Chapter 1

Personal Income Tax

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ALERT!	Effective for tax year 2023 and thereafter, payments originating from federal or state government, Norfolk Southern Railway, or an agent thereof, received as a result of the East Palestine, Ohio train derailment that occurred February 3, 2023, are not considered taxable income for PIT purposes. These payments need not be reported on a taxpayer's PA-40 annual tax return. See Act 56 of 2024.

1-1 OVERVIEW

The Pennsylvania Personal Income Tax (PIT) is imposed at a flat rate of 3.07 percent. [72 P.S. §7302(a)]. With regard to tax base, Pennsylvania is one of the few states that does not look to federal taxable income for purposes of the PIT, but instead imposes the tax only on eight separate statutorily defined classes of income. [72 P.S. §7303(a)]. These eight classes of income are as follows:

(1) Compensation;

(2) Net profits;

(3) Net gains or income from disposition of property;

(4) Net gains or income derived from or in the form of rents, royalties, patents, and copyrights;

(5) Dividends;

(6) Interest;

(7) Net gambling and lottery winnings (other than noncash Pennsylvania Lottery winnings); and

(8) Net gains or income derived through estates or trusts.

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Except for a few narrowly defined reductions to compensation, the tax is applicable to gross income (e.g., gross compensation, gross interest income, and gross dividends).

"Taxpayers" for PIT purposes include resident and nonresident individuals, taxable estates or trusts, any partnership with a partner subject to the PIT, any Pennsylvania S corporation with a shareholder subject to the PIT, business trusts, and limited liability companies not taxed as corporations for federal purposes. In general, residents are taxed on all income categorized under the eight enumerated taxable classes, whereas nonresidents are taxed only on income from Pennsylvania sources.

Federal personal income tax principles (i.e., the Internal Revenue Code, treasury regulations, case law, administrative pronouncements, etc.), govern *only in part* for purposes of application of the Pennsylvania PIT. The PIT conforms to the Internal Revenue Code, however, only as amended to January 1, 1997. [72 P.S. §7301]. Thus, for example, Pennsylvania does not conform to the federal bonus depreciation rules enacted after January 1, 1997. One area of conformity, however, is that a taxpayer's federal tax year defines his or her Pennsylvania tax year. [72 P.S. §7301(v)].

Pennsylvania taxable income is determined on the basis of how the taxpayer keeps his or her books and records, rather than federal income tax accounting principles and methods. Further, Pennsylvania does not allow standard deductions, itemized deductions, or personal exemptions.

In computing income, a taxpayer shall use the method of accounting that he or she regularly uses to compute income in keeping his or her books. For some taxpayers, their method of accounting may not necessarily be in accordance with generally accepted accounting principles (GAAP). If the Department determines that no method has been regularly used, or if the method used does not clearly reflect income, the computation of income must be made under a method that clearly reflects income according to the Department. [72 P.S. §7303(a.1)].

Note: Taxpayers have successfully used tax accounting methods (as opposed to financial) in appeals before the Board of Finance and Revenue.

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1-2 IMPOSITION

The Pennsylvania legislature enacted the Pennsylvania Personal Income Tax in 1971 as part of the Tax Reform Code of 1971. [Act of March 4, 1971, P.L. 6, No. 2, Part III, as amended by the Act of August 31, 1971, P.L. 372, No. 93, Article III]. As amended, the Tax Reform Code remains the statutory authority for the Pennsylvania Personal Income Tax. Certain administrative provisions pertaining to the personal income tax are part of The Fiscal Code. Title 61 of the Pennsylvania Code contains all personal income tax regulations.

1-2:1 Parties Subject to Tax.

In general, any Pennsylvania resident is subject to tax as well as any non-resident of the state with income from Pennsylvania sources. Specifically, resident individuals, estates, and trusts are taxed on their worldwide income; nonresident individuals, estates, and trusts are subject to tax only on Pennsylvania-source income. Individuals are natural persons, including members of partnerships and associations. An association is "any form of unincorporated enterprise" subject to tax other than a partnership. [72 P.S. §7301(b)]. The term "trust" (resident or nonresident) does not include charitable trusts or pension or profit sharing trusts. [72 P.S. §7301(n), (s)].

1-2:2 Resident.

Pennsylvania residents are taxed on their worldwide income. For Pennsylvania purposes, residence is not the same as domicile. Pennsylvania defines a "resident" in two ways:

- Domiciled in Pennsylvania – An individual domiciled in Pennsylvania, unless: (1) the individual does not maintain a permanent place of abode in Pennsylvania; (2) the individual *does* maintain a permanent place of abode *outside* Pennsylvania; and (3) the individual spends, in the aggregate, not more than 30 days of the taxable year in Pennsylvania.
- The "Day" Test – An individual who is not domiciled in Pennsylvania but maintains a permanent

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place of abode in Pennsylvania and spends, in the aggregate, more than 183 days of the taxable year in Pennsylvania. [72 P.S. §7301(p)].

1-2:3 Domicile.

Domicile and permanent place of abode do not mean the same thing. A domicile is the place that an individual intends to be his or her permanent home, and to which he or she intends to return whenever absent. A permanent place of abode, on the other hand, is merely a dwelling place. [61 Pa. Code §101.1]. A taxpayer may only have one domicile at any given time. If someone has two or more homes, his or her domicile is the one that he or she regards and uses as his or her permanent home. [61 Pa. Code §101.3(d)].

Once established, the domicile of a taxpayer does not change until the taxpayer moves to a new location with the valid intention of making it a permanent home. It is a taxpayer's intention of maintaining a permanent place of abode that determines domicile. [61 Pa. Code §101.3(b)].

To qualify as a permanent place of abode, the dwelling must be used on a regular basis. For example, a vacation home does not qualify as a permanent place of abode. [61 Pa. Code §101.1]. If a member of the armed services lives on a military installation or in assigned or rented government quarters, he or she is not considered to maintain a permanent place of abode. However, a member of the armed forces who leases, rents, or buys a dwelling place near his or her duty station and occupies it with his or her family generally is considered to maintain a permanent place of abode if the duty assignment is of an indefinite nature. [61 Pa. Code §121.12(b)].

It is possible for a person to be a resident for some purposes, like voting, while not for personal income tax purposes.

"Domicile" for PIT purposes is not dependent upon citizenship. For example, an immigrant to the United States who has permanently established his home in Pennsylvania is domiciled in Pennsylvania for PIT purposes regardless of his citizenship status. [61 Pa. Code §101.3(c)].

In *Hvizdak v. Commonwealth*, 50 A.3d 788 (Pa. Commw. Ct. 2012), the Commonwealth Court addressed whether a taxpayer was considered a Pennsylvania nonresident in 2004. The taxpayer claimed that he was a Pennsylvania nonresident in 2004 because he

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was not domiciled in Pennsylvania and did not spend more than 183 days of the year in Pennsylvania. Rather, the taxpayer argued that he was domiciled in Florida in 2004, as evidenced by holding a Florida driver's license, registering to vote in Florida, and receiving mail at his Florida residence. However, the taxpayer's wife resided in Pennsylvania—with their children—throughout 2004. Further, the taxpayer provided the entire support for his wife and children. Accordingly, the court held that Pennsylvania was his domicile for 2004. Because the taxpayer maintained a permanent place of abode in Pennsylvania during the tax year, the taxpayer was properly considered a Pennsylvania resident for personal income tax purposes.

1-2:4 Nonresident.

An individual is a nonresident if he or she is not a resident pursuant to the test described above. A nonresident estate or trust is one that is not a resident estate or trust. [72 P.S. §7301(m), (n)]. Nonresidents are taxed at the same flat rate and on the same eight classes of income as residents. However, nonresidents are taxed only on "income from sources within [Pennsylvania]." The statute defines "income from sources within" Pennsylvania for a nonresident to mean the "same as compensation, net profits, gains, dividends, interest or income enumerated and classified under Section [7303]." [72 P.S. §7301(k)]. The statute describes five ways that income for a nonresident can be considered Pennsylvania-source income:

- By reason of ownership or disposition of any interest in real or tangible property in Pennsylvania;
- In connection with a trade, profession, or occupation carried on in Pennsylvania or from the rendition of personal services in Pennsylvania (e.g., compensation earned as an employee);
- As a distributive share of the income of an unincorporated business, Pennsylvania S corporation, profession, enterprise, undertaking, or other activity as a result of work done or services rendered in Pennsylvania;

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- From intangible personal property employed in a trade, profession, occupation, or business carried on in Pennsylvania; and
- As gambling and lottery winnings by reason of a wager placed in Pennsylvania, the conduct of a game of chance or other gambling activity located in Pennsylvania or the redemption of a lottery prize from a lottery conducted in this Commonwealth, other than noncash prizes of the Pennsylvania State Lottery. [72 P.S. §7301(k)].

If property is located in Pennsylvania, gain derived by a nonresident from the disposition in Pennsylvania is sourced to Pennsylvania. The Commonwealth Court specifically held that such an imposition does not violate the Commerce Clause of the U.S. Constitution because such activity has "substantial, if not exclusive, nexus to Pennsylvania." [*See, e.g.*, *Andrews v. Commonwealth*, 196 A.3d 1090 (Pa. Commw. Ct. 2018)].

In general, Pennsylvania does not tax interest or dividends received by nonresidents. However, if intangible personal property is used in a trade or business in Pennsylvania, the resulting income, including interest, can be classified as Pennsylvania-source income according to the Pennsylvania Department of Revenue. A special rule applies to certain investment companies. Specifically, income from an investment company registered with the Federal Securities and Exchange Commission is not Pennsylvania-source income. [72 P.S. §7301(k)].

1-2:5 Part-year Residents.

A part-year resident is one who changes his or her residence during the taxable year from a place outside Pennsylvania to Pennsylvania with the intent of residing permanently in Pennsylvania or from Pennsylvania to a place outside Pennsylvania with the intent of residing permanently outside Pennsylvania. [61 Pa. Code §121.7]. A part-year resident is subject to the Pennsylvania Personal Income Tax in two capacities: (1) as a resident for the part of the year domiciled in Pennsylvania, and (2) as a nonresident for the part of the year domiciled outside Pennsylvania. [61 Pa. Code §121.8]. A part-year resident follows two sets of rules but files only one PA-40 return.

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In *Lust v. Commonwealth*, 2015 Pa. Commw. Unpub. LEXIS 911 (Dec. 17, 2015) (unreported), the taxpayers filed an initial Pennsylvania personal income tax return for tax year 2005 listing New Jersey as their current place of residence, and designating themselves as part-year Pennsylvania residents for the period from January 1, 2005 through October 5, 2005. Nearly three (3) years later, the taxpayers filed an amended return claiming that they did not reside in Pennsylvania at any time during 2005 and requested a refund of all 2005 Pennsylvania taxes paid. The Department of Revenue and Board of Finance and Revenue denied the claim, and a panel of the Commonwealth Court upheld the denial. The court held that the burden of proof was upon the taxpayers to prove that they were not residents of Pennsylvania during 2005. The court determined that statements contradicting the information given on the return, and a self-made calendar were insufficient to meet the burden of proving that they did not reside in Pennsylvania during 2005. Additionally, the 2004 Pennsylvania and New York returns filed on August 15, 2015 listed the taxpayers' address as Pittsburgh, Pennsylvania; the taxpayers claimed part-year Pennsylvania residency on both their Pennsylvania and New York tax returns for 2005; the husband still held a Pennsylvania driver's license during 2005; documents for the purchase of a home in New Jersey filed during 2005 listed Pittsburgh as the husband's home address; and a letter sent to the Department of Revenue by the taxpayer's accountant during 2006 unambiguously informed the Department of Revenue that the husband was domiciled in Pennsylvania until October of 2005. Therefore, the court upheld the denial of refund.

1-2:6 Estates and Trusts.

A "resident estate" means the estate of a decedent who at the time of death was a resident individual. [72 P.S. §7301(r)]. A "resident trust" is defined as: (1) a trust created by the will of a decedent who was a Pennsylvania resident at time of death; or (2) any trust created by, or consisting in whole or in part of property transferred to a trust by a person who at the time of such creation or transfer was a resident. A "resident trust" does not include charitable trusts or pension or profit sharing trusts. [72 P.S. §7301(s)].

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In *Robert L. McNeil Jr. Trust v. Commonwealth*, 67 A.3d 185 (Pa. Commw. Ct. 2013), the Department of Revenue assessed PIT upon the income of two (2) inter vivos trusts, which were located in, administered in, and governed by the laws of Delaware and which had no Pennsylvania income or assets during the years at issue. The Department assessed PIT because the trusts' settlor resided in Pennsylvania when he established the trusts during 1959 and the trusts' discretionary beneficiaries were Pennsylvania residents. Citing the United States Supreme Court's decision in *Complete Auto Transit v. Brady*, 430, U.S. 274 (1977), the Commonwealth Court held that imposition of PIT upon the trusts violated the Federal Commerce Clause because the settlor's and discretionary beneficiaries' residency in Pennsylvania lacked substantial nexus to Pennsylvania, was not fairly apportioned and was not related to benefits Pennsylvania provides to the trusts.

Subsequently, the United States Supreme Court reached a similar conclusion in *North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213 (2019), holding that, based upon the Due Process Clause of the United States Constitution, a state cannot tax the undistributed income of a trust when the only connection between the trust and the taxing state is the residency of its beneficiaries.

1-2:7 Grantor Trusts.

The personal income tax statute does not incorporate the federal grantor trust provisions. For personal income tax purposes, trusts are classified as either revocable or irrevocable. With respect to a trust which, under its governing instrument and applicable state law, is revocable, the settler shall be deemed to be the recipient of the income or gains of the trust. [61 Pa. Code §105.1]. An irrevocable trust is treated as a trust for personal income tax purposes. As this question from the 2012 PICPA Questions for the Pennsylvania Department of Revenue (June 19, 2012) illustrates, the difference in treatment of grantor trusts for federal and Pennsylvania tax purposes may impact the availability of the resident credit for taxes paid to other states.

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> ***Question:***
>
> Would the Department allow a credit on the PA-41 for a federal grantor trust for nonresident taxes paid to another state by the individual who is the grantor? In this instance, the Pennsylvania taxpayer is the trust for resident state income tax purposes, but the individual grantor is the taxpayer on the same income that is taxable as nonresident source income in another state.
>
> ***Answer:***
>
> A resident credit would not be allowed in this instance. There are two different taxpayers in this example.

In instances where the settlor of a grantor trust erroneously includes the income of an irrevocable grantor trust on his personal income tax return, the irrevocable trust will need to file a PA-41 to report the income of the trust and the settlor will need to file an amended PA-40 that does not include the grantor trust's income.

1-2:8 Allocation of Nonresident Income.

If a nonresident taxpayer receives income from sources both within and outside of Pennsylvania, the taxpayer must allocate the appropriate portion of income to Pennsylvania and pay Pennsylvania Personal Income Tax on that portion of total income. The taxpayer is required to allocate income to Pennsylvania under rules prescribed in the Department of Revenue's regulations. [72 P.S. §7310]. A nonresident partner's share of Pennsylvania income from a partnership that conducts activities in Pennsylvania as well as other states is determined at the partnership level, regardless of whether the partner performed services in Pennsylvania or outside Pennsylvania. Even if the partner performed no services in Pennsylvania, his or her partnership income will include some Pennsylvania income if the partnership had Pennsylvania income. [61 Pa. Code §107.2].

Nonresidents are required to allocate compensation to Pennsylvania in proportion to days worked in Pennsylvania in the same manner used for withholding purposes. In regard to withholding, the earnings of a salesman or other individual whose compensation is a function of the volume of business transacted by the employee are apportioned by a fraction based on the volume of

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business transacted in Pennsylvania, rather than by working days in Pennsylvania.

1-2:9 Administration.

The Pennsylvania Department of Revenue administers and collects the personal income tax.

1-3 TAX BASE, EXCLUSIONS AND EXEMPTIONS

1-3:1 Income Defined.

The Pennsylvania Personal Income Tax is levied on "the privilege of receiving" each of eight statutorily defined classes of income. [72 P.S. §7302(a)]. There is no mention of gross income, adjusted gross income or taxable income in the Tax Reform Code. The Pennsylvania system provides for neither deductions nor exemptions, and has no distinction between gross income, adjusted gross income, or taxable income. The Pennsylvania Personal Income Tax forms and regulations use the phrase "taxable income" to refer to the total base to which the tax rate is to be applied, and in practice the term "deduction" is used to refer to items of expense that are not included in the statutory definition of income.

1-3:2 Income Subject to Tax.

As discussed in the Overview section, Pennsylvania does not look to federal taxable income for purposes of the PIT, but instead imposes the tax only on eight separate classes of income. [72 P.S. §7303(a)]. These eight classes of income are as follows:

(1) Compensation;

(2) Net profits;

(3) Net gains or income from disposition of property;

(4) Net gains or income derived from or in the form of rents, royalties, patents, and copyrights;

(5) Dividends;

(6) Interest;

(7) Net gambling and lottery winnings (other than noncash Pennsylvania Lottery winnings); and

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(8) Net gains or income derived through estates or trusts.

1-3:3 Taxable Income Defined – Federal vs. Pennsylvania.

For federal income tax purposes, income is taxable "from whatever source derived." [*See* I.R.C. §61]. Pennsylvania, however, taxes only those items of income falling within one of the eight statutorily defined classes listed above. Pennsylvania taxpayers should not assume, therefore, that because an item of income is taxable for federal purposes it is also taxable in Pennsylvania. For instance, the discharge of indebtedness is taxable at the federal level unless specifically excluded from income by Internal Revenue Code §108. In Pennsylvania, however, the Department of Revenue takes the position that the discharge of indebtedness is taxable only if the debt relates to one of the eight classes of taxable income. For instance, the discharge of debt by an employer is taxable compensation. Likewise, the discharge of a business debt by a creditor produces income taxable within the "net profits" class according to the Department. However, pursuant to this logic, discharge of debt by and between family members would not fall into one of the eight classes and would not, therefore, result in recognition of taxable income.

A gain in one class of income may not be offset with a loss in another class of income. Losses may only be utilized to offset gains in the same class of income. If there is a net loss in one class of income on the PA-40, it shall be treated as zero (0) in computing taxable income [61 Pa. Code §121.13(a), (b)]. The Form PA-40 Instructions also state that taxpayers must attach an appropriate schedule to their PA-40, in order to detail the loss, even though it is not included in the calculation of taxable income.

Spouses cannot use each other's losses [61 Pa. Code §121.15(d)]. On a joint return, one spouse cannot use a loss in one class of income to offset a gain of the other spouse in the same class of income. If one spouse has a net loss in one class of income and the other spouse has a net gain, the total amount of income to be reported for that class is the amount of the gain. The loss is counted as zero (0).

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Losses not used in one year are not available in any other year. Taxpayers are prohibited from carrying losses back or forward from year to year [61 Pa. Code §103.1, 103.2].

Income flowing from a “pass-through” entity such as a partnership, Pennsylvania S corporation, estate or trust retains its character to the individual recipient. Such individuals should report the income in the category within which the item arose at the pass-through level (e.g., interest earned by a partnership engaged in a business flows to the individual partners as interest income rather than net profits).

1-3:4 Computation of the Tax.

After categorizing one’s income within the applicable classes, the taxpayer first totals the income, but cannot offset the income within one class of income against losses in another.

Example: Ethan has the following items of income for 2010:

Item	Amount	Class
Salary	$105,000	Compensation
Loss on sale of stock	$ 15,000	Gain/loss from prop. trans.
Gain on sale of stock	$ 9,000	Gain/loss from prop. trans.
Partnership loss	$ 12,000	Net loss from a business
Dividends	$ 5,000	Dividends

Ethan’s taxable income is $110,000 ($105,000 compensation + $5,000 dividends). Note that he cannot use the net loss from property transactions or the net loss from a business to offset income in other classes. He can, however, offset the gain on the sale of stock against the loss on sale of stock because they are in the same class of income.

1-3:5 When to Include Items in Income.

The Pennsylvania taxation system generally adheres to the federal rule with regard to when items of income are taxable. The federal rule operates by taxing an item of income to an accrual-basis taxpayer in the year during which all events have occurred to ensure the right to receive the income and determine the amount of income with reasonable accuracy. By way of comparison, an item of income to a cash-basis taxpayer is taxed in the year during which it is actually or constructively received pursuant to

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61 Pa. Code §101.7. A taxpayer constructively receives income if he or she would have actually received the income but for his or her own election to defer actual receipt to a later period.

Note: The federal income rules governing whether income is constructively received may not govern whether income is constructively received for personal income tax purposes.

1-3:6 Partnership Income.

Income from a partnership is classified/categorized at the partnership level. The amount of partnership income, along with its corresponding class of income, is outlined for each partner in one of two forms: a Form RK-1 (resident partners) or a Form NRK-1 (nonresident partners). It is the responsibility of the partnership to inform the partner of the classification from which guaranteed payments to partners are made. The guaranteed payment falls within the class of income from which the payments were made. Whether or not the guaranteed payment and the loss are from the same class of income dictates whether the partner can offset any loss against the guaranteed payment. Losses from one class may not be used to offset gains in any other classes. Pennsylvania generally does not tax dividends and interest flowing through to a nonresident. The interest or dividend is considered Pennsylvania-source income only if the income-producing property is used in a trade or business in Pennsylvania.

The Federal Tax Cut and Jobs Act of 2017 placed a $10,000 cap on the federal deduction an individual is permitted to take for state and local taxes. I.R.C. §164(b)(6). In response, a number of states implemented entity level taxes (ELT) on pass-through entities as a workaround. The Department of Revenue has taken the position that a resident credit could only be claimed by an ELT imposed upon a pass-through entity treated as an S Corporation for Pennsylvania income tax purposes. The resident credit could not be claimed for an ELT imposed upon other types of pass-through entities, such as partnerships and LLCs classified as partnerships. *See* https://revenue-pa.custhelp.com/app/answers/detail/a_id/3618. The Department's position seems to be grounded in the fact that Pennsylvania law only provides a resident credit for out-of-state tax imposed on either the individual Pennsylvania resident or a

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Pennsylvania S corporation in which the Pennsylvania resident is a shareholder.

However, the Department's position is suspect. The resident credit is contained in 72 P.S. §7314(a), which provides:

> A resident taxpayer before allowance of any credit under section [7]312 shall be allowed a credit against the tax otherwise due under this article *for the amount of any income tax, wage tax or tax on or measured by gross or net earned or unearned income imposed* on him or on a Pennsylvania S corporation in which he is a shareholder, to the extent of his pro rata share thereof determined in accordance with section [7]307.9, by another state *with respect to income which is also subject to tax under this article . . .*

(emphasis added). There are two requirements for a resident taxpayer to claim the Resident Credit: (1) Pennsylvania must impose PIT on income of the taxpayer and (2) the other state must impose a tax on the taxpayer (or the taxpayer's Pennsylvania S corporation) on the same income that Pennsylvania taxes. It should be immaterial whether the tax paid to the other state was paid directly by the taxpayer to the other state or was paid by claiming a credit for the taxpayer's share of income taxes paid or withheld on behalf of the taxpayer by a partnership or entity taxed as a partnership.

1-3:7 Decedents.

1-3:7.1 Income in Respect of a Decedent (IRD).

Pennsylvania does not conform to the federal definition of taxable income. Accordingly, Pennsylvania does not have an "income in respect of a decedent" provision in the manner of Internal Revenue Code (I.R.C.) §691. (Note: Pursuant to I.R.C. §691, anyone who receives "income in respect of a decedent" must report that income to which the decedent was entitled but which was not includable in taxable income under the decedent's accounting method at the date of death.) Thus, "IRD" income is not taxable for PIT purposes.

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1-3:7.2 Filing Obligation of a Decedent.

An executor, administrator, or other responsible person of a decedent must file a PIT return if the decedent had a filing obligation at the time of his death. The taxable year of a decedent ends on the date of his or her death. [72 P.S. §7331 and 61 Pa. Code §117.3].

1-3:7.3 Exceptions.

(1) During the year in which a spouse dies, a surviving spouse may file a return jointly with the final return of a deceased spouse if the joint return could have been filed if both spouses were living for the entire taxable year. A personal representative, executor, administrator, or other fiduciary appointed on behalf of a deceased spouse must consent to the filing of a joint return if he or she is appointed before the due date of the deceased spouse's return is filed. Both the fiduciary for the deceased spouse's estate and the surviving spouse must sign the joint return.

A surviving spouse may make, sign, and file the final tax return for a deceased spouse if the deceased spouse did not previously file a return for that taxable year and if a personal representative, executor or administrator has not been appointed by the time the return is made, signed and filed. If the surviving spouse properly files a final return for the deceased spouse, a fiduciary who is later appointed for the deceased spouse may supersede the final return filed by the surviving spouse by filing a separate return for the deceased spouse. Any joint return improperly filed by the surviving spouse or superseded by the fiduciary shall be treated as void. If the surviving spouse files his or her own tax return jointly with the deceased spouse's return and the return is superseded by the filing of a return by the deceased spouse's fiduciary, the surviving spouse shall be required to file a separate return within 90 days of the filing of the fiduciary's return. The surviving spouse's separate return shall be deemed to be filed: (i) on the day the joint return was filed if it is filed within such time; or (ii) the date the department receives it (effective for tax years beginning on or after January 1, 2013).

(2) If both taxpayers die during the same taxable year, a final return for each deceased spouse may be jointly filed if a joint return could have been filed had both spouses lived for the entire

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taxable year and with the consent of the personal representatives, executors or administrators of both deceased spouses by the due date, including extensions, of the joint tax return. Both fiduciaries must sign the joint return. [72 P.S. §7331 (effective for tax years beginning on or after January 1, 2013)].

The filing due date is generally the same as it would have been had the decedent lived through the end of his or her tax year. Only amounts properly includable under the decedent's accounting method are included in taxable income on the decedent's final tax return. Appropriate methods of accounting include:

- **Accrual method.** In this method of accounting, amounts accrued only by reason of the decedent's death are not included in the computation of taxable income.
- **Cash-basis method.** In this method, only those amounts that are actually or constructively received are included in taxable income.

1-4 TAXABLE CLASSES OF INCOME

1-4:1 Compensation.

1-4:1.1 Compensation, Generally.

In general, "compensation" refers to income received for services rendered. More specifically, Pennsylvania defines "compensation" to mean and 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 in property." The term "compensation" also includes "any part of a distribution under a plan described in [I.R.C. §409A(d)1] attributable to an elective deferral of income or the income on any elective deferral of income, whether paid or payable during employment or to a retired person upon or after retirement from service." [72 P. S. §7301(d)].

Certain items are excluded from the definition of compensation. For example, the term compensation does not include the pay servicemen receive for serving in a combat zone or for active

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duty. [72 P.S. §7301(d)]. Compensation also does not include income derived from the U.S. government for active duty outside Pennsylvania as a member of its armed forces and income from the U.S. government or Pennsylvania for active state duty for emergency within or without Pennsylvania. [72 P.S. §7303(a)]. This definition is exhaustive for items of income received for services rendered. For instance, Pennsylvania's Department of Revenue treats fees paid to corporate directors as compensation. So while directors' fees would be reported on Schedule C for federal purposes, in Pennsylvania they would be reported with all other items of compensation. The taxpayer would be entitled to claim unreimbursed employee business expenses for Pennsylvania purposes.

Since the statute defines compensation as including "items of remuneration received . . . for services rendered as an employee . . ." [61 Pa. Code §101.6(a)], compensation includes items such as exercised, exchanged, sold or otherwise disposed of stock options, scholarships, stipends, grants and fellowships (provided that services are rendered in connection with them), incentive payments, tips, severance payments, rewards, vacation pay and employee's tax paid by the employer. Current market value is used to determine the value of non-cash compensation. [61 Pa. Code §101.6(e)]. Compensation does not include guaranteed payments to a partner, even if they are for services. [61 Pa. Code §101.6(b)(13)].

Every employee who receives cash tips, which are defined as wages by Internal Revenue Code §3401(a), must report the tips to their employer on or before the 10th day of the month following the month in which the tips were received. Employers are required to deduct and withhold tax only on tips of which the employer has the control, receipt, custody, or payment or tips that are reported by the employee. (61 Pa. Code §113.2).

The term compensation also includes "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 . . ." [61 Pa. Code §101.6(a)]. This regulation also excludes from compensation federal old age insurance benefits payable under the Railroad Retirement

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Act and benefits payable by an employer or labor union under a supplemental employment benefit plan, whether payable on a periodic basis or in the form of cash, services, or property. [61 Pa. Code §101.6(c)(3) and (14)].

Several definitions, including "severance pay" and "supplemental unemployment benefit plan," are included in the list of definitions applicable to all personal income tax regulations. [*See* 61 Pa. Code §101.1].

The Pennsylvania Supreme Court also held that qui tam payments are taxable as "compensation." *O'Donnell v. Allegheny Cnty. N. Tax Collection Comm.*, 266 A.3d 2 (Pa. 2021). During 2014, the taxpayer brought a qui tam lawsuit alleging, on behalf of the United States, that his employer violated the federal False Claims Act (FCA). To compensate the taxpayer for acting as a whistleblower under the FCA, the taxpayer received 16% of the global settlement. The taxpayer took the position that the whistleblower payment was not subject to tax in Pennsylvania because it did not fall within any of the categories of taxable income. The Pennsylvania Supreme Court noted that incentive payments are included in the statutory definition of compensation and although an incentive payment is not statutorily defined, an incentive is generally understood as something provided to motivate further action. The Pennsylvania Supreme Court reasoned that by the terms of the FCA, the taxpayer's qui tam payment was intended to incentivize whistleblowers, like the taxpayer, to identify employer fraud, initiate a qui tam action, and provide valuable information to the federal government. Thus, according to the court, the qui tam payment was the taxpayer's incentive and taxable as compensation under the plain language of the Pennsylvania Tax Reform Code, and, therefore, as earned income under the Local Tax Enabling Act.

1-4:1.2 Items Not Considered Compensation.

Generally, there are three reasons why certain amounts received by taxpayers for services rendered may not fall within the statutory definition of compensation:

- the individual is not an "employee" within the meaning of the Tax Reform Code;

- the item is statutorily excluded from the class of income called compensation; or
- the item is intended to cover certain business expenses of the employee.

Certain items of compensation within the commonly accepted meaning of that term are not taxable compensation within the meaning of the Pennsylvania Tax Reform Code. For example, 72 P.S. §7301(d) specifically excludes the following items:

(1) Periodic payments for periods of sickness or disability other than regular wages. This includes payments made by third party insurers for periods of sickness or disability.

(2) Disability, retirement or other payments arising under workmen's 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. This does not include severance payments to an employee who terminates without retiring. Severance payments are taxable compensation to the extent they exceed the employee's contribution to any plan from which the payments are made. *See*, for example, *Bickford v. Commonwealth*, 533 A.2d 822 (1987), in which recipients of payments under an employer's special incentive compensation plan were not excludable. Because the plan allowed distribution on termination of employment and was written as a management incentive plan rather than a retirement plan, the payments did not qualify as old age or retirement benefits. See discussion below.

The Department's position is that retirement benefits are only excludable if they do not discriminate against employees before retirement

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age. The result is that workers who get golden handshakes – extra benefits in return for early retirement – receive taxable compensation so far as their actual benefits exceed the normal benefits for retirement at that age.

When a taxpayer retires from one job and then takes another, he or she might argue that payments relative to the first job are excludable retirement payments. However, if the taxpayer isn't really retired, or if the payment in issue is a severance payment dressed up to look like a "retirement" plan, the taxpayer may be liable for tax on payments from the "pension."

(4) Payments commonly known as public assistance, or unemployment compensation payments by any governmental agency.

(5) Payments to reimburse actual expenses.

(6) Cafeteria plan benefits. Payments made by employers or labor unions for programs covering hospitalization, sickness, disability or death, supplemental unemployment benefits, strike benefits, and retirement, provided that the programs do not discriminate in favor of highly compensated individuals in terms of eligibility, payment, or program benefits. This exclusion applies to programs covering cafeteria plans qualifying under I.R.C. §125.

(7) Any compensation received by United States servicemen serving in a combat zone or for active duty outside the Commonwealth of Pennsylvania as a member of its armed forces.

(8) Foster care payments. Compensation does not include payments received by a foster parent for in-home care of foster children from an agency of the Commonwealth or a political subdivision thereof or an organization exempt from federal tax under §501(c)(3) of the Internal Revenue Code

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that is licensed by the Commonwealth or a political subdivision thereof as a placement agency

(9) Payments made by employers or labor unions for employee benefit programs covering social security or retirement.

(10) Personal use of an employer's owned or leased property or of employer provided services.

Special Events Resulting in Non-Taxable Income.

(1) Economic impact payments (i.e. COVID-19 related stimulus checks) are not taxable under Pennsylvania Tax Reform Code because they are considered a non-taxable rebate. Similarly, Paycheck Protection Program loans used to pay business expenses during COVID-19 and subsequently forgiven by the lender are likewise non-taxable income. *See* L. 2021, S109 (Act 1), *effective 02/05/2021*; Pa. Dep't of Rev., COVID-19 Information, 02/08/2021. However, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provided that certain student loan repayments made by an employer of up to $5,250 were not subject to federal income tax. However, Pennsylvania treats those repayments as taxable and as such those payments should be included as compensation on an employee's PIT return. CARES Act: Pennsylvania Taxability, Pa. Dep't of Rev., 02/01/2021.

(2) Under the 2022 Student Debt Relief Plan, student loan borrowers will receive up to $20,000 in relief. That relief will not be subject to tax in Pennsylvania. *See* Governor Wolf Reminds Pennsylvanians: Student Loan Forgiveness Will Not Be Taxed in Pennsylvania, Pennsylvania Governor's Office, 08/31/2022.

(3) Effective for tax year 2023 and thereafter, payments originating from federal or state government, Norfolk Southern Railway, or an

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agent thereof, received as a result of the East Palestine, Ohio train derailment that occurred February 3, 2023, are not considered taxable income for PIT purposes. These payments do not need to be reported on a taxpayer's PA-40 annual tax return. *See* Act 56 of 2024.

1-4:1.3 Contributions to Benefit Plans.

Pennsylvania taxes employee contributions (but not employer contributions) to 401(k) plans currently, even though federal taxation is deferred. *AMP Prods. Corp. v. Commonwealth*, 593 A.2d 1 (Pa. Commw. Ct. 1991).

1-4:1.4 Keogh or IRA Contributions, Self-employment Taxes, and Health Insurance Premiums.

Pennsylvania's personal income tax does not allow self-employed individuals to claim above-the-line deductions for their Keogh or IRA contributions, some of the self-employment social security tax payments, or their health insurance premiums, even though those deductions are allowed for federal income tax purposes.

1-4:1.5 Tax Credit Arising from Employee Tips.

While an employer in the food and beverage business may claim a nonrefundable income tax credit for part of the employer's share of social security taxes paid or incurred after 1993 on employee cash tips, for federal income tax purposes, no such credit exists in Pennsylvania.

1-4:1.6 Deductions, Exemptions and Exclusions.

Deductions, exemptions, and exclusions are not explicitly provided for in the Tax Reform Code. However, items commonly called deductions (e.g., employee business expenses) are allowable as exclusions from certain classes of income; and individuals whose income is low enough to qualify for the Special Tax Provisions for Poverty are entitled to forgiveness of all or part of their Pennsylvania Personal Income Tax liabilities. Net profits and net gains, however, are defined as income net of expenses.

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1-4:1.7 Federal Deductibility of Miscellaneous Itemized Deductions vs. Pennsylvania Treatment.

According to the Internal Revenue Code, miscellaneous itemized deductions (which include unreimbursed employee business expenses) are deductible only to the extent that they exceed 2 percent of adjusted gross income. Pennsylvania Personal Income Tax guidelines have no such provision. If allowable employee business expenses for Pennsylvania are ordinary, necessary, reasonable and actual, they are 100 percent deductible.

1-4:1.8 Available Employee Business Expenses.

Pennsylvania allows the exclusion of employee business expenses from compensation as long as the expense is:

- Ordinary, customary, and accepted in the industry or occupation in which the employee works;
- Actually paid while performing the duties of employment;
- Reasonable in amount and not excessive;
- Necessary to enable the employee to properly perform the duties of employment;
- Directly related to performing the duties of employment; and
- Unreimbursed by the employer. [Instructions to PA-40, 2011].

1-4:1.9 Examples of Disallowed Employee Business Expenses.

Pennsylvania does not permit exclusion from compensation of the following expenses:

- Personal, living, or family expenses;
- Dues to fraternal organizations or professional societies;
- Subscriptions to publications (even if related to trade or business);
- Political contributions;
- Charitable contributions;

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- Commuting expenses;
- Cost of meals while working late, unless out of town overnight on business;
- Child or elderly care expenses;
- Insurance premiums;
- Contributions to deferred compensation plans or other pension plans;
- Legal fees, except to recover back wages;
- Bribes, kickbacks or other illegal payments;
- Job hunting expenses;
- Moving expenses (unless for the convenience of the employer);
- Educational expenses (except when required by law or by the employer);
- Capital expenditures;
- Expenses calculated at federal per-diem rates. [Instructions to PA-40, 2011].

1-4:1.10 Medical Care Savings Accounts.

The taxation of Health Savings Accounts and Archer Medical Savings Accounts generally follows the federal rules. Under the federal rules, employer contributions are excluded from the employee's taxable income and employee contributions are deducted from income if they meet the criteria outlined in the Internal Revenue Code. Distributions that are not used for qualified medical expenses are taxable as interest income.

1-4:1.11 Medical Care Savings Accounts.

2016 Act 17 (H.1589), effective April 18, 2016, establishes "Achieving a Better Life Experience" (ABLE) accounts for individuals with disabilities, and provides that contributions to such accounts, any increase in the value of those contributions, the retention or transfer during life or as a result of death of any legal interest in an account, and payment of qualified disability

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expenses of eligible individuals from an account, are exempt from all taxation by Pennsylvania and its political subdivisions.

H.B.542, enacted Oct. 30, 2017, similarly provides that undistributed earnings, and distributed amounts that are not included in gross income under I.R.C. §529A(c)(1) (relating to "[q]ualified ABLE programs"), are exempt from Pennsylvania state and local taxes. [72 P.S. §7304.2(A)]. That statute also provides all distributed amounts not exempt from tax constitutes taxable income to the designated beneficiary of the account. [72 P.S. §7304.2(C)].

H.B.542 also provides that the amounts contributed to an account may be deducted from the taxable income from the contributor for the tax year that the contribution is made, up to the amount set forth in I.R.C. §2503(b) (relating to "[t]axable gifts"), and not to reduce the contributor's taxable income below zero (0). [72 P.S. §7304.2(B)(2), (3)].

1-4:1.12 Qualified Tuition Programs.

Contributions to any qualified tuition program (as defined in section 529 of the Internal Revenue Code, 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 Internal Revenue Code for purposes of federal estate and gift tax, which is $13,000 for 2012. The deduction cannot result in taxable income being less than zero. Distributions 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 purposes. Rollovers to a Roth IRA were previously taxable at the state level. Effective January 1, 2024, 529 account owners who transfer funds into a Roth IRA will not incur Pennsylvania personal income tax, up to the limit of $35,000. See Act 56 of 2024. Distributions that are not used for qualified higher education expenses are subject to tax.

Effective for tax year 2024, any amount an employee receives through an employer's matching contribution to the 529 Savings Account Employer Matching Contribution Tax Credit is excluded from taxable income for the employee. *See* Act 56 of 2024.

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Additionally, effective for tax year 2025, student loan interest paid on qualified student loans may be deducted from a taxpayer's taxable income for personal income tax purposes. The deduction must not exceed $2,500 per tax year and cannot result in a taxpayer's taxable income being less than zero.

1-4:1.13 Retirement Benefits.

Generally, Pennsylvania taxes distributions from retirement plans to the extent that contributions were not previously taxed, with the following two exceptions: (1) distributions made upon or after retirement from service after reaching a specific age or after a stated period of employment; or (2) distributions transferred into another plan, when the transferred amounts are not included in income for federal income tax purposes.

1-4:1.14 Contributions to Employers' Pension or Profit-sharing Plans.

Compensation does not include employer contributions to pension and profit-sharing plans, but does include employee contributions. Unlike the federal exclusion from taxable income of employee contributions (*see* I.R.C. §401(k)), Pennsylvania law includes no statutory basis for the exclusion of employee contributions to any retirement plan. For this reason, the following items are included within Pennsylvania taxable compensation:

- Employee contributions to annuity contracts tax sheltered under I.R.C. §403(b) that are bought by an educational institution or charitable organization.
- Employee contributions to I.R.C. 401(k) plans whether elective or non-elective.
- Civil Service employee contributions to Civil Service pension plans. *See Bernknopf v. Commonwealth*, 425 A.2d 880 (Pa. Commw. Ct. 1981), *aff'd per curiam*, 442 A.2d 693 (Pa. 1982).
- The tax is imposed on employee contributions to pension or profit-sharing plans, regardless of whether the contributions are withheld from the

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employee's pay. Those contributions are classified as constructively received by the employee before contribution to the fund. *See also AMP Prods. Corp. v. Commonwealth*, 593 A.2d 1 (Pa. Commw. Ct. 1991).

1-4:1.15 Non-qualified Deferred Compensation.

Act 2005-40 incorporates the federal rules under I.R.C. §§83 and 451, as well as the specific requirements of I.R.C. §§409A and 457 relating to actual or constructive receipt. However, where inconsistent, I.R.C. §§409A and 457 supersede or override I.R.C. §§83 and 451. *See* PIT Tax Bulletin 2005-3.

- **Pre-January 1, 2005**
  - **Deferrals** – The Department of Revenue took the position that an elective employee deferral of compensation to a nonqualified plan constituted taxable compensation at the time of deferral, even if there was a substantial risk of forfeiture. The Department of Revenue's position was sustained in *Ignatz v. Commonwealth*, 849 A.2d 308 (Pa. Commw. 2004).
  - **Distributions** – The taxation of a distribution from a nonqualified deferred compensation plan depended upon whether the plan constituted an "eligible Pennsylvania retirement plan." In general, a distribution to a participant from the plan constituted compensation and was subject to PIT to the extent that the distribution exceeded previously taxed deferrals. Special rules applied for determining the taxability of a distribution made to a nonresident participant and a distribution made to a beneficiary that constituted income in respect of decedents.

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- **Effective January 1, 2005**
  - **Deferrals** – The federal treatment should apply for Pennsylvania Personal Income Tax purposes.
  - **Distributions** – The federal treatment should apply for Pennsylvania Personal Income Tax purposes. Under special transition rules, a participant may recover, tax-free, elective deferrals upon which he/she previously paid tax. In determining the portion of a distribution that is taxable, the participant will use the cost recovery method. The statute precludes a participant from claiming that a distribution constitutes a nontaxable retirement benefit. Special rules apply for determining the taxability of a distribution made to a nonresident participant and a distribution made to a beneficiary that constitutes income in respect of decedents.
  - **Special transition rules (pre-2005 tax years)** – As a result of retroactively adopting the federal rules for taxing deferred compensation, the Department of Revenue has adopted transition rules.
  - **2002 through 2004** – The rules contained in I.R.C. §§83 and 451 will determine when deferred compensation is taxable. In instances where a participant had paid tax on an elective deferral not "received" under those rules in 2002, 2003 and 2004, the participant has the option of obtaining a refund or treating the elective deferral as the employee's cost in the contract. If the participant treats the elective deferral as the employee's cost in the contract, the participant should only be liable on subsequent distributions that exceed previously taxed deferrals. For most taxpayers, the three-year statute of

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limitations for filing for a refund of 2003 tax expires on April 15, 2007.

- **Note:** In instances where a participant took the position that a distribution qualified as a nontaxable retirement benefit, he/she may owe additional tax.

- **Prior to 2002** – In instances where a participant had paid tax on an elective deferral in a year prior to 2001 and did not receive a refund or credit on the ground that the amount taxable was not taxable, the Department of Revenue is permitting the participant to treat the elective deferral as the employee's cost in the contract. The participant should only be liable on subsequent distributions that exceed previously taxed deferrals.

Note: The 2005 statutory amendments to the personal income tax statute that incorporate I.R.C. §§409A, 83 and 451 do not apply to employer contributions/deferrals to, and distributions from a SERP. Employer contributions/deferrals to a SERP should not be subject to taxation at the time of contribution/deferral. The taxability of distributions should depend upon whether: (1) the SERP qualifies as an "eligible retirement benefit plan" for personal income tax purposes, and (2) the distributions are made solely in the case of death, disability or retirement.

There is no "definition" for what constitutes an eligible retirement plan. The statute doesn't define it and the Department of Revenue has never established a firm policy. The only consistent guidance that has ever been issued is that a retirement plan has to meet the following criteria (*see* DOR online Q&A Answer ID 433):

A. The plan is reduced to writing and has been communicated to the participants.

B. The plan establishes eligibility requirements for separation of service or a combination of old age or infirmity, and long-continued service.

C. 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

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payments or payments does not disqualify the retirement nature of the plan as long as the other provisions are provided.

D. 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.

Distributions made to a nonresident from either an employer or employee funded SERP may not be taxable under 4 U.S.C. §114 (Limitation on State Income Taxation of Certain Pension Income).

1-4:1.16 Cost Recovery Method.

The cost recovery method determines taxable compensation from distributions from pension and profit-sharing plans. When all employee contributions have been depleted they become fully taxable. Up until that point, distributions are considered a tax-free return of capital. Distributions considered to be retirement pay are also totally tax free, and this applies to retirement due to disability as well. Interest on the assets retained in the plan is not taxable. [61 Pa. Code §101.6(c)(8)].

1-4:1.17 Fringe Benefits.

Personal use of an employer's owned or leased property is excluded from the definition of compensation. Also excluded is personal use of employer provided services.

1-4:1.17a Cafeteria Plans.

Any cash option relative to a cafeteria plan is includible as compensation. For instance, if, under the terms of the plan, the employee can elect to either apply $500 of employer provided funds to a number of benefit options (e.g., life insurance, medical insurance, etc.) or receive $500 in cash, the $500 is includible. However, the value of the employer subsidized benefits is not includible.

1-4:1.17b Fringe Benefits in the Form of Use of Property.

Under 61 Pa. Code §101.6(a), "remuneration for services received in the form of personal or business use of property is not taxable as compensation" provided that "the property belongs to, or is held under a lease by, the employer at the time of use" and "no title, interest or estate therein is conferred upon, or vested in,

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another person." In addition, "remuneration . . . in the form of consumption of a consumable, such as food and supplies, is not taxable as compensation." The section goes on to list examples of employer-provided property that are not taxable to the employee:

- Educational or training facilities.
- Housing or clothing.
- Day care facilities.
- Passenger cars and commuter highway vehicles.
- Aircraft or water craft.
- Construction or recreation vehicles.
- Athletic facilities or equipment.
- Recreational facilities or equipment.
- Parking facilities.
- Eating facilities.
- Office facilities or equipment.
- Tools, equipment or supplies.

1-4:1.17c Fringe Benefits in the Form of Use of Services.

In addition, 61 Pa. Code §101.6(a) also provides that "remuneration for services received in the form of personal or business use of services is not taxable as compensation if either: (1) [t]he service is provided or supplied directly by the employer or a co-employee, [or] (2) rights to the service were procured beforehand by the employer." This section gives these examples of nontaxable employer-provided services.

- The operation of an eating facility.
- Transportation in a commuter highway vehicle.
- Air or rail transportation of passengers or cargo.
- Parking.
- Education or training.
- Legal, medical, accounting or other professional or technical services or assistance, including adoption assistance.

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- Day care services or assistance.
- Dependent care assistance.
- A tuition reduction provided to an employee or his dependents or to a teaching and research assistant.

The Pennsylvania Department of Revenue has stated that college courses that are provided free of charge by employers to their employees are not considered taxable compensation because they are employer-provided services that are excluded from Pennsylvania Personal Income Tax. If an employee had Pennsylvania Personal Income Tax improperly withheld from their pay for the value of the courses provided by their employer, they can file amended Pennsylvania Personal Income Tax Returns in order to obtain a refund of their overpayment of tax, provided that the amended return is filed within the statute of limitations. Pennsylvania Personal Income Tax Ruling No. PIT-04-030.

To find out more concerning employee fringe benefits and wage/salary supplements, see the Pennsylvania Department of Revenue publication REV-634.

1-4:1.18 Military Personnel.

Taxable income does not include military pay received by members of the armed forces serving in combat zones. [72 P.S. §7301(d)]. In addition, military pay received while on active duty outside Pennsylvania is also excluded from the Pennsylvania Personal Income Tax. [61 Pa. Code §121.10(c)(8)].

However, Pennsylvania residents in the U.S. Public Health Service or the U.S. Foreign Service are not considered on active duty, therefore making their compensation taxable in Pennsylvania. The PA-40 instructions stipulate that reservists and National Guardsmen ordered to active duty for two-week training in the summer are presumed to be on federal active duty. The pay they receive for that training is also excludable since the training takes place outside the Commonwealth.

The PA-40 instructions suggest that the burden is on the taxpayer to establish that military pay was received while on active duty. However, the authority section of the taxpayer's orders will be accepted by the Department of Revenue as proof. For instance, if authority for the active duty is based on a federal

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statute (e.g., 32 U.S.C. §§316, 502, 503, 504, 505), federal active duty will be presumed; but if authority for active duty is based on a Pennsylvania statute (e.g., 51 P.S. §§508 or 3102), state active duty will be presumed. This exemption doesn't cover items falling within the other seven classes of income. An individual domiciled in Pennsylvania can still qualify as a Pennsylvania resident even if away on duty.

Under the Soldiers and Sailors Civil Relief Act of 1940 (50 U.S.C. §501, *et seq.*), nonresident servicemen cannot be taxed in Pennsylvania on military pay, although any income other than military pay earned in Pennsylvania, as well as income of spouses and/or other household members who are not members of the armed forces, is subject to Pennsylvania's personal income tax. [61 Pa. Code §121.12(a)].

On March 17, 2010, the Department of Revenue issued Personal Income Tax Bulletin 2010-01 addressing the Military Spouses Residency Relief Act. The Military Spouses Residency Relief Act (MSRRA) was signed into federal law on November 11, 2009. The MSRRA allows a service member's nonmilitary spouse to retain status as an out-of-state resident and source any nonmilitary compensation to the state of residence under the following circumstances:

- The service member must be in Pennsylvania in compliance with military orders; and
- The service member's spouse must have the same domicile (legal residence) as the service member.

For tax years beginning on or after January 1, 2018, a service-member's spouse may elect to use the same residence as the servicemember for purposes of taxation regardless of the date on which their marriage occurred.

The bulletin also addresses a nonmilitary spouse's other income from Pennsylvania sources. The nonmilitary spouse's other income is subject to Pennsylvania Personal Income Tax to the extent it is earned, received or acquired from sources within the Commonwealth as follows:

- By reason of ownership or disposition of an interest in real or tangible personal property in Pennsylvania;

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- In connection with a trade or business in Pennsylvania, except to the extent the trade or business receives income for services performed by the MSRRA-qualifying service member's spouse; and/or
- From intangible personal property employed in a trade, profession, occupation or business carried on in Pennsylvania.

Spouses of service members who meet the requirements detailed in the Bulletin and who either had Pennsylvania income tax withheld from 2009 wages or made other Pennsylvania income tax payments for the 2009 tax year may receive refunds of such taxes paid by filing a Pennsylvania Personal Income Tax return, PA-40. The nonmilitary spouse should report zero wages on Line 1 of his/her Pennsylvania Personal Income Tax return and include the total Pennsylvania taxes withheld on Line 14.

The nonmilitary spouse of a service member whose wages/salary is exempt from Pennsylvania income tax under MSRRA should file form REV-419 with his/her Pennsylvania employer, claiming exemption from Pennsylvania income tax withholding.

1-4:1.19 Members of the Clergy.

The question of whether members of the clergy receive compensation as employees as opposed to earnings from self-employment is a controversial one. Its answer lies within the facts and circumstances surrounding the individual case. The Department of Revenue maintains that churches and congregations should apply the common law rules in establishing whether the relationship may be classified as employer-employee. [Pa. Dep't of Rev. Release 2-5-81].

Two conditions must be considered in order to declare that the value of a parsonage provided to a clergyman by a congregation is excludable from compensation:

- Whether the clergyman is an employee or a self-employed person; and
- Whether the parsonage is provided for the convenience of the congregation [Pa. Dep't of Rev. Legal Bur. Chief Counsel Opinion; 1-27-82].

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Regulations impart that the value of meals and lodging given an employee for the convenience of the employer is not compensation. [61 Pa. Code §101.6(c)(7)]. If the clergyman is deemed an employee and the parsonage is provided for the convenience of the employer, the value of the parsonage is not taxable compensation to the clergyman; otherwise, the value is taxable. [Pa. Dep't of Rev. Legal Bur. Chief Counsel Opinion; 1-27-82]. Cash allowances for a parsonage are taxable to clergymen.

1-4:2 Net Profits From a Business.

The second class of income subject to taxation is "net profits," which is defined as "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." [72 P.S. §7303(a)(2)]. "Accepted accounting principles and practices" are defined under 72 P.S. §7301(a) as "those principles, systems or practices, including the installment sales method of reporting, which are acceptable by the standards of the accounting profession and which are not inconsistent with the regulations" of the Department of Revenue. [72 P.S. §7301(a)]. This means that taxpayers do not have to use federal rules if generally accepted accounting principles (GAAP) differ.

The regulations define "business" as, "[a]n enterprise, activity, profession, vocation, trade, joint venture, commerce or other undertaking of any nature if engaged in as a commercial enterprise and conducted for profit or ordinarily conducted for profit, whether by an individual, partnership, association or other unincorporated entity." [61 Pa. Code §101.1].

1-4:2.1 When Income Constitutes "Net Profits."

The regulations adopt three criteria for determining whether income constitutes net profits for PIT purposes.

(1) The gross profits shall be derived from one of the following:

(i) The marketing of a product or service to customers on a commercial basis or from

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securities employed as working capital in the business operations.

(ii) Accounts and notes receivable from sales of products or services sold in the ordinary course of the business operations.

(iii) Assets which serve an operational function in the ordinary course of business operations.

(2) The marketing activity shall be conducted with the manifest objective of achieving profitable operations.

(3) The marketing activity shall be conducted with regularity and continuity and may not be limited or exclusive.

[61 Pa. Code §103.12(b)].

The definition of "net profits" is based upon the Commonwealth Court's decisions in *Morgan v. Commonwealth*, 42 Pa. Commw. 557 (1979), *aff'd per curiam*, 496 Pa. 400 (1981) and *Wettach v. Commonwealth*, 153 Pa. Commw. 293 (1993). In *Morgan*, the court held an individual's own investment activities did not constitute a business. The Court stated that "the legislature intended that the 'business, profession, or other activity' of Section [7]303(a)(2), must be 'engaged in as commercial enterprise' in order for the income derived therefrom to be taxable under Section [7]303(a)(2). Since the term 'commercial enterprise' is not defined in the Code, we must, pursuant to 1 P.S. §1903, construe that term according to its common and approved usage. Without engaging in a lengthy discussion as to the common and approved usage of the term 'commercial enterprise,' its *sine qua non* is, as ably pointed out in the Commonwealth's brief, the rendering of goods or services to others in a market place." *Morgan v. Commonwealth*, 42 Pa. Commw. 557, 561-62 (1979).

The engaging of activities through a pass-through entity will not affect whether the entity's income constitutes "net profits." The regulations provide, "[c]hoosing to form a partnership or other entity or to associate with others, receiving and reporting income or gain as the income of the partnership, entity or associates or dividing the same among its partners, beneficial owners or

associates or the trading in securities for the benefit of shareholders, partners, members or associates does not of itself make the income of the partnership, entity or associates net profits." [61 Pa. Code §103.12(d)]. Conversely, the character of income that an individual recognizes would not change merely from the conduct of a business as a sole proprietor, or a partner in a partnership.

1-4:2.2 Deductions Disallowed From "Net Profits."

Income from certain transactions ordinarily will not constitute net profits even if a business engages in those activities. Accordingly, corresponding items of expense are not deductible. For example, deductions for the following expenses are not deductible:

(1) The ownership or disposition of assets that are held for investment purposes or otherwise serve an investment function.

(2) The trading in securities for personal purposes and not for the accounts of customers.

(3) The sale, discontinuation or abandonment of a business or segment thereof.

(4) Any tax imposed on, or measured by, gross or net earned or unearned income.

(5) An isolated or nonrecurring transaction which is not a normal or routine business activity.

[61 Pa. Code §103.12(c)].

1-4:2.3 "Net Profits" – Investment Activity.

With respect to investment activities, the regulations provide that only certain "participants in the stock, securities, options, derivatives, futures or commodities market are engaged in marketing of a product or service to customers." These parties are:

(1) Those who maintain or provide a market place or facilities for bringing together purchasers and sellers of these financial investment products.

(2) Those who are licensed to act as their customer's agents and charge a negotiated commission for

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executing transactions and do not take title to the particular positions they buy or sell.

(3) Those who devote managerial attention to the financial investment products holdings of others, or who employ other persons to assist them in that management, in the capacity of a licensed investment advisor.

(4) Licensed dealers, including financial investment product specialists and market makers, if the conditions in subparagraphs (i)-(iv) are met:

(i) The dealer maintains an inventory of financial investment products with the objective of reselling his inventories at a profit to customers or operates as a specialist or market maker.

(ii) The dealer makes market by quoting the bid and asked prices at which he is willing to buy and sell the financial investment products and by buying directly from or selling directly to customers.

(iii) The dealer's profit is determined in whole or in part by a markup based on cost.

(iv) The dealer elects to inventory securities held for resale to customers or uses the mark-to-market system of accounting.

(5) Underwriters who facilitate initial sales of financial investment products by acting either as licensed dealers in a principal capacity or as brokers in an agency capacity.

[61 Pa. Code §113.12(e)].

Note: A number of hedge funds and private equity funds have appeals pending in Commonwealth Court challenging the Department of Revenue's position that they are not engaging in a trade or business. If found to be engaging in a trade or business, these entities would be able to net business expenses, e.g., management fees, against business income.

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1-4:2.4 Offsetting Income and Loss From Multiple Businesses.

If a person operates two businesses, one of which produces a gain and the other a loss, he or she can use the loss to offset the gain if both gain and loss qualify as "net income from the operation of a business;" however, if the loss exceeds the gain, the net loss cannot be used to offset any other class of income; and in the case of a married couple where each spouse owns a business, losses from one spouse's business may not offset gains or income from the other spouse's business unless the businesses are jointly owned by both spouses.

1-4:2.5 Allowable Deductions.

The federal computation of net profits is typically accepted by the Pennsylvania Department of Revenue for PIT purposes. However, some significant differences exist between federal and Pennsylvania tax treatment of some business deductions.

1-4:2.6 Adjustments for Pennsylvania Income Tax Purposes.

The following adjustments must be made when using a federal profit and loss statement for a business:

- Deductions such as the federal labor hired deduction or the federal wage deduction are not applicable to Pennsylvania's personal income. The deductions must be added back to the wage expense in the event these deductions are claimed for federal purposes.
- When claiming the Pennsylvania Employment Incentive Payments (EIP) credit and/or the Pennsylvania Jobs Creation Tax Credit, the amount of the credit must be subtracted from the total wages expense. See Chapter 18, below, for a detailed discussion of these credits.
- Any contributions a self-employed individual makes to a pension plan (e.g., IRA, Keogh plan) must be added back to taxable income.
- *Taxes*: Some federal, state and local taxes can be deducted. No taxes based upon gross or net income may be deducted. Pennsylvania does not

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permit a deduction for self-employment tax. The Philadelphia Business Privilege tax is an allowable deduction.

- *R&D Expenses*: Taxpayers may not deduct expenses allowed in computing the Pennsylvania Research and Development Tax Credit.

1-4:2.7 Optional Adjustments to Federal Profit and Loss Statements.

The following adjustments may be made if using a federal profit and loss statement for a business or farm.

Pennsylvania allows 100 percent of expenses for business meals and entertainment to be deducted, even though the deduction is currently limited to 50 percent of the total expense for federal tax purposes.

Sales tax on depreciable business assets can be a current expense for Pennsylvania Personal Income Tax purposes. The Pennsylvania basis and the federal basis will be different on disposition.

Under Pennsylvania's personal income tax, deductions are allowed for charitable contributions made from a business account that are publicly acknowledged by the recipient. However, the same does not apply for personal charitable contributions.

Any capitalization rules established by the trade, profession or industry may be used under its generally accepted accounting principles and practices. This method must continue to be used once it has been chosen.

Any generally recognized or currently accepted depreciation method for business or farm activity (including I.R.C. §179) may be used. This method must be continuously used once it has been chosen.

Even if limited by the Internal Revenue Service (IRS), itemized ordinary and necessary business expenses that are directly connected to the production of goods or services and reasonable in amount that are allowable under GAAP of Financial Accounting Standards Board (FASB) rules may be deducted.

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1-4:2.8 Depreciation.

- With respect to property employed in the operation of business or held for the production of income, a taxpayer will be entitled to a depreciation deduction. The deduction must be reasonable and shall be computed in accordance with the property's adjusted basis at the time placed in service, reasonable estimated useful life, and net salvage value at the end of its reasonably estimated useful economic life under the straight-line method or other method prescribed by the Department (Act 89, June 29, 2002).
- **Exception.** A taxpayer may use any depreciation method, recovery method, or convention that he or she uses in determining federal net income, if when placed in service, the property has the same adjusted basis for federal income tax purposes and the method or convention is allowable for federal income tax purposes at the earlier of: (1) the time the property is placed in service, or (2) the I.R.C. of 1986 (Act 89, June 29, 2002).

ALERT!	The bonus depreciation rules contained in I.R.C. §168(k) do not apply for PIT purposes.

1-4:2.9 Deduction for Cost and Percentage Depletion.

1-4:2.9a Allowance of Deduction for Cost Depletion [61 Pa. Code §125.51].

(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 in 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; the 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 the revised estimate.

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(b) *Recoverable units.* Recoverable units are the number of units (for example-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.*

(1) *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.

(2) *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.

(3) *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 those provisions, on the basis of the trust income allocable to each.

(4) *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.

(5) *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 the property.

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1-4:2.9b Allowance of Deduction for Percentage Depletion [61 Pa. Code §125.52].

The regulations provide a deduction for percentage depletion only in the following set of circumstances:

(1) The deduction is allowable 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.

The taxpayer must have unrecovered basis in the property in order to receive the benefit of a deduction for percentage depletion. Classifications and adjustments are required to account for annual differences between the taxpayer's federal and Pennsylvania PIT depletion deductions.

Effective for tax year 2024, taxpayers may claim a tax deduction for the percentage depletion of a mine, oil, or gas well and other natural deposits on a taxpayer's property consistent with federal law.

1-4:2.10 Intangible Drilling Costs.

Prior to July 9, 2013, intangible drilling costs associated with the creation of wells were not deductible. As long as the taxpayer or entity was engaged in the active conduct of a business and business activities had begun (beyond the exploration stage), and the drilling costs were reasonable in amount, the expenses were allowed to be amortized over the life of the wells. An entity could write off the remaining unamortized cost as a loss when the well proved unproductive. This loss was similar to a federal capital loss not subject to current expensing. Pennsylvania Personal Income Tax rules required the loss to be recorded as a loss on the sale, exchange or disposition of property. Pennsylvania Personal Income Tax classification and adjustment needed to be made to account for Pennsylvania Personal Income Tax difference from federal tax treatment.

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As of July 9, 2013, taxpayers may elect to expense intangible drilling and development costs as ordinary and necessary business expenses, similar to the Federal I.R.C. §263 rules. If a taxpayer does not elect to expense the intangible drilling and development costs, the costs must be capitalized and recovered during a 10-year period. Alternatively, a taxpayer may elect to currently expense up to one-third of the costs in the taxable year during which the costs are incurred and recover the remaining costs during a 10-year period. [72 P.S. §7303(a)(2)(a.8)].

1-4:2.11 I.R.C. §179 Property.

Pursuant to 72 P.S. §§ 7301, *et seq.*, taxpayers may treat the cost of property commonly referred to as Section 179 property (§ 179 Property) as a currently deductible expense (§ 179 Deduction). The § 179 Deduction is tied to the deduction permitted under § 179 of the Internal Revenue Code of 1986 (I.R.C.), depending upon when the property is placed in service. Unless stated otherwise, Pennsylvania follows the rules contained in I.R.C. § 179.

A taxpayer is permitted to claim a § 179 Deduction for Pennsylvania personal income tax purposes even if the taxpayer does not elect to currently expense the cost of the § 179 Property for federal income tax purposes.

The § 179 Deduction is a business expense. Thus, it can only be used to offset gain from net profits, or Schedule C income, for Pennsylvania personal income tax purposes. It cannot be used to offset gain from any other Pennsylvania personal income tax class.

The cost of the § 179 Property that can be used as a § 179 Deduction is subject to two limitations: (1) a dollar limitation; and (2) a business income limitation.

Dollar Limitation

For § 179 Property placed in service before 2023, the Pennsylvania personal income tax dollar limitation is based upon earlier of the I.R.C. § 179 dollar limitation at the time the § 179 Property was placed in service or the I.R.C. § 179 dollar limitation in effect in 2003. The applicable dollar limitation for those years are as follows:

1997:	$18,000
1998:	$18,500
1999:	$19,000
2000:	$20,000

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2001-02:	$24,000
2003-22:	$15,000

Act 53 of 2002 (Act 2022-53, P.L. 513, No. 53) amended the Pennsylvania personal income tax law to increase the dollar limitation to match the federal income tax dollar limitation. The amendment applies to § 179 Property placed in service in tax years beginning on or after 2023. In those instances, the dollar limitation is $1,000,000, subject to annual inflation adjustment.

Mirroring the federal dollar limitation, the Pennsylvania dollar limitation is reduced dollar-for-dollar by the amount the taxpayer's § 179 Property placed in service during such taxable year exceeds $2,500,000, subject to an annual inflation adjustment.

A taxpayer may elect to currently expense the cost of § 179 Property up to the abovementioned dollar limitations. A taxpayer is not required to expense any of the cost of its § 179 Property. Further, a taxpayer can elect to expense less than the dollar limitation, but not more. The dollar limitation applies to the *aggregate* cost of all of the taxpayer's § 179 Property for the taxable year.

The cost of any § 179 Property that the taxpayer does not elect to expense, either by choice or because of the dollar limitation, is treated as a capital expense and must be depreciated over the useful life of the asset (less salvage value) following normal Pennsylvania personal income tax depreciation rules. See section 1-4:2.8, below, for depreciation.

Business Income Limitation

Once a taxpayer elects the amount of the § 179 Property cost to currently expense, the taxpayer may deduct that amount subject to the business income limitation. For Pennsylvania personal income tax purposes, the § 179 Deduction cannot be greater than the taxpayer's Pennsylvania personal income tax net profits for the taxable year. The § 179 Deduction is applied after all other business-related expenses and losses and cannot reduce the taxpayer's Pennsylvania personal income tax taxable net profits below zero. To the extent the § 179 Deduction exceeds the taxpayer's net profits, the remaining deduction is carried over to the following year. The § 179 Deduction is carried over indefinitely to subsequent years until exhausted.

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For pass-through entities, the election to expense § 179 Property is made at the entity level. A partner or shareholder is required to follow the election. The § 179 Deduction is calculated at the entity level based upon its § 179 Property placed in service for the year, with the dollar limitation and the business income limitation calculated and applied at the entity level. The § 179 Deduction is passed through to the entity's owners according to the owner's pro rata ownership interest. The owner's share of the § 179 Deduction must be passed through as a separately stated item on the entity's Pennsylvania personal income tax entity return (PA 20S/65) and owner information statement (PA K-1s and NRK-1s). An entity's § 179 Deduction must be apportioned for its nonresident owners. The apportionment percentage is the same as the entity's taxable business income apportionment percentage for its nonresidents. For more information and examples, see Pennsylvania Personal Income Tax Bulletin No. 2023-02, 08/02/2023.

1-4:2.12 Depreciable Basis.

An asset's depreciable basis refers to its adjusted basis for the purpose of determining gain or loss on the sale, exchange, or other disposition for personal income tax purposes at the time the property is placed into service less its reasonably estimated net salvage value at the end of its reasonably estimated useful economic life.

Note: While Pennsylvania recognizes the depreciation deduction established by I.R.C. §179, Pennsylvania depreciation may only be calculated using the straight line method; use of the modified cost recovery system (MACRS) is not allowed. Additionally, the Pennsylvania deduction is limited to $25,000 (which is applied jointly for spouses regardless of filing status), and is phased out with respect to acquisitions over $200,000 for tax years prior to 1/1/2023. Effective 1/1/2023, Pennsylvania adopts I.R.C. §179 and increases the expense deduction to $1,080,000. Pennsylvania does not adopt federal bonus depreciation; the federal interest tracing rules; deferral of gain under I.R.C. §1031 (effective 1/1/2023 Pennsylvania will recognize I.R.C. §1031); the election to treat a sale of stock as an asset sale under I.R.C. §338(h)(10); and the election to depreciate a step-up basis under I.R.C. §754.

1-4:2.13 Revised Service Lives or Salvage Values.

Whenever facts are discovered or events occur that would change an earlier estimated service life or salvage value of an asset, revisions must be made. Such revisions only affect the remaining useful life of the asset; prior adjustments to depreciation deductions are neither required nor permitted.

1-4:2.14 Use of Federal Guidelines.

Service lives and salvage values determined under the Federal Class Life ACR System, I.R.C. §168 and I.R.C. §169 may be used as a convenience for Pennsylvania Personal Income Tax purposes, but only on the condition that they are also used for federal income tax purposes.

1-4:2.15 Basis Adjustments.

The basis of depreciable assets must be reduced (but not below zero) each year by the greater of the following:

- The amount actually deducted – and allowable – on a Pennsylvania return, but only so far as the deduction resulted in a reduction in income.
- The amount allowable using the straight-line method of depreciation without regard to whether the deduction would result in a reduction in income.

1-4:2.16 Partnership Income.

(See Chapter 6, below, for a detailed discussion of the taxation of pass-through entities.) The partnership agreement allocates the amount of partnership income to be reported by a partner. If this allocation has no substantial economic effect, the partnership agreement will be disregarded. *See* Instructions for Form PA-65. According to the Department of Revenue, the federal definition of "substantial economic effect" should be used to determine whether allocations pursuant to the partnership agreement have substantial economic effect. In order for the partnership agreement to be applicable, the allocations must have substantial economic effect independent of any tax consequences. The classification of income is made at the partnership level. Not all income from a partnership, however, can be classified as business income.

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1-4:2.17 S Corporation Income.

(See Chapter 6, below, for a detailed discussion of the taxation of pass-through entities.)

The following guidelines determine the treatment of a taxpayer's distributive share of Pennsylvania S corporation income:

- The character of any item of income or losses included in a shareholder's pro rata share is determined as if it were realized directly by the shareholder from the source in which it was realized by the corporation. Income or loss is prorated daily for assignment to shareholders during the taxable year. [72 P.S. §7307.9(b), (c)].
- Any deduction (except a net loss deduction) that was disallowed when a corporation was subject to the corporate net income tax is allowed in years in which the corporation is a Pennsylvania S corporation to the same extent and in the same manner that the deduction would have been allowed if it had remained subject to the corporate net income tax. [72 P.S. §7307.8(e)]. However, nonresident shareholders are allowed these "previously disallowed deductions" only to the extent they would have been considered Pennsylvania-source income. [72 P.S. §7307.9(d)].
- The aggregate amount of losses taken into account cannot exceed the sum of the adjusted basis of the shareholder's stock in the Pennsylvania S corporation and the shareholder's adjusted basis of any indebtedness of the Pennsylvania S corporation to the shareholder before adjustment. Any losses that cannot be used are lost. Loss carryovers are not allowed. [72 P.S. §7307.10(b)]. However, a year in which a Pennsylvania S election is in effect is considered a taxable year for purposes of the three-year net loss carryover period under the corporate net income tax. [61 Pa. Code §153.15(d)].

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- Resident shareholders must make estimated tax payments with respect to their distributive shares of income from a Pennsylvania S corporation. An S corporation is required to withhold and remit personal income tax on nonresident partners, Bear in mind, however, that although Pennsylvania resident shareholders are taxed on their entire share of S corporation income, regardless of where the S corporation earned the income, nonresidents pay tax only on income apportioned and/or allocated to Pennsylvania.
- Resident shareholders are allowed a credit for income taxes paid by the shareholder or the corporation to other states with respect to their pro rata share of the S corporation's income (subject to the limitations provided by law). [72 P.S. §7314(a)].
- Stock basis must be increased by the share of S corporation income, including nontaxable income; decreased by distributions not included in the taxpayer's income; and decreased by the share of corporate losses, to the extent that there was a tax benefit from the loss deduction. But taxpayers can never reduce their basis below zero.

1-4:2.18 Distributions from Accumulated Adjustment Accounts.

"Earnings and profits" refers to accumulated earnings and profits from non-Pennsylvania S years. If taxpayers receive a distribution from an accumulated adjustments account (e.g., upon termination of the corporation's Pennsylvania S election), the distribution is a nontaxable return of capital to the extent of their basis in their stock. Distributions from an accumulated adjustments account in excess of basis are considered taxable gains from the sale or exchange of property.

1-4:2.19 Basis Adjustments.

A taxpayer's basis in the stock of a Pennsylvania S corporation is increased by a taxpayer's share of the corporation's income

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(including nontaxable income). Pursuant to 72 P.S. §7307.11(b), basis in the stock "shall be decreased for any period, but not below zero by any distribution by the corporation" not included in the shareholder's income and by the shareholder's "share of the corporate losses . . . to the extent the losses reduced the shareholder's income subject" to either the Pennsylvania Personal Income Tax or a tax measured by net income imposed by another state. If stock basis is reduced to zero, "any excess losses will reduce the shareholder's basis but not below zero, in any indebtedness of the Pennsylvania S corporation to the shareholder." The reduction "shall be restored before the shareholder's basis in the Pennsylvania S corporation's stock is increased." [72 P.S. §7307.11].

1-4:2.20 Tax-Exempt Income of a Pennsylvania S Corporation.

A Pennsylvania S corporation retains its tax-exempt status for the shareholder if income is not taxable to it. Losses from tax-exempt obligations cannot be used to offset other taxable income on the individual shareholder's PA-40. However, taxpayers must adjust their basis for the corporation's nontaxable income. *See* §1-4:2.19, above.

1-4:2.21 Differences in Federal/Pennsylvania Personal Income Tax Rules for Deductions.

Federal income tax legislation and judicial decisions resulted in Department of Revenue rule revisions for certain deductions of sole proprietorships, partnerships, and S corporations for personal income purposes. See Chapter 6, below, for a discussion of the taxation of pass-through entities.

1-4:2.21a Bonus Depreciation.

Pennsylvania Personal Income Tax law does not follow the federal allowances for additional depreciation expenses.

1-4:2.21b Contributions Made to Organizations.

For federal income tax purposes, business deductions will be denied in cases of contributions made to organizations whose nondeductible lobby activities offer direct financial interest to the donor. For Pennsylvania income tax purposes, however, such a contribution may still be claimed if it is an expense incurred in

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the conduct of the taxpayer's business and complies with generally accepted accounting principles and practices because the General Assembly has not specifically refused this deduction. Note, though, that claiming contributions as unreimbursed employee business expenses is not permissible.

1-4:2.21c Charitable Contributions.

Charitable contributions made from business funds for business purposes and publicly acknowledged by the charity are allowable expenses for Pennsylvania.

1-4:2.21d Club Dues.

Club dues are not deductible for federal income tax purposes. For Pennsylvania income tax purposes, however, club dues may still be claimed if it is an expense incurred in the conduct of the taxpayer's business and complies with generally accepted accounting principles and practices because the General Assembly has not specifically refused this deduction. Again, claiming dues as an unreimbursed employee business expense is not permissible.

1-4:2.21e Entertainment.

For federal income tax purposes, taxpayers may deduct a maximum of 50 percent of the qualifying amount of business meals and entertainment. For Pennsylvania Personal Income Tax purposes, taxpayers may deduct 100 percent of the qualifying amount of business meals and entertainment.

1-4:2.21f Moving Expenses.

Under federal income tax provisions, deductible moving expenses are deductible for the computation of adjusted gross income (i.e., above-the-line) and are limited to the cost of: (1) transportation of household goods and effects and (2) travel (including lodging but not meals) to the new residence. The federal distance test for expenses is 50 miles. However, Pennsylvania's personal income tax mandates that deductible moving expenses may only be claimed as a Schedule UE expense (unreimbursed employee business expenses) and are limited to: (1) transportation of household goods and effects and (2) travel (including both lodging and meals) to the new residence. The expenses can only be deducted by taxpayers if

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they stemmed directly from moving between a single employer's work locations (moving from one official site to another) at the request or direction of the employer. Pennsylvania's distance test is also 50 miles. The moving expense deduction isn't available to new employees or self-employed individuals.

1-4:2.21g Office in the Home.

A taxpayer is entitled to a deduction for an office in the home only if it is his or her principal business location, which stems from Department of Revenue analysis of the United States Supreme Court decision in *Soliman* in regard to determining the deductibility of home office expenses. In regard to a business deduction for basic local telephone service charges, Pennsylvania follows the federal rule of denying it on the first phone line in residence even when claimed as an office-in-the-home expense.

The COVID-19 pandemic created an increase in the number of employees that were working from home, many of which may be tempted to claim a home office deduction. The deduction is allowable for taxpayers who were temporarily (or, now, permanently) working from home due to the pandemic if their employer did not provide a suitable work area or they were not permitted to go into the office due to the pandemic. In order to be eligible to claim the deduction, they must meet a number of requirements: (1) the employer must require, as a condition of employment, that the employee maintain a suitable work area away from the employer's premises; (2) the office or work area must be the principal place where the employee performs the duties of their employment; (3) the employee must use the office or work area regularly to perform the duties of their employment; and (4) there must be exclusive use of the area for which the deduction is claimed.

However, there may be adverse tax consequences to claiming the deduction. Taxpayers that claim the deduction will be required to pay income tax on the gain from the sale of their home on the portion of their home that is claimed as a home office. *See* PA Tax Talk: Can Pennsylvania Taxpayers Deduct Their Home Office Expenses During Telework, Pa. Dep't of Rev., 03/09/2021.

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1-4:3 Net Profits, Net Gains or Income From Disposition of Property.

The third category of Pennsylvania taxable income contains net gains or net income, less net losses, derived from the sale, exchange or other disposition of property, including real property, tangible personal property, intangible personal property or obligations issued by the federal government or obligations issued on or after February 1, 1994 by Pennsylvania, including those issued by any public authority, commission, board or other agency created by the Commonwealth, any of its political subdivisions or any public authority created by its political subdivisions. Net gains or income from disposition of property are determined in accordance with accepted accounting principles and practices. [72 P.S. §7303(a)(3)].

In *Alberti v. Commonwealth*, 2018 Pa. Commw. Unpub. LEXIS 298 (May 31, 2018) (unreported), the Commonwealth Court held that gain from the sale to a settlement company of a lottery annuity that the taxpayer had won in 1995 was taxable for Personal Income Tax purposes under 72 P.S. §7303(a)(3) as income from the sale of a Commonwealth obligation after February 1, 1994.

1-4:3.1 Reorganizations.

Under 72 P.S. §7303(a)(3)(iv), the "exchange of stock or securities in a corporation that is a party to a reorganization in pursuance of a plan of reorganization, solely in return for stock or securities in such corporation or in another corporation a party to the reorganization does not constitute a taxable sale or exchange. Likewise, the transfer of property to a corporation by one or more persons solely in exchange for stock or securities in such corporation does not constitute a taxable sale or exchange if immediately after the transfer, the receipt of the stock or securities is in control of the corporation." [72 P.S. §7303(a)(3)(iv)]. "The taxpayer's basis in the stock or securities received is the same as the taxpayer's actual or attributed basis for the stock, securities or property surrendered in exchange therefor." [72 P.S. §7303(a)(3)(iv)(F)].

Note: For purposes of applying the reorganization provisions in §7303, every limited liability company is deemed to be a corporation with respect to a "reorganization" as defined in that Section [15 P.S. §8925(b)].

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1-4:3.2 I.R.C. §338(h)(10) Elections Not Recognized.

For Pennsylvania Personal Income Tax purposes, gain recognized by shareholders under I.R.C. §338 is "deemed gain" from the sale of assets that is not to be taken into account. In preparing the PA-20S/PA-65, the I.R.C. §338(h)(10) gain on the sale of assets reported on the federal return should be backed out on either the Schedule M or the Schedule D. The Pennsylvania return should not include the fictitious gain from the §338(h)(10) transaction. The Pennsylvania shareholder should pick up the gain on the sale of stock on the PA-40 Schedule D. A resident shareholder may claim a resident credit for taxes paid to another state on Schedule D gain resulting from an I.R.C. §338(h)(10) transaction. The Schedule GL should show the tax paid to the other state on the transaction.

Example (From 2012 PICPA Questions for the Department of Revenue (June 19, 2012)).

> ***Question:***
>
> S Corporation A, an S corporation, merged into buyer Corporation B in a §338(h) transaction. For federal and Utah (UT) purposes, gain from the sale of stock is treated as a sale of assets by A and a liquidation of the proceeds to the shareholders. The gain on the sale is $350,000. The liquidating distribution is also $350,000.
>
> Each shareholder has a federal stock basis before the sale of $0. Income from operations in the year of sale is $5,000. $350,000 (pro-rata share of §338(h)) of the gain is apportioned to Utah (UT) [benefit derived state]. The character of UT income is ordinary business income, which is passed through to the shareholders to report on their individual UT income tax returns. Each A shareholder will file an individual UT personal income tax return and reports income from the year of sale as $355,000 ($350,000 gain from the sale of assets, plus $5,000 income from operations).
>
> Pennsylvania resident shareholders will file individual PA personal income tax returns. PA does not allow §338(h) for S Corporations; therefore gain on sale

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is taxed at the shareholder and not the corporate level for PA purposes. PA resident shareholders report the $5,000 on PA-40, line 4 as income from the operation of a business and a gain of $345,000 on Schedule D as a sale of stock (Stock basis increases from $0 to $5,000 ($5,000 income from operations) before the sale. Sales proceeds of $350,000 less stock basis of $5,000).

The same income (gain) is taxed to UT and PA but reported in a different class of income in each state. Will PA allow resident shareholders to take a credit for tax paid on the §338(h) income in UT?

Answer:

Yes. *See* PA PIT Guide, Chapter 16. On page 46 it states: A resident shareholder may claim a resident credit for taxes paid to another state on Schedule D gain resulting from an I.R.C. §338(h)(10) transaction.

1-4:3.3 Common Trust Funds.

The consequence of a transfer of all or most of a transferee's assets by a common trust fund (as it is defined in §584 of the I.R.C.) to another company or companies (as defined in §851 of the I.R.C.) in exchange for stock or units of beneficial interest in the transferor(s) is not a taxable gain or loss if no gain or loss is recognized for federal income tax purposes. The transferor's basis in the assets transferred forms the basis of the beneficial interest received by the transferee. [72 P.S. §7303(a)(3)(v)].

1-4:3.4 Disposition of S Corporation Stock.

In Letter Ruling No. PIT-07-001, Taxpayer acquired stock in a corporation that was treated as an S corporation for federal purposes, but treated as a C corporation for Pennsylvania purposes. (The corporation had not filed an election to be treated as a Pennsylvania S corporation and was not treated as a Pennsylvania S corporation until the Pennsylvania Legislature passed Act 67 of 2006 (Act of July 6, 2006, P.L. 319, No. 67). Act 67 provides that for tax years beginning after December 31, 2005, "any corporation which has a valid election in effect under subchapter S of Chapter 1 of the Internal Revenue Code of 1986, as amended to January 1,

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2005" is a small corporation, that is, a Pennsylvania S corporation. Because the corporation had a federal subchapter S election in effect, it became a Pennsylvania S corporation as of January 1, 2006).

When Taxpayer sold its stock in the corporation in 2006, Taxpayer's basis in the stock is the cost of the stock at the time of acquisition reduced by any subsequent distribution from the corporation, other than those distributions out of current earnings or profits, until December 31, 2005. Beginning January 1, 2006, the date when the corporation became a Pennsylvania S corporation, the basis should be adjusted as required pursuant to 72 P.S. §§7307.11 and 7307.12.

1-4:3.5 Partnership Distributions by Pennsylvania S Corporations.

A distribution of property by a Pennsylvania S corporation that has no accumulated earnings and profits is not included in the shareholder's income to the extent that it doesn't exceed the shareholder's adjusted basis in the stock. However, a distribution in excess of the adjusted basis in the stock is treated as gain from the sale of property. [72 P.S. §7307.12(a)].

1-4:3.6 Transfers or Exchanges of Partnership Interests.

In any partnership, a transfer of interest (for purposes of personal income tax) for an interest in another enterprise of like classification does not generate taxable gain or loss for Pennsylvania personal income purposes unless the gain or loss is taxable for federal income tax purposes. Likewise, gains or losses that result from the liquidation of a partnership or an exchange made following a statutory merger, consolidation or division are not taxable for Pennsylvania purposes unless taxable for federal tax purposes. In such transactions, the taxpayer's basis for the interest received is equivalent to the taxpayer's actual or attributed basis for the interest surrendered in the transaction. [72 P.S. §7303(a)(3)(vi)]. *See* Chapter 6, below, for discussion of the taxation of pass-through entities.

> **Distinguish:** With limited exceptions, a corporate partner is deemed to own its proportionate share of partner-

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ship assets and not an intangible asset for corporate net income tax purposes. Therefore, a corporation that sells its interest in a partnership would be deemed to be selling its proportionate share of partnership assets. [72 P.S. §7402.2].

1-4:3.7 Business Property.

In regard to the disposition of depreciable tangible personal property held for productive use in a trade or business, gains or losses should not be reported as net gains or income from disposition of property but as net income from a business, trade, or profession as long as the sale proceeds are used to acquire property to take the place of the business property sold.

Federal income tax law allows optional adjustment to basis (*see* I.R.C. §734 and §743). Pennsylvania law contains no provisions allowing these adjustments for Pennsylvania Personal Income Tax purposes. Furthermore, there is no Pennsylvania election similar to that allowed by I.R.C. §732(b).

1-4:3.8 Like-kind Exchanges.

For tax years prior to January 1, 2023, Pennsylvania Personal Income Tax law did not conform to I.R.C. §1031 and did not have similar nonrecognition provisions for "like-kind exchanges." [PIT Bull. 2006-07]. See also *Pearlstein v. Commonwealth*, 2024 Pa. LEXIS 1418 (2024), wherein the Pennsylvania Supreme Court held that net gains on like-kind exchanges of real property must be taxed in the years in which the exchange occurred. Thus, for tax years prior to 2023, gain or income from the exchange of properties was equal to the fair market value of property received at the time of the exchange reduced by a taxpayer's adjusted basis in the property given in exchange. [61 Pa. Code §103.13].

Notwithstanding, the Department of Revenue has indicated that an exchange pursuant to APB Opinion 29 may qualify as a tax-free like-kind exchange under Pennsylvania law, if a taxpayer consistently used GAAP and followed APB Opinion 29.

Effective for tax years beginning January 1, 2023, Pennsylvania recognizes I.R.C. §1031 like-kind exchanges. Act 53 of 2022, §4.

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1-4:3.9 Capital Gains Distributions.

Capital gains from mutual funds or other regulated investment companies are considered dividends and not gains from disposition of property. *See* Form PA-40R Instructions.

1-4:3.10 Transfers Incident to Divorce.

Pennsylvania's personal income tax does not apply to transfers of property incident to divorce as long as neither gain nor loss is recognized for federal purposes. (See I.R.C. §1041 dealing with the federal treatment of transfers incident to divorce). The Pennsylvania Department of Revenue Office of Chief Counsel has, in private letter rulings, classified such transfers as gifts, not exchanges.

1-4:3.11 Gain Upon Demutualization of an Insurance Company.

When a taxpayer relinquishes rights in a demutualization transaction, the relinquished rights must be assigned a $0 basis. As such, taxpayers will recognize gain upon demutualization equal to the fair market value of the stock or cash received in the transaction. Taxpayers who disagree, bear the burden of establishing that the basis in the rights relinquished is greater than $0. *Pennsylvania Personal Income Tax Bulletin 2009-01*, April 27, 2009. The bulletin also explains that taxpayers cannot rely on the 2008 federal tax decision, *Fisher v. United States*, 82 Fed. Cl. 780 (2008), as authority for using the open transaction doctrine to establish the cost basis for calculating gain arising from a demutualization transaction. *Pennsylvania Personal Income Tax Bulletin 2009-01*, April 27, 2009. Taxpayers must recognize the gain at the time the cash or stock is received in a demutualization transaction. A demutualization is, "[t]he conversion of a mutual insurance company owned by participating policyholders into a publicly-traded stock company owned by shareholders." *Pennsylvania Personal Income Tax Bulletin 2009-01*, April 27, 2009. For more information regarding the Fisher case and the Department's position, please refer to *Pennsylvania Personal Income Tax Bulletin 2009-01*, April 27, 2009.

1-4:3.12 Fraudulent Investment Schemes.

Personal Income Tax Bulletin 2010-02 provides investors with guidance regarding the tax treatment of losses from fraudulent

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investment schemes. Pennsylvania does not follow the federal income tax treatment of losses from fraudulent investment schemes pursuant to I.R.C. §165.

The Bulletin reiterates the Department's general position regarding a taxpayer's income from fraudulent investment schemes. If a taxpayer reports fictitious income from a fraudulent investment scheme in a prior tax year, the income reported increases the taxpayer's basis in the investment and any gain or loss will be recognized upon the final disposition of the investment. The loss is reportable on Schedule D by the taxpayer.

The Bulletin states that the period of recovery will be deemed to be final at the conclusion of all legal action to obtain a recovery on the investment; and/or when the taxpayer receives notification that all proceeds have been paid out of existing funds; or when the taxpayer has provided irrevocable notice in writing to the investment scheme that the taxpayer has relinquished all right, title, and interest in any recovery from the fraudulent scheme; or the year in which the taxpayer is precluded under state or other applicable law from pursuing any claim for recovery from the fraudulent investment scheme or any third party.

- *Gain/Loss* – A taxpayer realizes a loss upon the disposition of investment in the fraudulent scheme to the extent that the taxpayer's basis is greater than the amount recovered. Taxpayer realizes a gain to the extent the amount recovered is greater than the taxpayer's basis. The amount recovered from the investment includes the amount of cash and the fair market value of other property received in bankruptcy or other type of recovery which may include any insurance coverage, contractual guarantees or any amounts payable from the Securities Investor Protection Corporation or any similar recovery. If a promissory note is distributed to the taxpayer, then the amount recovered equals the face amount of the note.
- *Increase/Decrease to Basis* – A taxpayer's basis in the investment in the fraudulent scheme is calculated by subtracting basis reductions from

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basis increases. Basis reductions include the amount of any distributions of cash or other property received over the life of the investment or in the final year of investment; losses used by the taxpayer in any state including Pennsylvania, any decrease in the taxpayer's allocable share of any entity liabilities. Basis increases include the taxpayer's initial investment in the form of cash or other property; income from the investment (whether actual or fictitious) that the investor reported and upon which the taxpayer paid Pennsylvania Personal Income Tax; any further investments in the form of cash or other property; any non-deductible, non-capitalizable expenses; tax-exempt income; and any increase in taxpayer's allocable share of entity liabilities.

- *Limitations on Losses* – 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. A taxpayer with actual or constructive notice of fraud at the time he or she contributed cash or property to a fraudulent investment fund may not claim a loss for any portion of the loss attributable to such contribution.

The Department of Revenue will not accept amended returns to reduce income from a fraudulent investment scheme from a previous year tax return. A taxpayer will have to file a petition for refund with the Board of Appeals. The Bulletin provides details on the procedure for filing a petition for refund with the Board of Appeals as well as discussing the burden of proof and the documentation required to be provided by the taxpayer.

The Bulletin also sets forth a number of comprehensive examples for the taxpayer to determine the proper treatment of losses incurred from fraudulent investment schemes.

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1-4:3.13 Basis.

With few exceptions, basis equals cost at acquisition less depreciation or amortization. Pursuant to 61 Pa. Code §103.13(c), "[i]f property is acquired by a taxpayer by inheritance, the basis shall be the fair market value at the date of death. If property is acquired by a taxpayer by gift, the basis shall be the same as it would be if the property had remained in the hands of the donor. Otherwise, the basis shall be the cost."

1-4:3.14 Pre-June 1, 1971 Acquisitions.

The current Pennsylvania Personal Income Tax was enacted effective June 1, 1971. The legislature acted to preclude taxation of gain attributable to pre-June 1, 1971 appreciation of property. Hence, under 61 Pa. Code §103.13(f), for purposes of computing gains, the basis of property acquired before June 1, 1971 shall equal the higher of acquisition cost or June 1, 1971 fair market value. [61 Pa. Code §103.13(f)]. For purposes of computing losses, the basis of property acquired before June 1, 1971 shall be the cost or other basis as adjusted without reference to the fair market value as of June 1, 1971. [61 Pa. Code §103.13(f)]. If the selling price is greater than cost but less than the June 1, 1971 value, there is neither taxable gain nor loss. [61 Pa. Code §103.13(f)].

There are four ways to determine the fair market value on June 1, 1971:

- The Listed Security Method: Under this method, the fair market value of property on June 1, 1971, is one of the following: (1) The opening price on June 1, 1971; (2) the price of the last sale during the preceding week if it was not traded on June 1, 1971; or (3) the average of the high and low price or the average of the bid and asked quotations on June 1, 1971, whichever is appropriate, if it was not traded on or during the week preceding June 1, 1971.
- The Appraisal Method: The taxpayer may utilize an appraisal of fair market value made on or about June 1, 1971.

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- The Proration Method: The fair market value of an asset may be determined in accordance with the following property value formula:
- Property's Value as of 6/1/71 = Current Fair Market Value of Property × A + Historic Cost of Property × B.

  A is a fraction. The numerator is the number of full calendar months the property was held prior to 6/1/71 and the denominator is the number of full calendar months in the taxpayer's entire holding period for the property.

  B is a fraction. The numerator is the number of full calendar months the property was held after 5/31/71 and the denominator is the number of full calendar months in the taxpayer's entire holding period of the property.

  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.
- Deemed Value: If the taxpayer cannot determine the fair market value on 6/1/71, the value of the property shall be deemed to be its adjusted basis as of 6/1/71, or zero if the adjusted basis cannot be determined.

1-4:3.15 Tax Benefit Rule.

The basis of property shall be reduced, but not below zero, for depreciation by the greater of: (1) the amount deducted on a 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 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 reasonable estimated useful life, regardless of whether the deduction results in a reduction of income (Act 89, June 29, 2002).

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In a 2012 case, the Commonwealth Court addressed the application of the tax benefit rule in the context of COD income generated from the foreclosure on partnership property. *Marshall v. Commonwealth*, 41 A.3d 67 (Pa. Commw. Ct. 2012). In *Marshall*, a nonresident invested in a limited partnership which owned a building in Pennsylvania which went into foreclosure. The partnership purchased property in Pittsburgh for $360 million, of which $308 million was financed with a nonrecourse purchase money mortgage note secured by the property. Interest on the note accrued monthly, but if the accrued interest exceeded actual net operating income of the partnership, the excess was deferred and compounded. The lender foreclosed on the property during 2005, and the Pennsylvania Department of Revenue assessed the taxpayer on the basis that the discharge of debt was income to the partnership and, thus, income to the taxpayer.

The court first rejected several arguments by the taxpayer, including: (1) that the taxpayer should not be subject to Pennsylvania income tax because he was not a resident of Pennsylvania and did not have sufficient minimum contacts with the Commonwealth; (2) Pennsylvania regulations do not allow for the inclusion of discharge of indebtedness income in Pennsylvania taxable income; (3) the Department is prohibited from taxing him because he actually derived no income from his investment in the partnership; and (4) gain was not correctly computed.

Next, the taxpayer argued that the tax benefit rule should apply, limiting the included amount of COD income to the portion of the accrued but unpaid interest that the partnership was able to deduct in prior years. The court rejected this argument, noting that the income at issue was in a different class than the deductions. Specifically, while the income related to the disposition of property, the interest deductions were operations expenses associated with net profits. [72 P.S. §7303(a)(2), (3)]. The court concluded that the tax benefit rule could not be applied in the method offered by the taxpayer because Pennsylvania law prohibits offsetting a gain in one class of income with a loss in another class. Further, the court observed that applying the tax benefit rule would equate to

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allowing an NOL carryover in excess of $2 billion, when carryovers are not allowed for PIT purposes.

Taxpayers appealed to the Pennsylvania Supreme Court asserting that the Commonwealth Court committed nine errors, which the Pennsylvania Supreme Court addressed in five parts. *Wirth v. Commonwealth*, 95 A.3d 822 (Pa. 2014), *cert. denied*, 135 S. Ct. 1405 (2015). First, the Court addressed the Commerce Clause and Due Process Clause arguments. Initially, the Court concluded that neither of those clauses prohibited the Department of Revenue from assessing PIT against the taxpayers. Regarding the Commerce Clause, the Court found that taxpayers had waived their right to that claim. Regarding the Due Process Clause, the Court found that the taxpayers had minimum contacts with Pennsylvania because the primary purpose of the partnership was to own, operate, and gain income from a Pennsylvania office tower. Second, the Court agreed with the Commonwealth Court that pursuant to 72 P.S. §7303(a)(3) and 61 Pa. Code §103.13, PIT could be assessed against taxpayers for their share in any gain associated with the nonrecourse foreclose on the property. Third, the Court examined whether the taxpayers could deduct the loss associated with the failed investments from the assessed PIT related to the foreclosure on the property, which the Court determined they may not. Fourth, the Court found that the inability of the taxpayers to deduct the investment loss did not violate the Privileges and Immunities Clause or the Uniformity Clause. Finally, taxpayers argued that whether the accrued interest could properly be included within the assessment of PIT depended on the application of the tax benefit rule. The Court held that there could be no application of the tax benefit rule in this case, since it is required that the attempted exclusion of realized gain be related to a deduction without tax consequences from a prior year.

1-4:3.15a Tax Benefit Rule – Federal and Pennsylvania Differences.

It is common for a taxpayer to receive a federal tax benefit but not a Pennsylvania tax benefit from items such as depreciation. This is due to the Commonwealth's prohibition against offsetting between or among classes of income. As a result, the Pennsylvania basis in property often differs from the federal basis. Pennsylvania's Department of Revenue requires no reduction of a taxpayer's basis

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in a partnership or S corporation by losses for which he or she has no benefit in Pennsylvania or any other state.

1-4:3.16 Method of Reporting Gains.

As a rule, in this class of income, gains or losses are reported in full as ordinary taxable income. However, the installment sales method of reporting is permitted in Pennsylvania upon the sale of tangible personal property or real property; Pennsylvania does not allow installment sale reporting for the sale of intangible personal property, for transactions of which the object is the lending of money or the rendering of services, or the sale of a principal residence where the taxpayer elects to exclude gain. [72 P.S. §7301(1.1); Form PA-40R Instructions]. Consequently, the sale of securities, partnership interests, or accounts receivable cannot be reported on the installment sales method. Taxpayers engaged in the sale of tangible personal property who regularly sell on the installment plan are able to report on the installment sales method on a Pennsylvania Schedule C, even though for taxable years beginning after January 1, 1988, they are prohibited from reporting on the installment method for federal income tax purposes. A Pennsylvania S corporation can use the installment sales method for personal income tax purposes if it is used for book purposes. Adjustments should be made on Schedule CF and should include an adequate explanation. [*Pennsylvania Legislative Alert* (PICPA), Vol. VIII, Issue 2, July 31, 1989, pp. 4-5]. Taxpayers who opt for the installment method allocate the gain in equal proportion to each payment to be received.

The installment method does not apply unless one opts for it in the case of Pennsylvania Personal Income Tax purposes, whereas it does apply for federal income tax purposes if all criteria are met unless one opts out of it.

If a cash basis taxpayer enters into an agreement for the sale of intangible personal property under which at least one payment is to be received in a taxable year following the year of sale, the seller shall use the cost recovery method of accounting, provided that the note or contractual promise is not assignable. Under the cost recovery method, the basis in the intangible personal property is recovered first. After the payments under the note or contractual promise exceed the seller's basis in the intangible personal property, gain is recognized.

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Interest stemming directly from the installment sale contract or agreement is reported as gain from the disposition of property. *See* Form PA-40R Instructions.

1-4:3.17 Nonrecognition of Gains or Losses.

Pennsylvania allows non-recognition of gain or loss only with regard to the following situations: (1) corporate reorganizations; (2) transfers to controlled corporations; (3) gains on the disposition of obligations exempt from the Pennsylvania Personal Income Tax (if these obligations were issued before February 1, 1994; gains on government obligations issued on or after February 1, 1994, are taxable) and; (4) gains on the sale of one's principal residence.

1-4:3.18 Exempt Obligations.

In general, gains on the transfer of the following obligations are free from taxation for state and local purposes in Pennsylvania:

- obligations issued prior to February 1, 1994 by the Commonwealth of Pennsylvania, any public authority, commission, board or other agency created by the Commonwealth, any political subdivision of the Commonwealth, or any public authority created by any political subdivision of the Commonwealth; and
- obligations issued by the United States of America.

However, the obligations subject to the inheritance and estate tax and profits, gains or income derived from the sale, exchange or other disposition of state and local obligations issued on or after February 1, 1994 are taxable. The exemption still applies to gains on state and local obligations issued before February 1, 1994. [72 P.S. §7303(a)(3)(iii)].

Federal law mandates the exemption for income on obligations issued by or on behalf of the U.S. Government. [31 U.S.C. §742].

Pennsylvania's personal income tax does apply to gains from the disposition of obligations of other states and countries. Although taxpayers may use losses to offset gains within a class of income, they may not use a net loss in one class to offset a net gain in another class. A net capital loss for a given year may not be carried forward or back to another year. The Pennsylvania Personal Income Tax

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system *does not* provide for carryback or carry forward of gains or losses.

1-4:3.19 Exclusion of Gains From the Sale or Exchange of a Principal Residence.

Pennsylvania states that the definition of "net gains or net income, less net losses" does not include any gain or loss from the sale, exchange, or other disposition of a taxpayer's principal residence. [72 P.S. §7303(a)(3)(vii)]. The statute defines a "principal residence" as having "been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating at least two years during the five-year period ending on the date of the sale, exchange or disposition." If, during the required five-year period, a taxpayer has used only a portion of the residence as his or her principal residence, the exclusion will result only from the gain attributable to the portion used as a principal residence. A prior sale, exchange or disposition by the taxpayer of a principal residence prohibits the exclusion of any gain or loss unless the disposition was due to a change in employment, health or (to the extent provided in regulations) unforeseen circumstances [72 P.S. §7303(a)(3)(vii)(B)].

In Letter Ruling No. PIT-07-002, the Department ruled that the taxpayers did not satisfy all of the conditions of 61 Pa. Code §103.13(h) in order to exclude gain from the sale of their Pennsylvania residence from Pennsylvania taxable income. Although the taxpayers' sale of their home in Pennsylvania was due to "unforeseen circumstances," taxpayers did not meet the 2 year ownership and usage conditions required for exemption.

1-4:3.20 Exclusion of Gains Invested in Opportunity Zones.

The definition of "net gains or net income, less net losses" does not include any gain or loss excluded from Federal Income Tax under special federal rules for capital gains invested in federally designated opportunity zones set forth in 26 U.S. §1400Z-2 [72 P.S. §7303(a)(3)(viii)].

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1-4:4 Net Gains or Income Derived from or in the Form of Rents, Royalties, Patents, and Copyrights.

The fourth class of taxable income is "net gains or income derived from or in the form of rents, royalties, patents and copyrights." [72 P.S. §7303(a)(4)]. There is guidance in neither the Pennsylvania statutes nor regulations with regard to the method to be used to compute net gains or income from these sources. Hence, federal income tax rules are generally acceptable for the computation of net income from this class of income. Nonresidents are only taxed for property located or used within Pennsylvania.

1-4:4.1 Home-Sharing Rentals.

Renting out sleeping accommodations for less than thirty (30) days is a hotel rental and the state's six-percent (6%) hotel occupancy tax applies. This applies to homeowners who use online home rental websites. Homeowners must report income from home-sharing rentals with their Personal Income Tax Return, using Schedule C, Profit or Loss from Business or Profession. To collect the hotel occupancy tax, property owners must first register with the Department of Revenue for a Sales, Use and Hotel Occupancy Tax License by completing and submitting Form PA-100. The department collects an additional one-percent (1%) local hotel tax in Philadelphia and Allegheny County. [Revenue Department Reminds Homeowners Using Home-sharing Sites to Register, Collect and Remit the Hotel Occupancy Tax, Pa. Dep't of Rev., 05/31/2016].

1-4:5 Dividends.

1-4:5.1 The Fifth Class of Income is Dividends.

[72 P.S. §7303(a)(5)]. Dividends include any distribution in cash or property made by a corporation, association or business trust out of accumulated earnings and profits, or out of earnings and profits of the year in which such dividend is paid. Dividends do not include a return of premium. [72 P.S. §7301(f); 61 Pa. Code §101.1].

The Tax Cuts and Jobs Act of 2017 introduced the federal Repatriation Transition Tax (RTT), which imposes a tax upon untaxed earnings and profits of foreign corporations accumulated

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between 1986 and 2018. The RTT is imposed upon income constituting a "deemed dividend" to the foreign corporation's shareholder, which means that it is imposed as though the income constitutes a dividend even though no actual distribution of cash or property from of E&P occurs. Because the "deemed dividend" does not involve an actual distribution of cash, it is not a dividend for PIT purposes. [Info. Notice Corp. Taxes and Personal Income Tax 2018-1, Tax Cuts and Jobs Act of 2017, Issued April 20, 2018].

The term "dividends" does not include any gain or loss excluded from Federal Income Tax under special federal rules for capital gains invested in federally designated opportunity zones set forth in 26 U.S. §1400Z-2 [72 P.S. §7303(a)(5)].

1-4:5.2 "Dividends" of Certain Financial Institutions.

The Pennsylvania Department of Revenue takes the position that "dividends" attributable to depositor accounts with a financial institution such as a savings and loan, mutual savings bank, cooperative bank or credit union should be classified as interest for Pennsylvania purposes.

1-4:5.3 Exempt Interest Dividends.

Exempt interest dividends are derived from the income collected from a mutual trust that can be attributable to excludable obligations from the Pennsylvania Personal Income Tax (e.g., Pennsylvania or federal obligations). The criteria for classifying a mutual fund as excludable takes into account both the mutual fund's organization and the core assets producing the income. A mutual fund's income is taxable if it is organized as a business fund, whereas if it is organized as a fixed portfolio investment trust, a portion of the income (that which comes from the trust attributable to Pennsylvania exempt obligations) is excludable; the remainder of the fund's income is taxable.

1-4:6 Interest.

Pursuant to 72 P.S. §7303(a)(6), taxable income 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 United States."

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Simply because an obligation is exempt from the federal income tax does not mean that it is also exempt from the Pennsylvania Personal Income Tax. The exclusion for federal tax-exempt obligations does not automatically extend to those obligations whose only statutory basis for exclusion is the Internal Revenue Code.

Pursuant to 61 Pa. Code §103.16(a), "interest includes any charge for the use or detention of money or for a forbearance from enforcement of a debt that is due, whether or not payable as such or as principal, including, for taxable years beginning on or after January 1, 1993, any excess of a publicly offered obligation's stated redemption price at maturity over the first price at which a substantial amount of the obligations included in the issue is sold to the public. For this purpose, the public does not include bond houses, brokers or other persons or organizations acting in the capacity of underwriters or wholesalers. As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable."

Taxable interest includes the following:

- Interest on savings or other bank deposits;
- Interest on coupon bonds;
- Interest on open accounts, promissory notes, mortgages, and corporate bonds;
- Interest portions of condemnation awards;
- Usurious interest (unless state law classified it as payment of principal);
- Interest on legacies;
- Interest on life insurance proceeds held under an agreement to pay interest thereon;
- Interest on tax refunds; and
- Interest received under an annuity contract.

1-4:6.1 Bonds.

If a taxpayer purchases bonds where interest has accrued but has not been paid, interest that is in arrears but has accrued at the time of purchase is not taxable interest. If subsequently paid, the payments are returns of capital that reduce basis. Interest

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that accrues after the purchase date is taxable interest income for the year in which it is received or accrued, depending on the taxpayer's method of accounting. [61 Pa. Code §103.16(b)]. If bonds are sold between interest dates, part of the sale price represents taxable interest accrued to the date of the sale. [61 Pa. Code §103.16(c)].

1-4:6.2 Unstated or Imputed Interest.

Unstated or imputed interest, including interest derived from government obligations, is computed in the same manner as it is required to be computed for federal income tax purposes. [61 Pa. Code §103.16(f)]. In letter ruling No. PIT-10-002, Issued June 7, 2010, the Department of Revenue determined that the parent should compute imputed interest income on the no interest loan made to his child using the federal rules and rates applicable to imputed interest for Pennsylvania Personal Income Tax purposes.

1-4:6.3 Government Obligations.

Interest on obligations issued by or on behalf of the United States Government is not taxable by Pennsylvania. Likewise, Pennsylvania does not tax interest on obligations issued by the Commonwealth itself, a public authority, commission, board or other agency created by the Commonwealth, a political subdivision of the Commonwealth, or a public authority created by a political subdivision of the Commonwealth. [72 P.S. §103.16(e)]. Interest on obligations issued by other states and territories, their political subdivisions and instrumentalities is taxable under this section. [72 P.S. §103.16(e)].

However, interest on obligations issued by the Government of Puerto Rico is not taxable.

1-4:6.4 Interest on Federal and Pennsylvania Obligations Indirect Ownership.

The Pennsylvania Department of Revenue takes the position that an exempt obligation must be owned directly by the taxpayer or an investment company in which the taxpayer has direct ownership in order for interest on such obligation to retain tax exempt status. Therefore, with regard to an ownership of an investment company,

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according to the Department, only those investment companies that have established fixed portfolio unit investment trusts to hold governmental obligations can pass nontaxable interest through to their shareholders. The tax applies to interest received from open-ended or closed-ended diversified management companies.

1-4:6.5 Interest on Repurchase Agreements.

Entities often invest cash with a bank or other financial institution overnight and over the weekend in what are normally referred to as repurchase agreements or repos. Usually this investment is secured by U.S. government instruments that the bank has purchased. If the investment is simply secured by the U.S. government instrument under a collateralized borrowing arrangement, the interest income generated by such an arrangement is not considered to be from a U.S. government instrument. But in the event the entity, under the repurchase agreement, actually buys the U.S. security and then sells it back to the bank, the interest received is from a U.S. security. The pivotal factor is the transfer of ownership. See *Nebraska Department of Revenue v. Lowenstein*, 513 U.S. 123 (1994), for more on this issue.

1-4:7 Net Gambling and Lottery Winnings.

Pennsylvania Personal Income Tax law establishes a class of taxable income that comprises gambling and lottery winnings. All gambling and lottery winnings, other than noncash prizes of the Pennsylvania State Lottery, are taxable. [72 P.S. §7303(a)(7)]. Taxable winnings include gains arising from gambling and lotteries. In calculating gains, taxpayers may deduct gambling and lottery losses (other than losses on the Pennsylvania State Lottery), but may not deduct the costs and expenses incurred in connection with gambling and lottery activity. Taxpayers must maintain detailed records substantiating gambling and lottery losses. The burden of proof is on the taxpayer to prove that gambling losses have occurred. [61 Pa. Code §103.17]. Pennsylvania imposes tax on nonresidents for all gambling and lottery winnings from Pennsylvania sources, except for noncash prizes of the Pennsylvania State Lottery.

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1-4:8 Net Gains or Income Derived Through Estates or Trusts.

Income "derived through estates or trusts" is the eighth class of income. [72 P.S. §7303(a)(8)]. The term "trust does not apply to any business trust, including any trust treated as a real estate investment trust for federal income tax purposes." [61 Pa. Code §105.1]. An estate or trust is an independent taxable entity that can establish a taxable year different from the taxable years of beneficiaries. A beneficiary's income from an estate or trust is his or her portion of income for the tax year of the fiduciary ending within or with the beneficiary's tax year. Whether the income to the beneficiaries should be taxed or not depends on the terms of the trust, the actual distributions made to beneficiaries, and the residency status of all the parties. Resident beneficiaries are required to report all estate or trust income received during the year. Nonresident beneficiaries must report only the portion of estate or trust income that is attributable to sources within Pennsylvania. [61 Pa. Code §§105.4(c)(1), (2)]. Typically the taxpayer's residence is viewed as the situs of intangibles. So, even if the trust is administered in Pennsylvania, a nonresident taxpayer doesn't have to pay tax on interest, dividends, and gains on intangibles from the trust. However, the tax does apply to a nonresident for gains on tangible personal property and real property if the trust is administered in Pennsylvania.

1-5 SPECIAL TAX PROVISIONS FOR POVERTY

According to 72 P.S. §7304, the General Assembly has the authority pursuant to the Pennsylvania Constitution to establish "a class or classes of subjects of taxation the property or privileges of persons who, because of poverty, are determined to be in need of special tax provisions." The General Assembly created what is known as the poverty income exemption to help those who meet the criteria for poverty.

Pursuant to 72 P.S. §7301(o.1), "poverty" is defined as, "an economic condition wherein the total amount of poverty income is insufficient to adequately provide the claimant, his spouse and dependent children with the necessities of life." The poverty income exemption is available to those who meet the statute's criteria. [72 P.S. §7304(c)]. The term "claimant" refers to those subject to

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Pennsylvania's personal income tax who are entitled to the poverty exemption. [72 P.S. §7301(o.2)].

1-5:1 Poverty Income.

Pursuant to 72 P.S. §7301(o.2), poverty income is defined as, "all moneys or property (including interest, gains or income derived from obligations which are statutorily free from state or local taxation under any other act of the General Assembly of the Commonwealth of Pennsylvania or under the laws of the United States) received of whatever nature and from whatever source derived, but not including:

- Periodic payments for sickness and disability other than regular wages received during a period of sickness or disability;
- Disability, retirement or other payments arising under workers' compensation acts, occupational disease acts and similar legislation by any government;
- 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;
- Payments commonly known as public assistance payments or unemployment compensation payments by any governmental agency;
- Payments to reimburse actual expenses;
- Payments made by employers or labor unions for programs covering hospitalization, sickness, disability or death, supplemental unemployment benefits, strike benefits, Social Security and retirement;
- Any compensation received by United States servicemen serving in a combat zone."

1-5:2 Poverty Exemption.

Individuals whose level of income falls below certain prescribed levels are entitled to partial or full abatement of Pennsylvania

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Personal Income Tax. [72 P.S. §7304(d)(1)]. Full abatement or forgiveness applies to individuals whose poverty income for an entire taxable year is $6,500 or less. [72 P.S. §7304(d)(1)]. Likewise a married couple whose joint poverty income level for an entire taxable year is $13,000 or less shall be entitled to a full abatement of personal income tax. [72 P.S. §7304(d)(1)]. Pennsylvania permits an additional income allowance of $9,500 for each dependent. [72 P.S. §7304(d)(1)].

For purposes of the poverty exemption provisions, a claimant shall not be considered to be married if:

(i) The claimant and the claimant's spouse file separate returns; and

(ii) The claimant and the claimant's spouse live apart at all times during the last six months of the taxable year or are separated pursuant to a written separation agreement. [72 P.S. §7304(d)(1)].

The forgiveness percentage reduces as the claimant's income exceeds the poverty income exemption limit. The forgiveness percentages are as follows. [72 P.S. §7304(d)(2)]:

Ninety percent if excess total poverty income is less than or equal to $250.

- Eighty percent if less than or equal to $500.
- Seventy percent if less than or equal to $750.
- Sixty percent if less than or equal to $1,000.
- Fifty percent if less than or equal to $1,250.
- Forty percent if less than or equal to $1,500.
- Thirty percent if less than or equal to $1,750.
- Twenty percent if less than or equal to $2,000.
- Ten percent if less than or equal to $2,250.
- Poverty exemption – short year. If an individual has a taxable year of less than twelve months, the poverty income thereof shall be annualized.

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1-5:3 Estimated Tax.

If a claimant is required to file an estimated tax return, he or she may use the special tax provisions in computing the amount of estimated tax.

1-6 CANCELLATION OF INDEBTEDNESS

During 2009 the Department issued a number of bulletins addressing the cancellation of indebtedness and its treatment as it relates to Pennsylvania Personal Income Tax. The bulletins include: PIT Tax Bulletin 2009-02 through PIT Tax Bulletin 2009-06. The bulletins address cancellation of indebtedness in the following situations: (1) personal indebtedness; (2) indebtedness secured by a principal residence; (3) business debt; (4) investment indebtedness; and (5) rents, royalties, patents and copyrights indebtedness.

1-6:1 General Definitions.

"Cancellation" is defined in the Bulletin as:

> [o]ccuring when a debtor is legally discharged from primary liability for an indebtedness and it is probable that the debtor will not be required to make future payments as guarantor of the indebtedness. A debtor is legally discharged on the occurrence of one of the following identifiable events:
>
> 1) Discharge of indebtedness in bankruptcy;
> 2) Discharge of indebtedness in receivership;
> 3) Expiration of the statute of limitations for collecting the indebtedness;
> 4) Discharge of indebtedness arising from the creditor's election to pursue foreclosure which statutorily extinguishes its right to pursue further collection;
> 5) Extinguishment of indebtedness under a probate proceeding;
> 6) Discharge pursuant to an agreement between the creditor and debtor for less than full consideration; and

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7) Discharge according to a decision by the creditor, and under a defined policy of the creditor, to discontinue collection activity and to cancel the indebtedness.

Pennsylvania Personal Income Tax Bulletin 2009-02, April 30, 2009.

The definition also provides for a 36-month testing window as a determining factor for when an indebtedness has been cancelled. "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 discharged." *Pennsylvania Personal Income Tax Bulletin 2009-02*, April 30, 2009.

"Indebtedness" is defined as, "[a]n obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount. The term includes principal, interest, penalties, fines and administrative fees." *Pennsylvania Personal Income Tax Bulletin 2009-02*, April 30, 2009.

Cancellation of Personal Indebtedness. Generally, when an individual borrows money, the loan proceeds are not considered income because it is assumed that the borrowed funds are to be repaid to the lender. When the amount of the obligation is subsequently forgiven, the amount an individual is forgiven is income. Cancellation is taxable income to the extent it represents a substitute for one of the eight classes of income. Personal indebtedness is defined as:

[A]ny obligation other than:

1) An obligation incurred with respect to business or rents, royalties, patents or copyrights activity, or the proceeds of which are used for business or rents, royalties, patents or copyrights purposes;

2) An obligation secured wholly or in part by business or rents, royalties, patents or copyrights property; or

3) An obligation for which a deduction or other offset against income was made for costs associated therewith; or

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4) An obligation to the extent it is included in the cost basis of business or rents, royalties, patents or copyrights property.

Pennsylvania Personal Income Tax Bulletin 2009-02, April 30, 2009.

1-6:2 Credit Cards and Other Unsecured Indebtedness.

If an individual's credit card company or bank writes off all or a portion of a credit card balance or other unsecured indebtedness, the cancellation should not be considered income, if the credit card or loan proceeds were used strictly for personal purposes. If a portion of the credit card or loan proceeds were used for other than personal purposes, the amount forgiven related to non-personal uses must be reported as income on the PA-40.

1-6:3 Student Loans.

If all or a portion of student loans are paid for by a third party or cancelled, the payment or cancellation is taxable if it falls within one of Pennsylvania's eight classes of taxable income. Cancellation of a student loan can also be taxable if the student provides services to someone in exchange for the loan being paid off. Although such situations typically arise in an employer/employee context, an employer/employee relationship is not required for such payments to be taxable. All that is required is that the student provide services to the payor in exchange for the loan payments.

Cancellation of student loan can also be taxable if the student provides services to the lender in exchange for payment of the debt. Federal and state programs exist that provide for the payment or cancellation of student loans when the student works for a period of time in a specific profession. Generally, such loan payments or cancellation are not subject to Pennsylvania personal income tax unless the student provides services directly to the payor or lender in exchange for the cancellation. (Pennsylvania Personal Income Tax Guide: Cancellation of Debt and Bankruptcy Considerations, Pa. Dep't of Rev., 12/01/2021.)

1-6:4 Personal Use Property.

"If all or a portion of a loan secured by personal use property is cancelled and the taxpayer gives up his ownership of the property,

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a taxpayer will realize net gain to the extent the cancelled amount exceeds his or her adjusted basis in the property." *Pennsylvania Personal Income Tax Bulletin 2009-02*, April 30, 2009.

1-6:5 Cancellation in the Employment Context.

"If an employer lends money to an employee or subcontractor, cancellation of the indebtedness will result in compensation to the employee or subcontractor. If interest on the loan was capitalized, the taxpayer will also realize compensation to the extent the capitalized interest is cancelled." *Pennsylvania Personal Income Tax Bulletin 2009-02*, April 30, 2009.

1-6:6 Exceptions.

The bulletin addresses two situations in which the cancellation of personal indebtedness would not result in income. The two situations are with disputed indebtedness and the cancellation of purchase-money indebtedness. "If the amount of indebtedness is genuinely in dispute, a settlement of a claim for less than the creditor seeks is not income if the debtor disputes the claim. This is because the amount payable is not fixed." *Pennsylvania Personal Income Tax Bulletin 2009-02*, April 30, 2009.

If indebtedness arising in a sale on credit is cancelled or reduced, the amount is usually treated as an adjustment to the purchase price.

An indebtedness reduction is treated as a reduction of purchase price, rather than indebtedness cancellation income, if:

1) The cancelled or reduced obligation is indebtedness of a purchaser of property to the seller of such property, arising out of the purchase of such property;
2) The taxpayer is not insolvent or in bankruptcy when the reduction occurs; and
3) The reduction would, apart from this rule, be cancellation of indebtedness income.

Pennsylvania Personal Income Tax Bulletin 2009-02, April 30, 2009.

For further guidance and additional examples, please see *Pennsylvania Personal Income Tax Bulletin 2009-02*, April 30, 2009.

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1-6:7 Cancellation of Indebtedness Secured by a Principal Residence.

Cancellation of indebtedness secured by a principal residence may result in reportable, taxable income for Pennsylvania Personal Income Tax purposes to the extent it represents a substitute for gain from the sale, exchange or disposition of property. A taxpayer will not be taxed on the gain or loss realized on the transaction to the extent that he or she qualifies for an exclusion of gain from the sale, exchange or disposition of a principal residence pursuant to 72 P.S. §7303(a)(3)(vii). *Pennsylvania PIT Bulletin 2006-03* defines a principal residence as:

> The home where you ordinarily live most of the time. It can be a house, lodging or place of habitation, including a trailer or condominium, which has independent or self-contained cooking, sleeping and sanitation facilities, and which is physically occupied and used for residential purposes by the taxpayer. The term includes personal property which is a fixture under the law of the state in which the property is located. A residence which is a principal residence for federal tax purposes is presumed to be a principal residence for Pennsylvania tax purposes. *Pennsylvania Personal Income Tax Bulletin 2009-03*, Issued April 30, 2009.

Indebtedness secured by a principal residence is defined as, "[a] mortgage, a junior mortgage, or any other indebtedness which is secured by a taxpayer's principal residence." *Pennsylvania Personal Income Tax Bulletin 2009-03*, April 30, 2009.

1-6:7.1 Exclusion from Gain.

A taxpayer may exclude from gain the amount of the cancellation if all of the following requirements are true:

(1) The indebtedness which was discharged was secured by a principal residence;

(2) The date of disposition occurred after December 31, 1997;

(3) The taxpayer used or had used the residence as a principal residence for a total of at least two years

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during the five-year period ending on the date of sale;

(4) The taxpayer owned or had owned the residence as a principal residence for a total of at least two years during the five-year period preceding the date of sale; and

(5) The taxpayer did not sell another principal residence during the two years preceding the date of sale.

If the taxpayer is able to exclude the cancellation from his or her Pennsylvania income, the taxpayer must reduce his or her basis in the principal residence by the amount of the discharge. The exclusion from gain does not apply when the property secured by the indebtedness is mixed use property. The exclusion does not apply and gain is taxable to the extent the property is used in part for business or rental purposes or to the extent the land surrounding the residence is in excess of that which is reasonably necessary for the use of the dwelling as a home. The department applies a rebuttable presumption that reasonable use does not exceed five acres. *Pennsylvania Personal Income Tax Bulletin 2009-03*, April 30, 2009. The exclusion from gain also does not apply if during the two-year period ending upon the date of the sale, exchange or disposition, there was a prior sale, exchange or disposition by the taxpayer of a principal residence.

1-6:7.2 Cancellation of Purchase-Money Indebtedness.

"If indebtedness arising in a sale financed by the seller is cancelled or reduced, the amount cancelled is usually treated as an adjustment of the purchase price, to be applied in reduction of the buyer's adjusted basis of the property, rather than included in gross income as cancellation of indebtedness income." *Pennsylvania Personal Income Tax Bulletin 2009-03*, April 30, 2009. Please see the three criteria discussed above for when an indebtedness reduction is treated as a reduction of purchase price rather than indebtedness cancellation.

Please refer to *Pennsylvania PIT Bulletin 2009-03* for additional examples and for instructions on how to calculate the gain if the exclusion is not applicable.

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1-6:8 Cancellation of Business Indebtedness, Investment Indebtedness and Rents, Royalties, Patents and Copyrights Indebtedness.

The bulletins issued by the Department regarding the three topics listed above are similar in nature with similar treatment. In this discussion, business indebtedness refers to the Pennsylvania class of income commonly referred to as “net profits” or income from a “business, profession or other activity.”

1-6:8.1 Definitions.

Business indebtedness is defined as

[A]n obligation to the extent it is any of the following:

1) An obligation incurred with respect to business activity or the proceeds of which are used for business purposes;
2) An obligation secured wholly or in part by business property;
3) An obligation for which a deduction or other offset against business income was made for costs associated therewith;
4) An obligation included in the basis of business property.

Pennsylvania Personal Income Tax Bulletin 2009-04, April 30, 2009.

“Business property” is then defined as, “[r]eal property, tangible personal property, or intangible personal property used in the conduct of a business activity.” *Pennsylvania Personal Income Tax Bulletin 2009-04*, April 30, 2009.

“Investment indebtedness” is defined as an obligation to the extent it is secured wholly or in part by investment property. *Pennsylvania Personal Income Tax Bulletin 2009-05*, April 30, 2009. Investment property is real property, tangible personal property, or intangible personal property, including but not limited to the following:

1) Land and buildings;
2) Stocks, bonds, securities, options and similar property;

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3) Intangible ownership interest in an LLC, S corporation, or partnership;
4) Artwork; and
5) Collectibles.

Pennsylvania Personal Income Tax Bulletin 2009-05, April 30, 2009.

Rents and royalties indebtedness is an obligation to the extent it is any of the following:

1) An obligation incurred with respect to production, collection, conservation, or maintenance of rents and royalties property;
2) An obligation for which a deduction or other offset against rents and royalties income was made for costs associated therewith;
3) An obligation secured wholly or in part by rents and royalties property; or
4) An obligation included in the basis of rents and royalties property.

Pennsylvania Personal Income Tax Bulletin 2009-06, April 30, 2009.

Rents and royalties property is "a taxpayer's property rights in rents, royalties, patents, copyrights, and similar property. The term does not include such property used in the conduct of a business, profession or farm." *Pennsylvania Personal Income Tax Bulletin 2009-06*, April 30, 2009.

1-6:8.2 Calculating the Amount of Reportable Income.

If business indebtedness is secured by business property, or if rents and royalties indebtedness is secured by rents and royalties property, and if the property is relinquished in the cancellation of the indebtedness, the taxpayer must recognize income from the disposition of property. If a taxpayer disposes of investment property, he or she must recognize income from the sale, exchange or disposition of the investment property. The amount of income to be reported is calculated as described below.

The taxpayer must add the following items together:

1) the amount of discharged principal, plus;

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2) the amount of discharged interest, penalties, fees, administrative costs, and fines, plus;

3) the amount of any additional consideration received, including cash or other property.

The sum of items numbered 1 through 3 above is the total *amount realized*. If the taxpayer received a Form 1099-A or 1099-C, the amount in Box 2 of either form is the amount of discharged principal. If the taxpayer received a Form 1099-C and an amount is included in Box 3, the amount is included as discharged interest.

From the amount realized, the taxpayer subtracts his or her adjusted basis in any property securing the indebtedness or in which the indebtedness was included in basis. The adjusted basis is equal to the amount a taxpayer paid to purchase the property, including closing costs, realty transfer taxes, and one-time costs incurred to finance the property. The adjusted basis also includes the cost of any permanent improvements made to the property after purchase. The adjusted basis does not include property taxes, periodic interest expenses, or other recurring expenses not properly chargeable to the basis of the property. If the taxpayer is an individual, sole proprietor or owner of a disregarded entity, the adjusted basis is subtracted from the amount realized and this amount is the amount of gain to be reported on PA-40.

1-6:8.3 Mandatory Basis Adjustment.

If the business, investment or rents and royalties indebtedness is written down and the property securing the indebtedness is not relinquished, the taxpayer must reduce the basis in the property by the amount of the cancelled indebtedness.

1-6:8.4 Income from Cancellation of Unsecured Business, or Rents and Royalties Indebtedness.

If unsecured business or rents and royalties indebtedness is cancelled, taxable income is equal to the amount of discharged principal plus the amount of discharged interest, penalties, fees, administrative costs and fines.

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1-6:8.5 Classifying the Reportable Income.

A taxpayer reports income from cancellation of business and rents and royalties indebtedness in the class of which the income is a substitute depending on whether the indebtedness is secured or unsecured. A taxpayer reports income from cancellation of investment indebtedness as net gain or income from the sale, exchange or disposition of property. For all three types of indebtedness, if a partnership or S corporation indebtedness is discharged, the income is classified at the entity level; the partner, shareholder, member, or other owner reports the income in the class as determined at the entity level.

1-6:8.6 Loans from Owners to Businesses.

"An owner of a disregarded entity or sole proprietorship is not allowed to deduct any interest or other costs associated with a loan to a business. Therefore, the owner is not required to include cancellation of the indebtedness as income from the business." *Pennsylvania PIT Bulletin 2009-04*, April 30, 2009.

1-6:8.7 Partnerships.

The partnership determines the amount of cancellation indebtedness as discussed above and determines its classification. The partnership then calculates each partner's share of the income applying the rules as described below:

> As a general rule, if a partnership borrows money on a recourse basis, the partner must include the cancelled indebtedness in income to the extent he or she bears the economic risk of loss for the indebtedness. For administrative convenience, the Department applies an economic risk of loss analysis similar to the analysis under IRC §752 and the regulations and rules thereunder, if the partnership has consistently allocated liabilities this way and if the allocations clearly reflect income. The partners must include the cancellation in income in the same proportion it is includible for federal income tax purposes.

Pennsylvania PIT Bulletin 2009-04, April 30, 2009.

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"If the partnership borrows money on a nonrecourse basis, each partner must include the cancelled indebtedness in income to the extent he or she shares in the profits of the partnership." *Pennsylvania PIT Bulletin 2009-04*, April 30, 2009.

The cancellation of indebtedness at the partnership affects the partner's computation of his or her outside basis. "Each partner must increase his or her outside basis in the partnership ownership interest to the extent of his or her share of partnership income from cancellation of indebtedness, including any minimum gain chargeback." *Pennsylvania PIT Bulletin 2009-04*, April 30, 2009. Each partner must also decrease his or her outside basis in the partnership ownership interest to the extent he or she is relieved of indebtedness, consistent with his or her allocation of liabilities. *Pennsylvania PIT Bulletin 2009-04*, April 30, 2009. If the partner's share of partnership liabilities exceeds that partner's share of partnership income, the partner will recognize gain.

In *Marshall v. Commonwealth*, 41 A.3d 67 (Pa. Commw. Ct. 2012), discussed above, the Commonwealth Court addressed the application of Pennsylvania Personal Income Tax to a nonresident who invested in a limited partnership which owned a building in Pennsylvania that went into foreclosure. One of the taxpayer's arguments was that Pennsylvania regulations do not allow for the inclusion of discharge of indebtedness income in Pennsylvania taxable income. The regulation at issue provided that a gain on the disposition of property is recognized to the extent that the amount realized from the conversion of the property into cash or other property exceeds the adjusted basis of the property. The taxpayer argued that the property was not converted into cash or other property, and thus there could not be any taxable gain. The court concluded that the Department's interpretation of the Regulation's application was consistent with similar federal tax provisions, which have been interpreted as applying to real property foreclosures even when the mortgagor does not receive cash or other proceeds.

1-6:8.8 S Corporations.

An S corporation will calculate the amount and classification of any cancellation of indebtedness. The S corporation then must determine each shareholder's share of the income. Each

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shareholder must report cancellation of indebtedness income in accordance with the shareholder's pro rata share of S corporation income. Each shareholder must also adjust his or her basis due to the cancellation of indebtedness at the S corporation.

> Each shareholder increases his or her basis of the stock of the S corporation or in his or her shareholder indebtedness basis by an amount equal to the shareholder's pro rata share of cancellation of indebtedness income. The shareholder must increase his or her shareholder indebtedness basis before he or she may increase the basis of his or her S corporation stock.

Pennsylvania PIT Bulletin 2009-04, April 30, 2009.

If an S corporation shareholder lends money to the S corporation, this amount is included in his or her shareholder debt basis. The shareholder cancels the debt to the S corporation, the S corporation must recognize income as discussed above. In addition, the shareholder-lender may recognize a loss on account of the bad debt made to the entity to the extent of his or her remaining shareholder debt basis attributable to that debt. This loss must be reported as a Schedule D loss. The shareholder lender may recognize a loss only to the extent of his or her remaining shareholder debt basis. *Pennsylvania Personal Income Tax Bulletin 2009-05*, April 30, 2009.

1-6:8.9 Exceptions.

Again, there are two exceptions to the recognition of income when there is cancellation of business, investment or rents and royalties indebtedness: (1) when it is disputed indebtedness; and (2) when it is a cancellation of purchase-money indebtedness. Please see the discussions above for more detail on disputed indebtedness and purchase-money indebtedness.

1-7 OIL AND GAS ISSUES

1-7:1 Personal Income Treatment of the Division and Transfer of Oil and Gas Interests.

Informational Notice Personal Income Tax 2012-04 (Oct. 10, 2012) discusses the Department of Revenue's policy regarding

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the personal income tax treatment of the division and transfer of interests related to oil and natural gas.

1-7:1.1 Rents and Royalties.

When an owner of a mineral rights estate enters into an oil or gas lease, the lease typically provides for both rental and royalty payments (whether the usual and customary royalty and/or an overriding royalty) to the owner. A lessee can also reserve an overriding royalty under an oil or gas lease.

The net gains from rental and royalty payments are taxable for Pennsylvania Personal Income Tax purposes and are reportable on Schedule E of the PA-40. 72 P.S. §7303(a)(4). Calculation of net gains from rents and royalties are beyond the scope of this informational notice. However, it should be noted that real estate taxes are not deductible expenses because they are personal expenses that are not directly related to the production of the rental or royalty payments. Further, even though oil and gas in place are considered real estate, oil and gas in place are not subject to real estate taxes. Therefore, there are no real estate taxes that can be associated with oil and gas interests that could be used to reduce rental or royalty income for Pennsylvania Personal Income Tax purposes.

If a lessee and owner of a working interest under an oil or gas lease, conveys an overriding royalty to someone as consideration for services, the royalty is taxable compensation to the transferee based upon the value of the interest conveyed. The value is based upon the real estate value of the royalty at the time of conveyance and not the present value of the potential future royalty payments. (Presumably, the real estate value of the royalty will be commensurate with the value of the services rendered. The lessee will use this value to calculate any gain from the disposition of the royalty and the transferee will use the value as his cost basis in the overriding royalty interest.) Thereafter, any royalty payment that the transferee receives is taxable to the transferee as royalty income as explained above.

1-7:1.2 Conveyance of Mineral Rights Estate.

- **Sale.** Net income from the disposition of property is subject to Pennsylvania Personal Income Tax.

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[72 P.S. §7303(a)(3)]. If a mineral rights estate owner sells the mineral rights, the consideration less the owner's basis in the mineral rights and other costs associated with the sale is taxable. The gain is reported on Schedule D of the PA-40. If the seller owns both the surface rights and mineral rights in the real estate, the seller must allocate a portion of his basis to the mineral rights estate.

If the seller did not allocate his basis when he originally purchased the real estate, then the seller must allocate a portion of the basis to the mineral rights. The amount allocated to the mineral rights is the entire basis multiplied by a fraction, the numerator of which is the fair market value of the mineral rights estate and the denominator of which is the fair market value of the entire real estate. The fair market values shall be determined as of the date that the seller originally purchased the real estate. If the owner did not allocate the basis at the time of purchase and is unable to ascertain the allocable basis of the mineral rights estate, he must use a zero basis.

- **Gift or transfer for no or nominal consideration.** Pennsylvania does not impose a tax on gifts. If a mineral rights estate owner makes a gift of the mineral rights (e.g., to family members), the conveyance is not subject to tax. The transferee receives the owner's basis in the mineral rights estate as a carryover basis. 61 Pa. Code §103.13(c).

  If a mineral rights estate owner conveys the estate to a private trust for no or nominal consideration, the same rule applies.

  If a mineral rights estate owner conveys the estate to a business entity (such as a limited partnership or limited liability company) in a nontaxable exchange for an ownership interest in the entity, the conveyance is considered a capital contribution

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and the basis in his ownership interest in the business entity is his basis in the mineral rights estate.

- **Assignment of an oil or gas lease.** It is important to ascertain the rights that are being conveyed under an assignment of an oil or gas lease in order to determine the Pennsylvania Personal Income Tax consequences of the assignment. To the extent such an assignment effectuates the conveyance of the mineral rights estate, the "conveyance of mineral rights estate" provisions apply.

  If, however, the mineral rights estate owner retains the ownership and control of the mineral rights estate and only assigns income rights under the oil and gas lease, then there is a different tax result as explained below.

- **Sale of production payments.** A mineral rights owner who is the lessor under an oil or gas lease may sell and assign his rights to income from future production payments (including royalties) under the lease. For Pennsylvania Personal Income Tax purposes, the sale and assignment are treated as an anticipatory assignment of income.

Assignor: When a mineral rights estate owner sells and assigns his right to income from production payments under an oil and gas lease, he is considered to receive royalty income to the extent of the sale price (which sale price normally represents the present value of the future production payments assigned). The assignor reports the royalty income on Schedule E of the PA-40 in the tax year in which the sale proceeds are received. (The assignor does not receive a subsequent deduction when the production payments are made to the assignee.)

Assignee: The assignee, through his purchase of the income from the production payments, acquires a basis in the future production payments. There are two

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methods by which the assignee must account for his receipt of the future production payments and his basis therein. The proper accounting method depends upon whether the assignment is part of an open or closed transaction.

The transaction is an *open transaction* if the future production payments to which the assignee is entitled are not readily ascertainable. The transaction is a *closed transaction* if the amount is readily ascertainable. Situations involving open transactions are very rare and are determined on a case by case basis. The presumption is that the transaction is closed. The burden is on the assignee to prove otherwise.

If the purchase of the future production payments is a closed transaction, each future payment is considered a partial non-taxable return of the assignee's basis and the remainder is considered taxable royalty income reportable on Schedule E of the PA-40. The taxable and non-taxable amounts are apportioned based upon the amount of the anticipated future payments and the assignee's basis.

For example, a lessor under an oil or gas lease sells and assigns his right to future production payments for the next 25 years. The assignee agrees to pay $35,000 for the future payments. Assignee, therefore, has a basis of $35,000.00 in the future payments. It is anticipated that the total production payments will be $100,000 (1 yearly payment of $4,000 for 25 years). Based upon those numbers, by the time all future payments are made, the assignee will receive a full return of his basis and an additional $65,000 of taxable royalty income. The assignee's basis accounts for thirty-five percent of the future production payments and the taxable royalty income accounts for the remaining sixty-five percent. Consequently, the assignee must account for thirty-five percent of each production payment as a return of basis ($1,400) and the other sixty-five percent as taxable royalty income ($2,600).

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If the purchase of the future production payments is an open transaction, the purchaser/assignee is permitted to use the cost recovery method to account for the taxable amount of each future production payment. Consequently, any future payment will be applied first as a return of the purchaser/assignee's basis. Any payment over and above his basis is royalty income to the purchaser/assignee in the tax year in which it is received. The royalty income is reported on Schedule E of the PA-40.

- **Donative transfers of production payments.** Like the sale of production payments, a donative transfer (regardless to whom it is made – family, charity, etc.) of income from production payments under an oil or gas lease is an anticipatory assignment of future income. *See Flewellen v. Commissioner*, 32 T.C. 317 (T.C. 1959). When a production payment is paid, the assignor is deemed to receive the payment and, in turn, transfer the payment to the assignee. Therefore, the production payment remains taxable to the assignor as royalty income. However, the assignor does not report all of the payments assigned at the time of the assignment. Rather, the assignor reports the payments in the year in which each payment is paid.

The conveyance of the payment from the assignor to the assignee is considered a gift to the assignee. There is no tax imposed upon the gift.

Example: A lessor under an oil or gas lease conveys the right to the income from the lease royalties/production payments to his children for the remainder of his life or the remainder of the anticipated production period. The lessor is subject to Pennsylvania Personal Income Tax on each royalty/production payment when paid. He is then considered to make a gift of the payment to his children. When the lessor dies, the royalty/production payments pass to his estate and the gift to the lessor's children ends. The lessor's estate

reports income from the royalty/production payments until his estate is settled and the lessor's interest under the oil or gas lease is transferred to his heirs. If his children are the heirs to his estate, they will begin reporting the royalty/production payments as income after the estate transfers the lessor's rights to the oil or gas lease to them.

1-8 TAX RATE

All taxable income in Pennsylvania carries a flat personal income tax rate of 3.07 percent.

1-9 CREDITS, PAYMENTS AND RETURNS

1-9:1 Who Must File?

1-9:1.1 Individuals.

Every resident, part-year resident or nonresident with more than ($33) of gross income must file a return even if no tax is due. The same procedure must be used for a decedent's return; his or her executor/trix or administrator/trix must file a return on the decedent's behalf. The decedent's return covers the period beginning with the taxable year in which his or her death occurred and ends with the date of his or her death. [61 Pa. Code §§117.3(a), (b)]. The decedent and his or her spouse are not permitted to file joint returns for the year in which the decedent died. [61 Pa. Code §117.3(b)]. The appropriate person (e.g., guardian, committee, fiduciary) is responsible for filing returns for minors or other taxpayers who are unable to file due to disability who have total Pennsylvania gross taxable income in excess of the minimum amount. [61 Pa. Code §117.6]. The obligation of an individual to file overrides both illness and absence from the Commonwealth. An agent may be granted power of attorney in such cases to file an individual's return. [61 Pa. Code §117.6].

1-9:1.2 Estates and Trusts.

The amount of the income received by an estate or trust has no bearing on whether returns must be filed. In other words, any resident or nonresident estate or trust that receives taxable income

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must file a return. The return of an estate or trust must be filed by the fiduciary. The income or gains received by an estate or trust that has not been distributed or credited to its beneficiaries produces the estate's or trust's income. [72 P.S. §7305].

1-9:1.3 Partners and Partnerships.

The term "partnership" means, "a domestic or foreign general partnership, joint venture, limited partnership, limited liability company, business trust or other unincorporated entity that for federal income tax purposes is classified as a partnership." [72 P.S. §7301(n.0)]. If a Commonwealth resident is a partner in a partnership with no Pennsylvania-source income, she or he must file a return, which must state specifically the items of partnership gross income and allowable deductions, the names and addresses of all resident partners, and the amount of the distributive shares of income, gain, loss, deduction, or credit allocable to each resident partner. [61 Pa. Code §117.17(c)].

1-9:1.4 Refund Claimant.

Those who have had more money withheld than the amount of tax due are entitled to a refund. A return must be filed in order to claim such a refund. [61 Pa. Code §119.13].

1-9:1.5 Filing Status.

Since there are no exemptions, itemized deductions, standard deductions, or progressive rates in the Pennsylvania Personal Income Tax, filing status isn't nearly the issue it is in the federal income tax system. There is no reduction of tax or other benefits based on filing status. However, the concept of filing status does have some importance. For instance, an individual's withholding and estimated tax payments can be applied to his or her spouse's liability and spouses are treated as one shareholder for purposes of determining the number of shareholders in a Pennsylvania S corporation.

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