

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 6: BRIEF OVERVIEW OF PENNSYLVANIA PERSONAL INCOME TAX

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CHAPTER 6: BRIEF OVERVIEW OF PENNSYLVANIA PERSONAL INCOME TAX

I. OVERVIEW

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

Pennsylvania taxes eight classes of income-

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

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

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waiting period for corporations whose S election was terminated for exceeding the passive income limitation is repealed.

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

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II. TAX RATE

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

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

- (1) Effective tax rate after midyear rate change. Rate was 2.45 percent for the first half of the year and 2.35 percent for the second half of the year.
- (2) Effective tax rate after midyear rate change. The rate for the first eight months of the tax year commencing on or after Jan. 1, 1986 was 2.2 percent and for the final four months was 2.1 percent, for an effective rate of 2.16 percent.
- (3) Effective tax rate after midyear rate change. Rate was 2.1 percent for first half of the year and 3.1 percent for second half of the year.
- (4) Effective tax rate after midyear rate change. Rate was 3.1 percent for first half of the year and 2.8 percent for second half of the year.

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

III. EIGHT CLASSES OF INCOME

A. Gross Compensation

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

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B. Interest

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

- Interest derived from purchase-money mortgages on real estate or land contracts that the taxpayer or reporting entity includes in determining net gain or loss from the sale, exchange or other disposition of property;
- Interest incidental to the production of rental or royalty income that the taxpayer or reporting entity includes in determining net rent and royalty income;
- Interest that is statutorily free from Pennsylvania tax;
- Interest derived from assets employed as working capital in a business and from accounts and notes receivable from sales of products or services sold in the ordinary course of business that the taxpayer or reporting entity includes in determining net profit or loss from its business, profession or farm.

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

C. Dividends

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

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

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

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

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

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2. The taxpayer regularly and continuously conducts his or her commercial activities; and
3. The taxpayer does not limit or restrict his or her commercial activities to certain related or unrelated customers; and
4. The taxpayer computes his or her net income or loss solely from those items of revenue, cost, expense or liability that he or she receives from or incurs in-
 - The ordinary course and operation of his or her business, profession or farm; or
 - Securities employed as working capital in the ordinary operation of his or her business; or
 - Accounts and notes receivable from the sales of products and services in the ordinary operation of his or her business; or
 - Assets that serve an operational function in the ordinary operation of his or her business.

Refer to PA PIT Guide, Chapter 11.

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

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

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

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

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

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

Refer to PA PIT Guide, Chapter 13.

G. Net Income or Loss from Estates or Trusts

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

H. Gambling and Lottery Winnings

1. Resident

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

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

2. Nonresident

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

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

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

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

3. Reporting

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

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

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

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

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

Table 6-1	
Deductions Not Allowed for Pennsylvania Personal Income Tax which are Allowed for Federal Purposes in Arriving at Federal Adjusted Gross Income on the Federal Form 1040	
Federal	Pennsylvania Personal Income Tax
IRA deduction	No provision
Student loan interest deduction	No provision
Archer MSA deduction	No provision
Moving expenses	No provision
One-half of self employment taxes	No provision
Self-employed health insurance deduction	No provision
Self-employed SEP, SIMPLE and qualified plans	No provision
Penalty on early withdrawal of savings	No provision
Alimony	No provision

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

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

1. **Standard Deduction**

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

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

2. **Itemized Deductions**

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

Table 6-2 Deductions in Arriving at Federal Taxable Income but Not Allowed for Pennsylvania Personal Income Tax	
Federal	Pennsylvania Personal Income Tax
Standard deduction	No provision
Medical and dental expenses	No provision
Taxes paid	No provision
Interest	No provision
Gifts to charity	No provision
Casualty and theft losses	No provision
Job expenses	Unreimbursed business expenses reportable on PA Schedule UE.
Miscellaneous deductions	No provision

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

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

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

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

Table 6-3	
Credits Not Allowed for Pennsylvania Personal Income Tax which are Allowed for Federal Income Tax Purposes	
Federal	Pennsylvania Personal Income Tax
Foreign tax credit	No provision
Credit for child and dependent care expenses	No provision
Credit for the elderly or disabled	No provision
Education credits	No provision
Child tax credit	No provision
Adoption credit	No provision

V. EXPENSES ALLOWED UNDER PENNSYLVANIA PERSONAL INCOME TAX

A. Unreimbursed Business Expenses

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

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

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

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

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

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

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

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

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

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

- Receipts from the sale, exchange, or other disposition of rental, royalty and similar property; and
- Receipts from operating an oil, gas or mineral interest as a business, profession or farm, or otherwise derived in the ordinary course of, and from the operation of a business.

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

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

Such expenses include advertising, cleaning and maintenance, agent commissions, insurance, legal fees, management fees, interest, repairs, supplies, utilities, depreciation, and depletion. Deductions allowable under MACRS, including the IRC Section 179 deductions, in effect on Jan. 1, 1986, are acceptable deductions for Pennsylvania purposes. Taxpayers may not deduct the 30 percent additional first-year depreciation permitted under the Job Creation and Worker Assistance Act of 2002. In addition, Taxpayers may not deduct the 50 percent additional bonus depreciation

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permitted under the Jobs and Growth Tax Relief Reconciliation Act of 2003 or the KETRA/GOZA of 2005. Taxpayers may not deduct expenses for their own labor, capital investment or capital improvements. Taxpayers may not deduct personal expenses or any part of an allowable deduction that is personal. Refer to PA PIT Guide, Chapter 13.

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

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

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