anticipatory assignment of income doctrine were applicable.

Act 2005-40 incorporates into the personal income tax, where applicable, not only the Federal rules and rulings under IRC §§83 and 451 but also the specific requirements of IRC §§409A and 457 relating to actual or constructive receipt. It, however, also retains some long-standing personal income tax rules relating to the includibility of contributions transferred under a deferred compensation plan for the benefit of the employee to an employees' trust, pooled fund, or other arrangement that is not subject to the claims of creditors of the employer.

(b) Scope of bulletin.

The taxation of nonqualified deferred compensation plan contributions, deferrals, income, and benefits are explained in more detail as outlined below:

- Part II. What constitutes a plan?
- Part III. When is an amount subject to a substantial risk of forfeiture?
- Part IV. What constitutes a long-term deferral of compensation?
- Part V. What is a nonqualified deferred compensation plan?
- Part VI. When are amounts deferred under a nonqualified deferred compensation plan currently includible in income?
- Part VII. Distributions attributable to elective deferrals.
- Part VIII. Accounting Methods.
- Part IX. Pennsylvania withholding rules.

This bulletin applies only to "service providers" as defined in Treasury Regulation §1.409A-1 who are natural persons and use the cash basis method of accounting and are not actively engaged in the trade or business of providing substantial services other than as an employee.

Beyond the scope of this bulletin are retirement benefit plans, arrangements between a partner and a partnership that provide for the deferral of compensation, arrangements between a self-employed individual or director of a corporation and a "service recipient" within the meaning of Treasury Regulation §1.409A-1 that provide for the deferral of compensation, qualified employer plans, employees' welfare benefit plans or vacation leave, sick leave, compensatory time, disability pay, or death benefit plans, IRAs, Roth IRAs, and Coverdell education savings funds, employee stock purchase plans, statutory and non-statutory stock options, stock appreciation rights, and other equity-based compensation and plans for short-term deferrals of compensation. The taxation of contributions, income, and distributions under such arrangements will be explained in future bulletins.

This bulletin supersedes all regulations, instructions, letter rulings, and other published and unpublished statements of policy of the Department of Revenue that are inconsistent herewith.

2. Part II. What constitutes a plan?

Federal rules and rulings shall be determinative of whether an agreement, method or arrangement, including an agreement, method or arrangement that applies to one person, is a plan. Federal rules and rulings shall also be determinative of whether requirements are applied as if:

- A separate plan or plans is/are maintained for each service provider, and
- All compensation deferred with respect to a particular service provider is treated as deferred under a single plan.

3. **Part III. When is an amount subject to a substantial risk of forfeiture?**

Federal rules and rulings shall be determinative of whether compensation is subject to a substantial risk of forfeiture and whether the possibility of forfeiture is substantial.

4. **Part IV. What constitutes a long-term deferral of compensation?**

(a) Deferral of compensation.

Federal rules and rulings shall be determinative of whether a plan provides for the deferral of compensation.

(b) "Long-term" deferrals.

Federal rules and rulings shall be applicable with respect to what constitutes a long-term deferral.

(c) Earnings.

References to the deferral of compensation include references to income (whether actual or notional) attributable to such compensation or such income.

5. **Part V. What is a nonqualified deferred compensation plan?**

(a) In general.

Except as otherwise provided in this part, the term "nonqualified deferred compensation plan" means any plan (within the meaning of Part II) that provides for the long-term deferral of compensation (within the meaning of Part IV). The term does not include qualified employer plans. Accordingly, the term nonqualified deferred compensation plan does not include a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE or §501 (c) (18) trust.

(b) Certain welfare benefits.

The term nonqualified deferred compensation plan does not include any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For these purposes, the term disability pay has the same meaning as provided in §31.3121 (v) (2)-1 (b) (4) (iv) (C) of the Employment Tax Regulations, and the term death benefit plan refers to a plan providing death benefits as defined in §31.3121 (v) (2)-1 (b) (4) (iv) (C). The term nonqualified deferred compensation plan also does not include any Archer Medical Savings Account as described in IRC §220, any Health Savings Account as described in IRC §223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of IRC §§105 and 106.

6. Part VI. When are amounts deferred under a nonqualified deferred compensation plan currently includible in income?

(a) General rule.

In general, Federal rules and rulings shall be determinative of when amounts deferred under a nonqualified deferred compensation plan are currently includible in income. The general rule and the Federal rules relating to trusts and similar arrangements are also applicable for personal income tax purposes as follows:

(1) Effective for taxable years beginning after December 31, 2004, the determination of whether long-term deferred compensation as defined in Part IV is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC §409A applicable thereto as they exist as of the time of their application.

(2) For taxable years 2003 and 2004, the determination of whether long-term deferred compensation as defined in Part IV is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC §§83 and 451 applicable thereto as they exist as of the time of their application.

Taxpayers should note that, although the revisions to the Internal Revenue Code under IRC §409A make significant changes, they do not alter or affect the application of any other provision of the Internal Revenue Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under §409A may nevertheless be required to be included in income under §451, the constructive receipt doctrine, §83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Internal Revenue Code or common law tax doctrine.

(b) Consequences of a failure to satisfy the requirements of §409A.

Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of §409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC §409A(a)(1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.

Note: If a deferred amount is required to be included in Federal taxable income under IRC §409A, the amount also is subject to interest and an additional Federal income tax. No interest or additional income tax is imposed for personal income tax purposes.

(c) Pennsylvania exceptions for certain contributions to an employees' trust, pooled fund, or other arrangement that is not subject to the claims of creditors of the employer.

(1) Contributions made under wage or salary deduction arrangements.

Amounts lawfully deducted and withheld from the compensation of an employee and transferred under a deferred compensation plan for the benefit of the employee to an employees' trust, pooled fund, or other arrangement that is not subject to the claims of creditors of the employer are received by the employee as compensation at the time the deduction is made. This requirement applies whether or not such amounts are subject to a substantial risk of forfeiture or are available or transferable.

(2) Contributions made under cash or deferred arrangements or salary reduction plans.

Contributions under a deferred compensation plan to an employees' trust, pooled fund, or other arrangement which is not subject to the claims of creditors of the employer made by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement are received by the employee as compensation at the time the contribution is made. This requirement applies whether or not such contributions are subject to a substantial risk of forfeiture or are available or transferable and regardless of when the election is made or a payment is received.

(3) A contribution described in (1) or (2) of this Subsection (c) is not deductible in computing the income of the employee.

This rule shall apply whether or not such amounts may be subject to the claims of creditors or to a substantial risk of forfeiture or are transferable. As a consequence, such contributions are deemed to have been contributed by the employee and to constitute a cost of investment.

The rules of IRC §409A apply to nonqualified deferred compensation plans under IRC §457(f) in addition to any requirements already applicable to such plans under IRC §457(f). Eligible plans under IRC §457(b) are not subject to the requirements of IRC §409A. However, grandfathered plans under prior IRC §457 transition rules generally are subject to IRC §409A.

Accordingly, effective for taxable years beginning on or after January 1, 2005, the determination of whether an item of deferred compensation as defined in Part IV is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC §§457(f) and 409A applicable thereto as they exist as of the time of their application. However, for taxable years 2003 and 2004, the determination of whether an item of deferred compensation as defined in Part IV is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC §457(f) applicable thereto as they exist as of the time of their application.

7. Part VII. Distributions attributable to elective deferrals.

(a) Effective for taxable years beginning after December 31, 2002, any part of a distribution received under a deferred compensation plan that is attributable to an elective deferral of income not specifically described in subsection (b) of Part VI or the income on any elective deferral of income shall be included in compensation. This rule shall apply whether or not the distribution is commonly recognized as a retirement benefit and the distributee is retired from service at the time of distribution.

(b) Effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC §409A (a)(1) that is attributable to an elective deferral of income or the income on any elective deferral income shall be included in compensation. This rule shall apply whether or not the distribution is commonly recognized as a retirement benefit and the distributee is retired from service at the time of distribution.

8. Part VIII. Accounting Methods.

(a) General rule for determining the amount of investment.

The amount of investment in an employee deferred compensation plan is the total amount of the plan participant's contributions, whether through payroll deduction, a salary reduction agreement or otherwise, to an employees' trust, pooled fund, or other arrangement that forms a part of the plan and is not subject to the claims of creditors of the employer.

Except as provided in subsection (b) ("Special transitional rule for determining the amount of investment") of Part VIII, none of the following constitute investment in a plan:

- Contributions to an employees' trust, pooled fund, or other arrangement that is subject to the claims of creditors of the employer.
- Unfunded deferred compensation.
- Payments made by employers or labor unions.

(b) Special transitional rule for determining the amount of investment.

Elective deferrals made by employees pursuant to a cash or deferred arrangement or salary reduction agreement under a deferred compensation plan may be considered to have been contributed by the employee and to constitute the employee's cost of investment in the contract, provided one of the following is applicable:

(1) The taxpayer documents that the amount deferred is reported as taxable compensation on the taxpayer's final return for a taxable year beginning in 1999, 2000, 2001, 2002, 2003, or 2004 under this article, and no refund or credit is made on the ground that the amount deferred is not taxable.

(2) The taxpayer documents that the amount deferred was assessed by the Department as unreported taxable compensation for a taxable year beginning in 1999, 2000, 2001, or 2002, the assessed liability was paid, and no reassessment is made on the ground that the amount deferred is not taxable.

Taxpayers who use this special transitional rule must maintain sufficient records to substantiate that deferral amounts were taxed. A copy of the assessment or a letter from the employer that corroborates that deferrals were included on Pennsylvania taxable State Wages on the taxpayer's W-2 and copy of the taxpayer's tax return will be sufficient.

(c) Cost recovery method.

The cost-recovery rule shall be used to determine the amount of a distribution under a deferred compensation plan that shall be recognized as compensation. Under the cost-recovery rule, no income is recognized with respect to distributions until the distributee has enjoyed a full recovery of his investment in a plan. Thus, plan distributions that are not in excess of unrecovered employee contributions to a plan are excludible from tax; and plan distributions in excess of unrecovered employee contributions are taxable as compensation. The amount recognized as compensation is not determined under IRC §72.

9. Part IX. Pennsylvania withholding rules.

(a) Contributions described in Subsection (c) (1) or (2) of Part VI.

Contributions described in Subsection (c) (1) or (2) of Part VI constitute supplemental or other compensation that is subject to withholding. An employer shall determine the tax to be withheld by adding the contributions to the supplemental or other compensation for the current payroll period and multiplying the amount by the rate prescribed in Article III of the TRC.

(b) Distributions.

(1) "Net" Distributions.

Generally, withholding requirements apply only to the taxable portion of a distribution. The taxable portion is the amount, if any, by which the plan distribution exceeds unrecovered employee contributions computed without regard to any deferrals made under the special transitional rules of subsection (b) of Part VIII. For employer withholding tax purposes, elective deferrals shall not be considered employee contributions, and the burden of proof regarding the amount of unrecovered employee contributions shall be on the person having the duty or power to make the payment of the distribution.

(2) The employer has the control, receipt, custody, disposal, and payment of long-term deferred compensation.

Where an employer (or an officer or agent of an employer or another employee of the employer) has the duty or power to make the payment of taxable deferred compensation of the employer's employee, the employer, officer, agent or employee is required to deduct and withhold personal income tax from the deferred compensation. This requirement also applies to early retirement benefit plan distributions.

(3) A fiduciary or other person has the control, receipt, custody, disposal, and payment of long-term deferred compensation.

A fiduciary of a trust or other person who has the duty or power to make payment of long-term deferred compensation is not required to withhold if:

(i) All employer contributions to the trust, for Federal income tax purposes, were currently taxable to the employer's employees ; or

(ii) The fiduciary makes no payments attributable to contributions by the employer that were not previously includible in the income of the employer's employee; or

(iii) The fiduciary pays no amount to an employer's employee that is "wages" for Federal income tax purposes without regard to Internal Revenue Code §3405.

This rule also applies to early retirement benefit plan distributions.

However, withholding on a payment is required if, under Internal Revenue Code §3402 (relating to income tax collected at source), any of the following is applicable:

- o The fiduciary or person is required to withhold Federal income tax from the payment to the employee;
- o The fiduciary or person previously during the quarter in which the payment is made (or a previous quarter of the calendar year of the payment) was required to withhold Federal income tax from another payment to the employee;
- o The fiduciary or person would be required to withhold Federal Income Tax from the payment to the employee were the employee entitled to claim no withholding exemptions; or
- o The fiduciary or person previously during the quarter in which the payment is made (or a previous quarter of the calendar year of the payment) would have been required to withhold Federal income tax from another payment to the employee were the employee entitled to claim no withholding exemptions.

Cross References

The requirements relating to computing withholding of Pennsylvania Personal Income Tax on supplemental or other compensation are set forth in 61 PA Code §113.3 (a) (2).

V. Personal Income Tax Bulletin 2005 – 04 Issued: October 12, 2005

Section 457(b) Eligible Deferred Compensation Plans.

1. Part I. Overview.

(a) Receipt of compensation.

Taxpayers are required to include in the income they report on their tax returns income that is “received” by the taxpayer during the returnable period. The tax accounting rules for determining when income is received and thus must be taken into account for purposes of income tax reporting vary depending upon—

- The method of financial accounting used by the taxpayer.
- Whether overriding rules are set by statute or regulations to operate independently of the taxpayer’s financial accounting method.

For example, in the absence of overriding statutory or regulatory provisions, cash would become reportable as income only when actually received in hand under the cash receipts and disbursements method of financial accounting.

IRC §457 (relating to the inclusion in income of deferred compensation under deferred compensation plans of governmental and tax exempt entities) is an example of where the Internal Revenue Code sets overriding rules for determining when income is to be reported that operate independently of the taxpayer’s financial accounting method. IRC §457 supersedes or overrides any otherwise applicable financial accounting principle or practice relating to the recognition of income. Moreover, where inconsistent, IRC §457 also supersedes or overrides IRC §§83 and 451.

Act 2005-40 incorporates into the personal income tax, where applicable, the specific requirements of IRC §457 relating to actual or constructive receipt. It, however, also retains long-standing personal income tax rules relating to the includability of contributions set aside in a trust.

(b) Scope of bulletin.

The taxation of eligible deferred compensation plan contributions, deferrals, income, and benefits is explained in more detail as outlined below:

- Part II. What is an eligible deferred compensation plan?
- Part III. Annual deferrals under eligible deferred compensation plans.
- Part IV. When are amounts deferred under an eligible deferred compensation plan currently includible in income?
- Part V. Accounting methods.
- Part VI. Pennsylvania withholding rules.

This bulletin applies only to “service providers” as defined in Treasury Regulation §1.409A-1 who are natural persons, use the cash basis method of accounting, and are not actively engaged in the trade or business of providing substantial services other than as an employee. Ineligible deferred compensation plans described in IRC §457(e) are explained in Personal Income Tax Bulletin 2005-3.

Beyond the scope of this bulletin are retirement benefit plans, arrangements between a self-employed individual and a "service recipient" as defined at Treasury Regulation §1.409A-1 that provide for the deferral of compensation, qualified employer plans, employees' welfare benefit plans or vacation leave, sick leave, compensatory time, disability pay, or death benefit plans, IRAs, Roth IRAs, and Coverdell education savings funds, employee stock purchase plans, statutory and non-statutory stock options, stock appreciation rights, and other equity-based compensation, and plans for short-term deferrals of compensation. The taxation of contributions, income, and distributions under such arrangements will be explained in future bulletins.

This bulletin supersedes all instructions, letter rulings, and other published and unpublished statements of policy of the Department of Revenue that are inconsistent herewith.

2. Part II. What is an eligible deferred compensation plan?

(a) Compliance in form and operation.

An eligible deferred compensation plan is a written plan established and maintained by an eligible employer that is maintained, in both form and operation, in accordance with the requirements of Treasury Regulations §§1.457-4 through 1.457-10.

(b) Treatment as single plan.

Federal rules and rulings shall be determinative of whether requirements are applied as if:

- A separate plan or plans is maintained for each employee, and
- All compensation deferred with respect to a particular employee is treated as deferred under a single plan.

3. Part III. Annual deferrals under eligible deferred compensation plans.

(a) General rule.

Except as provided in Subsection (b) of this Part III, Federal rules and rulings shall be determinative of whether annual deferrals are excludable from the personal income of a participant in the year deferred or contributed and are excludable from personal income until paid to the participant in the case of an eligible governmental plan, or until paid or otherwise made available to the participant in the case of an eligible deferred compensation plan of a tax-exempt entity.

(b) Pennsylvania exceptions for contributions set aside in a trust for the exclusive benefit of participants and their beneficiaries.

(1) Contributions made under wage or salary deduction arrangements.

Amounts lawfully deducted and withheld from the compensation of an employee and set aside under an eligible deferred compensation plan in a trust for the exclusive benefit of participants and their beneficiaries are received by the employee as compensation at the time the deduction is made. This requirement applies whether or not such amounts are subject to a substantial risk of forfeiture or are available or transferable.

(2) Contributions made under cash or deferred arrangements or salary reduction plans.

Contributions set aside in a trust for the exclusive benefit of participants and their beneficiaries under an eligible deferred compensation plan that are made by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement are received by the plan participant as compensation at the time the contribution is made. This requirement applies whether or not such contributions are subject to a substantial risk of forfeiture or are available or transferable and regardless of when the election is made or a payment is received.

4. Part IV. When are amounts previously deferred under an eligible deferred compensation plan currently includible in income?

Except as provided in Subsection (b)(1) or (2) of Part III, Federal regulations and rulings under IRC §457 are determinative of whether an amount deferred under an eligible deferred compensation plan from a prior taxable year is includible in the personal income of a participant or beneficiary.

5. Part V. Accounting Methods.

(a) General rule for determining the amount of investment.

A contribution described in Subsection (b)(1) or (2) of Part III is not deductible in computing the income of the employee. This rule shall apply whether or not such amounts may be subject to the claims of creditors or to a substantial risk of forfeiture or are transferable. It shall be considered to have been contributed by the employee and to constitute the employee's cost of investment in the contract.

(b) Cost recovery method.

The cost-recovery rule shall be used to determine the amount of a distribution under an eligible deferred compensation plan that shall be recognized as compensation. Under the cost-recovery rule, no income is recognized with respect to distributions until the distributee has enjoyed a full recovery of his contributions. Distributions in excess of unrecovered employee contributions are taxable as compensation. The amount recognized as compensation is not determined under IRC §72.

6. Part VI. Pennsylvania withholding rules.

(a) Contributions described in Subsection (b)(1) or (2) of Part III.

Contributions described in Subsection (b)(1) or (2) of Part III constitute supplemental or other compensation that is subject to withholding. An employer shall determine the tax to be withheld by adding the contributions to the supplemental or other compensation for the current payroll period and multiplying the amount by the rate prescribed in Article III of the TRC.

(b) Distributions.

(1) "Net" Distributions.

Generally, withholding requirements apply only to the taxable portion of a distribution. The taxable portion is the amount, if any, by which the distribution exceeds unrecovered employee contributions. For employer withholding tax purposes, the burden of proof regarding the amount of unrecovered employee contributions shall be on the person having the duty or power to make the payment of the distribution.

(2) The employer has the control, receipt, custody, disposal or payment.

(i) Except as provided in Subsection (b)(2)(ii) of this Part or Subsection (a) of this Part, remuneration paid under or to an eligible deferred compensation plan which, at the time of such payment, is a plan described in IRC §457(b) which is maintained by an eligible employer described in IRC §457(e)(1)(A) is not subject to withholding tax.

(ii) Withholding on compensation paid by an employer under an eligible deferred compensation plan is required if, under Internal Revenue Code §3402 (relating to income tax collected at source), –

(A) The employer during the quarter in which the payment is made (or a previous quarter of the same calendar year) was required to withhold Federal income tax from another payment to the employee; or

(B) The employer during the quarter in which the payment is made (or a previous quarter of the same calendar year) would have been required to withhold Federal income tax from another payment to the employee were the employee entitled to claim no withholding exemptions.

(3) A fiduciary or other person has the control, receipt, custody, disposal, and payment.

A fiduciary of a trust is not required to withhold if the fiduciary pays no amount to an employer's employee that is "wages" for Federal income tax purposes without regard to Internal Revenue Code §3405. This rule also applies to early retirement benefit plan distributions.

(c) Rolled-over employee contributions.

For withholding and reporting purposes, if there has been a roll-over into an eligible deferred compensation plan from another plan, --

(1) The payor shall treat rollover distributions as not being attributable to amounts contributed to the other plan by the plan participant, and

(2) The plan participant has the burden of proof respecting the amounts contributed to the other plan by the plan participant.

Cross References

The requirements relating to computing withholding of Pennsylvania Personal Income Tax on supplemental or other compensation are set forth in 61 PA Code §113.3(a)(2).

VI. Personal Income Tax Bulletin 2005 – 05 Issued: November 07, 2005 (Revised: December 08, 2005)

Qualified Employer Plans

[Editorial Note: Changes from the PIT Bulletin 2005-05 Issued November 07, 2005 are in **BOLD**.]

1. Part I. Overview.

(a) Receipt of compensation.

Taxpayers are required to include in the income they report on their tax returns income that is "received" by the taxpayer during the returnable period. The tax accounting rules for determining when income is received and thus must be taken into account for purposes of income tax reporting vary depending upon:

- The method of financial accounting used by the taxpayer.
- Whether overriding rules are set by statute or regulations to operate independently of the taxpayer's financial accounting method.

For example, in the absence of overriding statutory provisions, cash would become reportable as income only when actually received in hand under the cash receipts and disbursements method of financial accounting or when all the events fixing the right to receive it has occurred under the accrual method of financial accounting.

Examples of where the Internal Revenue Code sets overriding rules for determining when income is to be reported that operate independently of the taxpayer's financial accounting method include:

(1) IRC §83 (relating to the inclusion in income of beneficial ownership interests acquired in connection with the performance of services).

(2) IRC §402 (relating to the taxability of a beneficiary of an employees' trust).

(3) IRC §403 (relating to the taxation of employee annuities).

(4) IRC §408 (k) (relating to SEPs).

(5) IRC §408 (p) (relating to SIMPLE plans).

(6) IRC §409A (relating to the inclusion in income of deferred compensation under nonqualified deferred compensation plans).

(7) IRC §451 (relating to the general rule for determining the taxable year of inclusion).

(8) IRC §457 (relating to the inclusion in income of deferred compensation under deferred compensation plans of governmental and tax exempt entities).

Each of these Code sections supersedes or overrides any otherwise applicable financial accounting principle or practice relating to the recognition of income. Moreover, where inconsistent, they also supersede or override IRC §§83 and 451.

Prior to the enactment of Act 2005-40, the personal income tax had no statutory provisions comparable to these Code sections. Consequently, for personal income tax purposes, there were only a few instances where the determination of when compensation is to be reported operated independently of the taxpayer's financial accounting method. They included instances in which the constructive receipt doctrine, economic benefit doctrine or anticipatory assignment of income doctrine are applicable.

Act 2005-40 incorporates into the personal income tax, where applicable, not only the Federal rules and rulings under IRC §§83 and 451 but also the specific requirements of IRC §§409A and 457 relating to actual or constructive receipt. Act 2005-40 also, however:

- Explicitly retains long-standing personal income tax rules relating to the includability of contributions transferred under a qualified or nonqualified employer plan for the benefit of the employee to an employees' trust, pooled fund, or other arrangement that is not subject to the claims of creditors of the employer, and

- Does not explicitly incorporate the specific requirements of IRC §§83, 402, 403, 408 or 451 relating to when amounts deferred under qualified employer plans are currently includible in income.

Consequently, Act 2005-40 did not change the Pennsylvania tax treatment of employee contributions to qualified employer plans. The purpose of this bulletin is to explain the long-standing Pennsylvania rules relating to such contributions.

(b) Scope of bulletin.

The taxation of qualified employer plan contributions, income, and benefits are explained in more detail as outlined below:

- Part II. What constitutes a qualified employer plan?

- Part III. When are amounts deferred under a qualified employer plan currently includible in income?

- Part IV. Accounting Methods.

- Part V. Pennsylvania withholding rules.

- Part VI. Reporting requirements.

This bulletin applies only to "service providers" as defined in Treasury Regulation §1.409A-1 who are natural persons and use the cash basis method of accounting and are not actively engaged in the trade or business of providing substantial services other than as an employee. Nonqualified and ineligible deferred compensation plans are explained in PIT Bulletin 2005-03, and eligible deferred compensation plans (within the meaning of IRC §457 (b)) are explained in PIT Bulletin 2005-04.

Beyond the scope of this bulletin are retirement benefit plans, arrangements between a partner and a partnership that provide for the deferral of compensation, arrangements between a self-employed individual or director of a corporation and a "service recipient" as defined in Treasury Regulation §1.409A-1 that provide for the deferral of compensation, governmental pension plans, qualified governmental excess benefit arrangements described in IRC §415 (m), employees' welfare benefit plans or vacation leave, sick leave, compensatory time, disability pay, or death benefit plans, IRAs, Roth IRAs, Roth qualified contribution programs, and Coverdell education savings funds, employee stock purchase plans, statutory and non-statutory stock options, stock appreciation rights, and other equity-based compensation, and plans for short-term deferrals of compensation. The taxation of contributions, income, and distributions under such arrangements will be explained in future bulletins.

This bulletin supersedes all regulations, instructions, letter rulings, and other published and unpublished statements of policy of the Department of Revenue that are inconsistent herewith.

2. Part II. What constitutes a qualified employer plan?

(a) Qualified employer plan.

Federal rules and rulings under subparagraph (A) of IRC §409A (d) (2) and subparagraphs (A) and (B) of IRC §219 (g) (5) shall be determinative of what constitutes a qualified employer plan for purposes of this bulletin. Under current Federal rules, a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE plan or §501 (c) (18) trust constitute a qualified employer plan.

(b) Certain welfare benefits.

The term qualified employer plan does not include any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For these purposes, the term disability pay has the same meaning as provided in §31.3121 (v) (2) - 1 (b) (4) (iv) (C) of the Employment Tax Regulations, and the term death benefit plan refers to a plan providing death benefits as defined in §31.3121 (v) (2) - 1 (b) (4) (iv) (C). The term nonqualified deferred compensation plan also does not include any Archer Medical Savings Account as described in IRC §220, any Health Savings Account as described in IRC §223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of IRC §§105 and 106.

(c) Federal rules and rulings shall also be determinative of whether requirements are applied as if:

- A separate plan or plans is maintained for each service provider, and
- All compensation deferred with respect to a particular service provider is treated as deferred under a single plan.

(d) Special Rule for Qualified Roth contribution.

A plan shall not be disqualified as a qualified employer plan **solely** by reason of including a qualified Roth contribution program. The included qualified Roth contribution program and the qualified employer plan in which it is included shall be treated as separate plans.

3. Part III. When are amounts deferred under a qualified employer plan currently includible in income?

(a) General rule.

The provisions of 61 PA Code §101.6 (c) (8) shall be determinative of when amounts deferred under a qualified employer plan are currently includible in income. Federal rules and rulings under IRC §§83, 402, 403, 408, and 451 shall be disregarded.

(b) Employee contributions.

An employee's income shall not be reduced for any contribution to a qualified employer plan made directly by the employee.

(c) Contributions made under wage or salary deduction arrangements.

Amounts lawfully deducted and withheld from the compensation of an employee and transferred under a deferred compensation plan for the benefit of the employee to an employees' trust, pooled fund, or other arrangement that is not subject to the claims of creditors of the employer are received by the employee as compensation at the time the deduction is made. This requirement applies whether or not such amounts are subject to a substantial risk of forfeiture or are available.

(d) Contributions made under cash or deferred arrangements or salary reduction plans.

Contributions under a deferred compensation plan to an employees' trust, pooled fund or other arrangement which is not subject to the claims of creditors of the employer made by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement are received by the employee as compensation at the time the contribution is made. This requirement applies whether or not such contributions are subject to a substantial risk of forfeiture or are available or transferable and regardless of when the election is made or a payment is received.

(e) Undistributed contributions and earnings.

Undistributed contributions and income are not includable in income even if made available to a distributee. Amounts deferred under a qualified employer plan are currently includible in income only when actually distributed to a distributee.

4. Part IV. Accounting Methods.

(a) General rule for determining the amount of investment.

A contribution described in Subsections (b), (c) or (d) of Part III is not deductible in computing the income of the employee. This rule shall apply whether or not such amounts may be subject to a substantial risk of forfeiture or are transferable. It shall be considered to have been contributed by the employee and to constitute the employee's cost of investment in the contract.

(b) Cost-recovery method.

The cost-recovery rule shall be used to determine the amount of a distribution under a deferred compensation plan that shall be recognized as compensation. Under the cost-recovery rule, no income is recognized with respect to distributions until the distributee has enjoyed a full recovery of his contributions. Distributions in excess of unrecovered employee contributions are taxable as compensation. The amount recognized as compensation is not determined under IRC §72.

5. Part V. Pennsylvania withholding rules.

(a) Contributions described in Subsection (c) or (d) of Part III.

Contributions described in Subsection (c) or (d) of Part III constitute supplemental or other compensation that is subject to withholding. An employer shall determine the tax to be withheld by adding the contributions to the supplemental or other compensation for the current payroll period and multiplying the amount by the rate prescribed in Article III of the TRC.

(b) Distributions.

(1) "Net" Distributions.

Generally, withholding requirements apply only to the taxable portion of a distribution. The taxable portion is the amount, if any, by which the distribution exceeds unrecovered employee contributions. For employer withholding tax purposes, the burden of proof regarding the amount of unrecovered employee contributions shall be on the person having the duty or power to make the payment of the distribution.

(2) The employer has the control, receipt, custody, disposal or payment.

(i) Except as provided in Subsection (b) (2) (ii) of this Part or Subsection (a) of this Part, remuneration paid under or to a qualified employer plan is not subject to withholding tax.

(ii) Withholding on compensation paid by an employer under a qualified employer plan is required if, under Internal Revenue Code §3402 (relating to income tax collected at source):

(A) The employer during the quarter in which the payment is made (or a previous quarter of the same calendar year) was required to withhold Federal income tax from another payment to the employee; or

(B) The employer during the quarter in which the payment is made (or a previous quarter of the same calendar year) would have been required to withhold Federal income tax from another payment to the employee were the employee entitled to claim no withholding exemptions.

(3) A fiduciary or other person has the control, receipt, custody, disposal, and payment.

A fiduciary of a trust is not required to withhold if the fiduciary pays no amount to an employer's employee that is "wages" for Federal income tax purposes without regard to Internal Revenue Code §3405. This rule also applies to early retirement benefit plan distributions.

(c) Rolled-over employee contributions.

For withholding and reporting purposes, if there has been a roll-over into an eligible deferred compensation plan from another plan:

(1) The payor shall treat rollover distributions as not being attributable to amounts contributed to the other plan by the plan participant, and

(2) The plan participant has the burden of proof respecting the amounts contributed to the other plan by the plan participant.

Cross References

The requirements relating to computing withholding of Pennsylvania Personal Income Tax on supplemental or other compensation are set forth in 61 PA Code §113.3 (a) (2).

6. Part VI. Reporting requirements.

Reporting requirements for persons making distributions to distributees out of qualified employer plans are set forth in 61 PA Code §117.18.