CHAPTER 7: GROSS COMPENSATION.

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CHAPTER 7: GROSS COMPENSATION.

I. OVERVIEW.

- 1. Definition of Gross Employee Compensation for Pennsylvania Personal Income Tax. Employee compensation includes salaries, wages, commissions, and every other item of receipt related to an employment, whether received directly, through an agent, in cash, in property or otherwise, unless specifically excepted. It includes:
 - Current, deferred, or prepaid remuneration for services.
 - Remuneration for refraining from services.
 - Amounts paid as a result of an
 - (A) Initiation, modification, rescission or breach of an employment contract;
 - (B) Unlawful practice with respect to terms, conditions or privileges of employment; or
 - (C) Unlawful discharge, failure, or refusal to hire or deprivation of employment opportunities.

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

- Tips and other amounts, over which the employer does not have the control, receipt, custody, or payment,
- A sum in excess of salary given an athlete for signing with a team or other bonus.
- Payments to current and former employees for a covenant not to compete,
- Back or front pay for a period of time during which an individual was wrongfully separated from his job and front pay paid in lieu of reinstatement.

Compensation includes:

- Salaries,
- Wages,
- Commissions,
- Bonuses, and incentive payments, whether based on profits or otherwise,
- Fees,
- Tips, and
- Similar remuneration received for services rendered by an individual whether directly or through an agent and whether in cash or in property.

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

- Cash,
- Foreign currency,
- Check or other negotiable instruments,
- Freely transferable readily marketable obligations or other cash equivalents,
- Property interests,
- Below-market-rate loans, and
- Discharge of liabilities.

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

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

There are significant differences between the Pennsylvania Personal Income Tax and the Federal Income Tax. Certain income items that are not taxable for the Federal Income Tax are taxable for the Pennsylvania Personal Income Tax. Certain income items that are taxable for the Federal Income Tax are not taxable for the Pennsylvania Personal Income Tax. Please reference the tables on the following pages.

Below is a table and two income checklists that illustrate what items are included in compensation for Pennsylvania Personal Income Tax and what items are not. The table highlights what items may be taxable based on the facts and circumstances of the item for Pennsylvania Personal Income Tax. The first checklist illustrates what items are always taxable for Pennsylvania Personal Income Tax in the compensation class of income. The second checklist illustrates what items are never taxable for Pennsylvania Personal Income Tax. Please consult the table and both checklists to determine whether an income item should be included in the gross compensation class.

3. Income Items ALWAYS Taxable as Pennsylvania Compensation Checklist – Table 7-1.

3. Income Items ALWAYS Taxable as Pennsylvania Compensation Checklist – Table 7-1.				
Table 7-1. Income Items ALWAYS Taxable as Pennsylvania Compensation Checklist.				
Type of Compensation:				
Salaries.				
Wages.				
Tips received directly by the employee or through his or her employer.				
Gratuities.				
Commissions.				
Bonuses.				
Incentive payments.				
Vacation/holiday pay.				
Termination/severance pay.				
Payment incentives for early retirement.				
Reimbursements and allowances in excess of allowable business expenses.				
Directors' fees (will constitute Pennsylvania Schedule C income if one's profession is being an outside board director).				
Jury fees. Witness fees (will constitute Pennsylvania Schedule C income if testifying as an expert in a field which is				
considered one's line of business).				
Eligible reimbursed moving expenses in excess of allowable expenses on Pennsylvania Schedule UE, UE-1. Honoraria (will constitute Pennsylvania Schedule C income if one's profession is being a professional speaker).				
Executor's or administrator's fees (will constitute Pennsylvania Schedule C income if one's profession is being an executor or administrator).				
Covenant not-to-compete or payments received as consideration for refraining from the performance of				
services.				
Proceeds from an employee stock ownership plan to extent of excess computed under cost-recovery method.				
Cash allowances for rent, utilities, or other expenses received by ministers.				
Reimbursements made by an employer for dependent care, legal services, or other personal services.				
National Service Education Awards.				
Income from Peace Corps, VISTA Job Corps and Americorp.				
Household employees.				
Employee contributions to an eligible Pennsylvania retirement plan and/or employee contributions to a nonqualified deferred compensation plan.				

4. Income Items NEVER Taxable as Pennsylvania Compensation Checklist – Table 7-2.

Table 7-2. Income Items NEVER Taxable as Pennsylvania Compensation Checklist.				
Type of Compensation:				
Federal active-duty pay earned outside Pennsylvania.				
GI Bill benefits including tuition and living expenses.				
Alimony.				
Child support.				
Income in respect of a decedent.				
Inheritance.				
Social Security.				
Railroad retirement benefits.				
Public assistance.				
Unemployment compensation.				
Occupational Disease Act benefits (if included on W–2, attach explanation).				
Meals and lodging provided to an employee by the employer.				
Personal use of employer-owned or leased property and/or services, at no cost or at a reduced cost. Personal use of company automobile, airplane, or other employer-owned or leased property. These amounts are not taxable fringe benefits for Pennsylvania Personal Income Tax.				
Employer-provided parking facilities. These amounts are nontaxable fringe benefits.				
Employer-provided professional services paid for directly by the employer. These are nontaxable fringe benefits.				
Premiums paid by an employer for group term life insurance (no limit).				
Rental value of parsonage owned by the congregation and required to be occupied by the cleric.				
Foster care.				
Employer-paid group term life insurance premiums.				
Amounts received for permanent loss of body function, disfigurement, or reimbursed medical expense.				
Disability payments paid by employer arising under occupational disease acts or other legislation.				
Strike benefits.				

Life insurance proceeds or settlements.

occupational disease acts, or

Distributions from eligible Pennsylvania retirement plans after retirement age.*

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

Table 7-3. Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances.					
Type of Compensation	Taxable Description	Non-Taxable Description			
Sick pay, sick leave.	Sick pay and sick leave are taxable compensation when representing your regular wages. Your employer must include them as compensation and withhold Pennsylvania tax. Request Form REV–634, "Employee Fringe Benefits and Wage/Salary Supplements," for more information.	Payments, not representing regular wages, including payments made by third party insurers for sickness or disability, are not taxable income for Pennsylvania purposes. Your employer should not include periodic payments for sickness or disability in box 16 of your Form W–2. If your employer includes this income and withholds Pennsylvania tax, you must obtain and submit a corrected Form W–2 or a statement from your employer explaining the error.			
Disability benefit payments, including payments made by third party insurers for sickness or disability.	Taxable if paid by employer.	Nontaxable if paid by third party insurer.			
A premature withdrawal from a regular IRA or Roth IRA. [Caution: Refer to PA PIT tax bulletins for an expanded discussion of this topic. After publication on the Department's website these bulletins will be included in New Guide Chapter 30: PIT POLICY GUIDANCE.]	A premature withdrawal from a regular IRA or Roth IRA is taxable as compensation to the extent that the taxpayer receives an amount that exceeds his or her previously taxed contributions. The cost-recovery method of accounting must be used to determine the taxable portion unless timely rolled over into an eligible Pennsylvania retirement plan. Please consult your Summary Plan Description or Plan Administrator.				
Payments received under workers compensation acts,	Taxable when the employee must turnover the worker's compensation	All other payments received under workers compensation acts.			

Occupational disease acts are not

payments to the employer in order to

^{*}Regarding what plans qualify as "eligible Pennsylvania retirement plans," the fact that a plan is a qualified plan for Federal Income Tax is **not** controlling for Pennsylvania Personal Income Tax.

similar legislation, including payments for injuries you received while working, and damages received, whether by suit or otherwise, for personal injuries (unless one is required to pay these monies back to the employer and receives regular salary in return).	receive his or her regular salary in return. The employee does not report the worker's compensation payments, but does report the full amount of his or her regular salary.	taxable.
Scholarships or fellowships and stipends.	The recipient is required to apply the skill and training to advance research, creative work or some other project or activity.	Made on the basis of need or academic achievement, is not taxable if awarded to encourage or allow the recipient to further his or her academic achievement.
Credit card debt forgiveness, unless includable as part of business or rental income. See discussion on discharge of indebtedness. See New PA PIT Guide Chapter 24. CANCELLATION OF DEBT FOR PA PIT PURPOSES.		
Employer-provided fringe benefits.	Non-excludible fringes; See Pennsylvania Personal Income Tax Guide Section Pennsylvania Taxation of Fringe Benefits for a list of non- excludable fringes including an option to receive cash or reimbursement.	Excludible fringes (e.g. personal use of an employer's owned or leased property and/or services, at no cost or at a reduced cost, and using your employer's dependent care facilities.) See Pennsylvania Personal Income Tax Guide Section Pennsylvania Taxation of Fringe Benefits.
A discharge of indebtedness. See PA PIT Guide Chapter 24. CANCELLATION OF DEBT FOR PA PIT PURPOSES.	Taxable in two circumstances, see Pennsylvania Personal Income Tax Guide Section entitled Discharge of Indebtedness.	Discharge of indebtedness is nontaxable unless two circumstances exist. See Pennsylvania Personal Income Tax Guide Section entitled Discharge of Indebtedness.
 Damage awards - Delayed damages received in connection with a court judgment or settlement. Federal taxable punitive damages awarded and settlements from personal injury. Damages, awards, and settlements from personal injury or sickness. All other damage awards. 	 Delay damages received in connection with a court judgment or settlement. Other damage awards that are also taxable e.g. damage awards and settlements to the extent that the payments represent back wages or other uncollected entitlement to Pennsylvania taxable incomes, damage awards for lost profits, etc.). Report on Pennsylvania Schedule MC Miscellaneous Compensation. 	 Federally taxable punitive damages received for personal physical injury or physical sickness, whether received by suit or by settlement. Damage awards and settlements from personal injury or sickness if pain and suffering, emotional distress, or another non-economic element was or would have been a significant evidentiary factor in determining the amount of the taxpayer's damages. See Pennsylvania

		Personal Income Tax Guide discussion on Taxation of Damage Awards.
Television Show winnings.	A prize awarded to a participant in a game or "reality" show is considered non-employee compensation for PA PIT purposes. The value of the prize should be reported on PA Schedule MC, Miscellaneous Compensation. If the prize is taxed in another state, then the taxpayer can use PA Schedule G—S or PA Schedule G—L to claim the out-of-state tax credit.	
Awards.	Awards given in recognition for past or future service.	All awards not given in recognition for past or future service.
Gifts.	Taxable if gift is a transfer of cash or property in payment for past or present services or as an inducement to perform future services	Gifts made from detached or disinterested generosity.
Tuition assistance or educational benefits unless the training or education is either: 1) Required by law or regulation; or 2) Required of the employee by the employer in order for the employee to retain the skills necessary for his or her present position. If the course, degree program, or training is designed to enable the employee to enter a new field or profession or to obtain a promotion, the reimbursement is taxable.	If employer reimburses employees for education cost, then the reimbursement is fully taxable and the employee may deduct only those directly related to business expenses allowed on <i>Pennsylvania Schedule UE</i> .	Employees of an institute of higher learning that received free or low-cost education.
Employer contributions to eligible Pennsylvania Retirement Plans and Nonqualifying Deferred Compensation Plans.	See Table: Pennsylvania Taxation of Employer Contributions.	See Table: Pennsylvania Taxation of Employer Contributions.
Employee contributions to Nonqualifying Deferred Compensation Plans.	See PA PIT Bulletin 2005–03 DEFERRED COMPENSATION UNDER NONQUALIFIED PLANS.	See PA PIT Bulletin 2005–03 DEFERRED COMPENSATION UNDER NONQUALIFIED PLANS.
Distributions from eligible Pennsylvania Retirement Plans and Nonqualifying Deferred Compensation Plans. See PA PIT Bulletin 2005–03	See Table: Pennsylvania Taxation of Distributions from Eligible Pennsylvania Retirement Plans and Nonqualified Deferred Compensation Plans. Act 2005–40 established the	See Table: Pennsylvania Taxation of Distributions from Eligible Pennsylvania Retirement Plans and Nonqualified Deferred Compensation Plans.

DEFERRED COMPENSATION
UNDER NONQUALIFIED
PLANS and PA PIT Bulletin
2005-05 QUALIFIED
EMPLOYER PLANS.

general rule that distributions are always taxable, unless the contributions were previously taxed, then use the cost recovery method.

- 6. Costs, Expenses, and Deductions Against Gross Compensation.
 - A. No Deduction Against Gross Compensation.

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

B. Exception: Unreimbursed Employee Expenses.

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

- 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 Schedule UE*.

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.

7. Pennsylvania Resident Compensation.

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

8. Nonresident Pennsylvania Compensation.

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

- II. PENNSYLVANIA COMPENSATION GENERAL RULES.
 - 1. Pennsylvania Regulations.

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

Compensation includes items of remuneration received, directly or through an agent, in cash or in property, based on payroll periods or piecework, for services rendered as an employee or casual employee, agent or officer of an individual, partnership, business or

nonprofit corporation, or government agency. These items include salaries; wages; commissions; bonuses; stock options; incentive payments; fees; tips; dismissal; termination or severance payments; early retirement incentive payments; and other additional compensation contingent upon retirement, including: payments in excess of the scheduled or customary salaries provided for those who are not terminating service; rewards; vacation and holiday pay; paid leaves of absence; payments for unused vacation or sick leave; tax assumed by the employer; or casual employer signing bonuses; amounts received under employee benefit plans and deferred compensation arrangements, and other remuneration received for services rendered.

2. W-2 Wage and Tax Statement.

A wage and tax statement (Form W–2) or **PA Schedule W2–S (Wage Statement Summary)** must be submitted with the PA–40 income tax return as evidence of compensation paid and taxes withheld by an employer. In submitting Form W–2s, the taxpayer must submit a separate form for each employer. W– 2s must be submitted if any of the following applies:

- 1. A W–2 shows income earned or taxes withheld in another state;
- 2. A W-2 shows incorrect income or tax withheld; or
- 3. A W–2 shows Pennsylvania tax withheld of more than 2.8% or 3.07% for taxable years beginning after December 31, 2003.

If submitting a *PA Schedule W2*—**S**, the taxpayer copies the information from each W–2 over to the *PA Schedule W2*—**S**. In addition, the taxpayer must enter the Employer Identification Number (EIN) from Box B, the amount of Federal wages from Box 1, the Pennsylvania taxable wages from Box 16, and Pennsylvania tax withheld from Box 17 for each employer. No Form W–2s need be submitted if using a *PA Schedule W2*—**S**, although, the State does reserve the right to request them if needed. When computing Pennsylvania compensation from a Form W–2, it is important to use state wages from block 16 of the Form W–2, not the Federal wages. This is a common mistake. The state number is often higher because Pennsylvania taxes the employee's contributions or elective deferrals. If the taxpayer was not furnished with or was unable to obtain a Form W–2, he or she must provide a copy of Federal substitute Form W–2 Form 4852 or copies of evidence of compensation paid and tax withheld such as pay stubs. Also, include an explanation.

3. Withholding Requirements.

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

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

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

4. Reciprocal Compensation Agreements.

Pennsylvania currently has reciprocal agreements with Indiana, Maryland, New Jersey, Ohio*, Virginia, and West Virginia. Under these agreements, one state will not tax a resident of the other state on compensation that is subject to employer withholding. These agreements apply to employee compensation only. They do not apply to income reported as compensation, such

as executor fees, on which there is no Federal withholding requirement, nor does it apply to any other class of income.

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

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

If you are a resident of a reciprocal agreement state working or performing services in Pennsylvania and your employer withheld Pennsylvania income tax, you may request a refund of the Pennsylvania tax. You report zero taxable compensation on Line 1a and the Pennsylvania tax withheld on Line 13. Submit your Form W–2 or a photocopy and a signed copy of the resident income tax return that you filed/will file with your resident state and form REV-420. Also, submit a statement explaining that you are a resident of a reciprocal agreement state.

*Note regarding Ohio Reciprocal Compensation Agreement: Commencing January 1, 2004, remuneration paid to an Ohio resident shareholder-employee of a Pennsylvania S corporation for performing services in Pennsylvania is **not** covered by the Pennsylvania/Ohio Reciprocal Compensation Agreement and **will be subject** to Pennsylvania Personal Income Tax. This tax treatment applies to Ohio resident shareholder-employees with a 20% or greater interest in a Pennsylvania S corporation who worked or performed services for the S corporation in Pennsylvania. In addition, a *PA Schedule G—S or PA Schedule G—L* credit may be allowable **only if** the S corporation is **both** a Pennsylvania S corporation and an Ohio S corporation.

Federal Pennsylvania Personal Income Tax Differences in Arriving at Box 16 Wages.
 See PA PIT Guide Chapter 19 TAX WITHHOLDING AND ESTIMATED TAX PAYMENTS.

Caution: Act 2005–40 generally adopted the Federal constructive receipt rules for deferred compensation. However, there are some Pennsylvania exceptional rules.

Nonresident Pennsylvania Compensation.

Pennsylvania imposes Personal Income Tax on eight classes of income received by residents of Pennsylvania during each taxable year. Nonresidents are **not** taxed on interest, dividends, or intangible gains. (See PA PIT Guide Chapters 8: INTEREST, 9: DIVIDENDS and 12: NET GAINS OR LOSSES FROM THE SALE, EXCHANGE, OR DISPOSITION OF PROPERTY and PA PIT Guide Chapter 30 for Personal Income Tax Bulletin 2005–02 Gain or Loss Derived From The Disposition Of A Going Concern.)

Nonresidents are taxed on the remaining classes of income the same as residents (gross compensation, net income or loss from the operation of a business, profession, or farm, net income or loss from rents, royalties, patents, and copyrights, estate and trust income, gains from the sale, exchange, or disposition of tangible property, and gambling or lottery winnings derived from sources within Pennsylvania when employed in the operation of a business, profession, or farm), but only on the income that they receive from sources within the Commonwealth. (See 72 P.S. §§ 7302 and 7308.) Refer to both PA PIT Guide CHAPTER 11 NET INCOME OR LOSS FROM BUSINESS, PROFESSION, OR FARM and PA PIT Guide CHAPTER 15: GAMBLING AND LOTTERY WINNINGS.

Pennsylvania taxes nonresidents on gambling and lottery winnings by reason of a wager placed in this Commonwealth, the conduct of a game of chance or other gambling activity

located in this Commonwealth or the redemption of a lottery prize from a lottery conducted in this Commonwealth, other than prizes of the Pennsylvania State Lottery.

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

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

7. Apportioning Pennsylvania Taxable Income.

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

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

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

III. CURRENT COMPENSATION – "PENNSYLVANIA WAGES."

1. Covenants not to compete or to surrender a right to future employment and early separation incentive payments.

A. Payments For Covenant Not-To-Compete.

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

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

B. Amounts paid to surrender a right to future gainful employment.

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

- i. The employment agreement secures for the employee a right to future gainful employment; and
- ii. The only consideration given by the employee to obtain that right is the promise to work in the future.

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

2. Early Separation Incentive Payments.

Payments made under a limited plan of termination constitute taxable compensation for voluntarily terminating employment rather than deferred compensation. A limited plan of termination is a plan that has one or more of the following attributes:

- The plan, when begun, is scheduled to be complete on a certain date or upon the occurrence of one or more specified events.
- ii. The number, percentage or classes of employees whose services are to be terminated are specified in advance of the employees' termination of service.
- iii. The plan is otherwise temporary or limited.

3. Clergy.

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

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

Summary:

- a. Where the employer provides housing for the clergy, the value of the housing is not taxable.
- b. Where the employer pays the costs of housing directly and not as a reimbursement to the clergy, the direct costs are not taxable.
- Where the employer pays a housing allowance to the clergy for living in provided housing on the employer's property, the payments are taxable – cash is always taxable.
- d. Where the employer pays a housing allowance to the clergy for living in housing that the clergy obtains, the housing allowance is fully taxable as Pennsylvania compensation, and the clergy may deduct directly related business expenses allowed on *Pennsylvania Schedule UE*.

4. Statutory Employees.

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

 As an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal;

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

"Statutory employees" are "employees" for Federal Employment Tax purposes because of special statutory rules. However, they do not always have the status of a common-law employee for Federal income tax purposes.

For a Federal statutory employee Federal Income Tax Withholding is shown on the Form W–2.

For Pennsylvania Personal Income Tax purposes, individuals must report all taxable remuneration they receive as a statutory employee as compensation. Those of their expenses that are not reported in a specific part of the *PA Schedule UE* should be itemized and claimed in Part C. Miscellaneous Expenses.

However, if such expenses are extensive, a *PA Schedule C* may be used in lieu of the *PA Schedule UE*, provided that the net income computed on the Schedule C is reported as compensation.

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

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

- a. Is not an employee of the United States, its agencies, or instrumentalities (including members of the Armed Forces and career appointees in the United States Foreign Service); and
- Does not hold an appointive office in the executive branch of the Government of the United States.

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

A. Resident Members of the Armed Forces – Overview.

Military pay, including housing allowances received by a Pennsylvania resident while not on Federal active duty or not on Federal active duty training, is fully taxable regardless of where the military service is performed. For example, all income received for inactive duty while attending weekend drills is taxable.

Out-of-state active Federal duty pay, including housing allowances (this includes a reserve unit's two-week summer training) and all combat-zone pay, is nontaxable.

While on active duty or active duty for training, any other income that the PA resident earns, receives, or realizes remains taxable for PA PIT purposes.

B. Nonresident Members of the Armed Forces – Overview.

Nonresident military personnel who are serving in Pennsylvania are exempt from Pennsylvania Personal Income Tax on their active duty military pay and housing allowances.

They and their families are, however, subject to tax on any other income normally taxable to nonresidents. This includes duty pay that is not active duty pay, such as weekend drills in Pennsylvania.

C. Nonmilitary Persons on Federal Active Service – Overview.

A Pennsylvania resident on Federal active duty outside Pennsylvania is not subject to tax on his or her compensation. The taxpayer must provide a copy of his or her orders in order to exempt this compensation from taxation.

D. U.S. Foreign Service.

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

E. Members of the Merchant Marine and Employees of U.S. Public Health Service – Overview.

Pennsylvania residents serving in the Merchant Marines or U.S. Public Health Service are subject to tax on compensation whether earned within or outside Pennsylvania unless called to active duty in a combat zone or hazardous duty zone.

F. Military Pay to Members of the Armed Forces and Nonmilitary Persons on Federal Active Service Residents of Pennsylvania.

Compensation earned by residents of Pennsylvania in the Armed Forces serving on active duty outside Pennsylvania is not taxable as compensation in Pennsylvania. However, compensation earned by a Pennsylvania resident for military service on active duty in Pennsylvania is subject to the Personal Income Tax, 72 P.S. §7303(a)(1).

Reservists and National Guardsmen ordered to active duty for training at a two-week summer encampment pursuant to Title 10 or Title 73 of the U.S. Code are presumed to be on Federal active duty.

Military pay received for service performed while on Federal active duty is excludable from taxable compensation provided the active duty training is performed outside the Commonwealth. In addition, scholarships or remuneration received by cadets and midshipmen at United States military academies are not taxable because none of these academies is within Pennsylvania and such individuals are on Federal active duty.

G. Nonresidents of Pennsylvania.

Nonresident military personnel who are serving Federal active duty in Pennsylvania in compliance with military or naval orders are exempt from Pennsylvania Personal Income Tax on their military pay because of Federal law. They and their family

members are, however, subject to tax on any other income normally taxable to nonresidents.

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

H. Nonmilitary Persons on Federal Active Service.

When a civilian employer either makes up the difference in a National Guardsman's or United States Reservist's regular wages or continues at full pay for the Guardsman or Reservist during the term of their active duty, the differential or full pay continuation will be considered state taxable compensation subject to Pennsylvania Personal Income Tax withholding.

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

- i. Inactive State duty pay received for services both within and outside the Commonwealth:
- ii. Inactive Federal duty pay received for services as a member of the United States Armed Forces both within and outside the Commonwealth:
- iii. Active Federal duty pay received for services within the Commonwealth;
- iv. Active State duty pay received for services both within and outside the Commonwealth.

I. Eligibility Income For Tax Forgiveness Purposes.

Active duty pay and active duty for training pay received by a member of the U.S. Armed Forces is not taxable for PA PIT Purposes. A taxpayer must include such compensation when determining eligibility for Tax Forgiveness on *PA Schedule SP*.

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

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

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

J. Military Differential Pay.

Differentail pay is defined as payments made voluntarily by an employer to represent the difference between the regular salary of an employee called to military active duty

and the aount being paid by the military, if the regular salary was higher. The term differential pay also includes military continuation pay, active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty. Unless otherwise excluded by a preceding section, military differential pay may be taxable non-employee compensation, whether it is subject to withholding or not.

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

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

L. Combat Zone and Hazardous Duty Service.

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

Regarding: COMBAT ZONE

PA Department of Revenue Bureau of Individual Taxes PO Box 280600

Harrisburg, PA 17128-0600

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

Regarding: COMBAT ZONE

PA Department of Revenue Electronic Filing Section PO Box 280507 Harrisburg, PA 17128-0507

M. Military Family Relief Assistance Program.

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

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

6. Athletes and Entertainers.

A. Resident Professional Athletes and Entertainment Performers.

A professional athlete or entertainment performer who is a full-year resident of Pennsylvania must report all the compensation he or she earns, directly or indirectly, from his or her professional sport or professional athletic team, or from professional performances. Such compensation includes, but is not limited to, any prize, contest, tournament or race winnings, and remuneration, such as, but not limited to: the individual's regular wages; any signing bonus; any incentive payments or performance bonuses; any severance or termination payments or any payments received for refraining from performing services (i.e., covenant not-to-compete payment); or any reimbursements for travel expenses except to the extent the reimbursements are for vouchered expenses which do not exceed the Federal per diem rate for the city in which the player or performer is located. In addition, product endorsement fees, honoraria for public speaking engagements, or fees received for attendance at card shows, autograph signings, or sports memorabilia events, would all have to be reported as Pennsylvania taxable compensation.

B. Nonresident Professional Athletes and Entertainment Performers.

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

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

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

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

- i. Compensation received by such nonresident employees will not be taxable if the employee is a resident of one of the following states at the time he receives the compensation:
 - New Jersey
 - Ohio
 - Maryland
 - Indiana
 - West Virginia
 - Virginia
- ii. Compensation received by nonresident employees of professional teams or performing companies who are residents of states other than those reciprocal compensation states above must use the following

apportionment formulas:

a. Members of professional athletic teams, other than professional football teams.

Calculate a "total games played within the Commonwealth" versus "total games played (including all post-season championship games)" fraction. Multiply that fraction against the taxpayer's total apportionable income. In determining "games played," include exhibition games that are officially sanctioned by the team's league office in both the numerator and denominator of this fraction.

b. Members of professional football teams.

Calculate a "total duty days within the Commonwealth" versus "total duty days" fraction. Multiply that fraction against the taxpayer's total apportionable compensation. In determining "duty days," include preseason and regular season practice sessions; preseason and regular season games; and post-season practice sessions and games that are officially sanctioned by the team's league office in both the numerator and denominator of this fraction.

c. Members of professional performing companies.

Calculate a "total performances within the Commonwealth" versus "total performances" fraction. Multiply this fraction against the taxpayer's total apportionable compensation. For example, if a traveling circus has 200 performances in 200% and 10 of those performances were in Pennsylvania, then 5% of the lion tamer's total compensation from the traveling circus would be apportionable to Pennsylvania if the lion tamer performed his act at each performance.

D. Apportionable Income.

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

"Apportionable income" for a nonresident individual does not include a contract signing bonus if the nonresident was not a resident of Pennsylvania at the time of the signing and the bonus is solely related to the individual's signing of his or her employment contract. "Apportionable income" for a nonresident individual also does not include periodic payments received on account of the nonresident's sickness or disability other than his or her regular wages if such an individual is disabled or injured and can not play in a game and also can not practice with his or her team. In such cases, both the numerator and denominator of the "games played," "duty day" or "performance" fraction will have to be modified to reflect these absences.

E. Classification of Income into Appropriate Income Class.

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

- i. Remuneration received by members of professional athletic teams or performing companies is classified as employee compensation subject to employer withholding.
- ii. Remuneration received by professional team athletes for services rendered outside of the contest of their sport (i.e., public speaking functions, attendance at card shows, product endorsements, paid participation in sporting events outside of their sport, etc.) is classified as nonemployee compensation.
- iii. Receipts received by professional athletes or performers who are not members of professional athletic teams or performing companies (i.e., golfers, tennis players, boxers, wrestlers, race car drivers, bicyclists, comedians, musicians, etc.) must be reported as "net income from the operation of a business or profession" and reported on a strict state-by-state accounting of income and expenses.
- iv. Income derived from book or magazine royalties by professional sports or entertainment figures must be reported as "net income derived from rents, royalties, patents and copyrights. (Nonresidents would have to report only on the royalties attributable to their Pennsylvania sales).

7. Bonuses.

Bonuses are always taxable as Pennsylvania Personal Income Tax compensation.

8. Incentive Pay.

Incentive pay is always taxable as Pennsylvania Personal Income Tax compensation.

9. Commissions

Commissions are always taxable as Pennsylvania Personal Income Tax compensation.

10. Tips and Gratuities.

Tips and gratuities are always taxable as Pennsylvania Personal Income Tax compensation.

11. Vacation Pay/Holiday Pay.

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

- Computed with reference to the period the employee is absent from work; and
- b. Paid in full or partial replacement of the base pay the employee could have earned for such period but for such absence.

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

12. Sick Pay.

A. Regular Wages - Pennsylvania Taxable.

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

B. Other Than Regular Wages – Pennsylvania Nontaxable.

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

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

A. Insurance Issued by a Commercial Third Party Insurance Company.

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

B. Accident or Health Plan.

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

- No program benefits are payable or subject to anticipation, assignment, or pledge until the commencement of a covered sickness or disability or death except:
 - The return of the participant's own contributions and taxable income or gains thereon;
 - Amounts paid for the prevention of sickness or disability; or
 - c. Amounts paid for a policy of accident, health, or term life insurance issued by a commercial insurance company.
- ii. The only means of obtaining entitlement to program benefits other than the return of the participant's own contributions and taxable income or gains thereon, or amounts paid for the prevention of sickness or disability, or commercial insurance is proof of hospitalization, sickness, disability, or death.
- The program offers no benefit that defers the receipt of compensation or operates in a manner that enables no participant to defer the receipt of compensation to another taxable year.

C. Discriminatory Programs.

Except as provided in "Disability Annuities" below, compensation includes the entire cost of employer-provided coverage provided to a highly compensated participant

under a discriminatory program covering hospitalization, sickness, or disability.

D. Disability Annuities.

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

E. Plan Payments.

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

- The periodic payments have some direct relationship to the employee's usual rate of compensation;
- ii. The periodic payments are computed without reference to the nature of the disability and with regard to the employee's job classification;
- iii. Periodic payments would not be reduced by payments arising under Workmen's Compensation Acts, Occupational Disease Acts, Social Security Disability, or similar legislation by any government;
- iv. The periodic payments cannot exceed the employee's usual compensation for the period.

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

- i. For which the employer, but for his agreement to indemnify his employees against loss arising from such contingencies, would, otherwise, have had no legal or moral duty whatsoever to make payment;
- ii. Which did not arise out or in the course of, and were not incidental to, any employment relationship; and
- iii. Which may be temporary, non-chronic, and of short duration, with no long-term or permanent impact.

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

- The amount payable for a period to a participant under the plan may differ from the amount payable to another participant for the period, even if both participants have the same job classification; and
- ii. The amount payable for a period to a participant under the plan may be the same as the amount payable to another participant for the period, even if both participants do not have the same job

classification.

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

F. Taxable Amounts.

All of the following are taxable:

- i. Amounts received during a period of sickness or disability for services performed during another period or to which the employee would have been entitled regardless of whether he was sick or disabled.
- ii. Paid leaves of absence due to sickness or disability.
- iii. Payments for unused sick leave.

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

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

Except in the case of cafeteria plans:

- i. Any amount lawfully deducted by an employer from the remuneration of an employee for accident or health insurance or plan coverage or a disability annuity shall be deemed to be a part of the employee's taxable remuneration and to have been paid to the employee as compensation at the time the deduction is made.
- ii. Any amount paid for accident or health insurance or plan coverage or a disability annuity by an employer to a third party or fund on behalf of an employee without deduction from the remuneration of, or other reimbursement from, the employee is excludible from the employee's income unless:
 - The payment is made pursuant to a cash or deferred arrangement under which an employee may unilaterally elect to have the employer make payments to such third party or fund for the benefit of the employee or to the employee directly in cash (in this instance, the payment shall be deemed to be paid to the employee as compensation at the time the payment is made).
 - The payment is made pursuant to an arrangement under which an employee may unilaterally choose between accident or health insurance or plan coverage (or a disability annuity) and coverage under another employee benefit plan (in this instance, the payment shall be deemed to be paid to the employee as compensation at the time the payment is made).

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

- They were not actually or constructively received, after taking IRC Section 125 into account;
- ii. The benefits selected or purchased are nontaxable under the Internal Revenue Code when offered under a cafeteria plan described in IRC Section 125;
- iii. The payments made for the plan would be nontaxable under the Pennsylvania Personal Income Tax if made by the employer outside a cafeteria plan described in IRC Section 125.

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

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

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

14. Disability.

A. Regular Wages - Pennsylvania Taxable.

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

B. Other than Regular Wages - Pennsylvania Nontaxable.

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

15. Strike Benefits.

Strike benefits are not taxable for Pennsylvania Personal Income Tax.

16. Group Term Life Insurance.

Group term life insurance is never taxable for Pennsylvania Personal Income Tax, regardless of the amount.

17. Unemployment Compensation.

Unemployment compensation is not taxable for Pennsylvania Personal Income Tax purposes.

18. Workers Compensation.

Workers compensation is never taxable for Pennsylvania Personal Income Tax purposes.

19. Occupational/Disability Act Benefits.

Occupational/Disability Act Benefits are never taxable for Pennsylvania Personal Income Tax.

20. Stipends.

A. Pennsylvania Taxable.

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

B. Pennsylvania Nontaxable.

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

- The benefits resulting from the services of the recipient are so minimal, given the actual services performed or expected to be performed, that they constitute no realistic basis for compensation by the institution sponsoring the fellowship or stipend; or
- The activities of the recipient are so closely and directly supervised and immediately controlled by regular faculty members so as to constitute a burden on the institution which would offset any benefit it receives from the recipient's activities; or
- The recipient is a candidate for a degree and the same activities are required for all candidates for that degree as a condition for receiving such a degree.

21. Scholarships/Fellowships.

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

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

22. Moving Expense Reimbursements.

A. Historical Background.

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

If parties to an employment contract recognize that the employee will pay for some business expenses out of his or her own pocket, these amounts may be excluded from income. Id. However, personal expenses, including daily living expenses of an employee, may not be excluded from compensation. Williamson v. Commissioner, 525 A.2d 475 (Pa. Cmwlth. 1987). In Williamson v. Commonwealth, 525 A.2d 475 (Pa.Cmwlth. 1987), an individual was transferred from St. Louis, Missouri to Pennsylvania and was reimbursed by his employer for certain expenses including costs associated with buying a new home (title insurance premium, notary fee, 1% mortgage

service charge, appraisal fee, credit report fee), certain state and local taxes, and the costs associated with replacing his driver's license and license plates. In that case, the taxpayer argued that the reimbursement fit within the exclusion from compensation of "payments to reimburse actual expenses" noted above. 72 P.S. §7301(d)(v). The Commonwealth Court of Pennsylvania rejected this argument noting:

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

B. Allowance for Moving Expenses for Pennsylvania Personal Income Tax.

Expenses one pays or incurs in moving himself, his immediate family, his household goods, and his personal effects are allowable. Allowable moving expenses include the cost of transportation to one's new home. One may use actual out-of-pocket costs or the Federal mileage allowance. The expenses for the storage of household goods, for meals and lodging on the way, including such costs on the day of arrival, and parking fees and tolls are also allowable.

C. Expenses to Sell or Purchase a Home.

Pennsylvania does not allow expenses to sell or purchase a home and costs to break a lease. One may not deduct pre-move house hunting expenses, temporary lodging prior to moving, and any costs or expenses not directly related to actually moving.

D. Distance Test.

One's new workplace must be at least 35 miles farther from his old residence than his old workplace was.

E. EXAMPLE.

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

If one is in the military service, he does not have to meet the distance test if his move is a permanent change of duty station. If one, one's spouse, and dependents are moving to the new duty station from different locations, he may claim all the allowable expenses.

23. Awards/Prizes from Employers.

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

A. National Service Education Awards and Income from Peace Corps.

Such income is taxable for Pennsylvania Personal Income Tax Purposes.

IV. PENNSYLVANIA TAXATION OF STOCK OPTIONS.

1. Overview.

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

Pennsylvania Personal Income Tax.

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

- a. Date of exercise of the option unless there are substantial restrictions, or
- b. Date that substantial restrictions on the option lapse, or
- c. Date of sale of the option.

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

Please reference the tables on the following pages.

2. Federal Statutory Stock Option (Qualified Stock Option) – Table 7-4.

Table 7-4 Federal Statutory Stock Option (Qualified Stock Option). Applicable option incentive stock option and qualified stock option. Pennsylvania.					
	Employee	Employer	Employee	Employer	
Grant Date. Exercise Date.	No tax impact. Alternative minimum tax adjustment equal to the difference between exercise price of stock and fair market value of stock on exercise date.	No tax impact. No tax impact.	No tax impact. The value of the option less any amount paid for the option will be taxed as compensation.	No tax impact. Compensation deduction equal to income withheld as Pennsylvania wages.	
Lapse Date. Stock Disposition Date.	Capital gain equal to difference between sale price of stock and exercise price of option.	No tax impact.	Gain from exchange or disposition of property equal to difference between sale price of stock and exercise price of option.	No tax impact.	

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

Table 7-5 Non-statutory Stock Option (Nonqualified Stock Option) Option Fully Transferable or Not Subject to Risk of Forfeiture.						
Option date	Federal no		Pennsylvania			
•	Employee	Employer	Employee	Employer		
IRC Section 83.			No tax impact.	No tax impact.		
	adily ascertainable fair m	narket value on date of	grant (option fully trans	sferable or not		
subject to risk Grant Date.	The value of the option less any amount paid for the option will be taxed as compensation.	Compensation (ordinary) deduction equal to income subject to withholding or Form 1099 issued to employee or independent contractor.	No tax impact.	No tax impact.		
Exercise Date.	No tax impact.	No tax impact.	The value of the option less any amount paid for the option will be taxed as compensation.	Compensation deduction equal to income subject to withholding or Form 1099 issued to employee or independent contractor.		
Stock Disposition Date.	Capital gain equal to difference between sale price and fair market value at the date of exercise option.	No tax impact.	Gain from exchange or disposition of property equal to difference between sale price of stock and exercise price of option.	No tax impact.		
	blicly traded or does NO			on date of grant		
Grant Date. Exercise Date.	No tax impact. The value of the option less any amount paid for the option will be taxed as compensation.	No tax impact. Compensation (ordinary) deduction equal to income amount recognized by employee.	No tax impact. The value of the option less any amount paid for the option will be taxed as compensation.	No tax impact. Compensation deduction equal to income subject to withholding or Form 1099 issued to employee or independent contractor.		
Stock Disposition Date.	Capital gain equal to difference between sale price and fair market value at the date of exercise option.	No tax impact.	Gain from exchange or disposition of property equal to difference between sale price of stock and exercise price of option.	No tax impact.		

4. Option is NOT Fully Transferable or Subject to Risk of Forfeiture – Table 7-6.

Table 7-6 Non-statutory Stock Option (Nonqualified Stock Option) Option is NOT Fully Transferable or Subject to Risk of Forfeiture. Applicable							
option date	Federal (Nonqualified)		Pennsylvania				
	Employee	Employer	Employee	Employer			
		market value on date	of grant (option NOT tra	ansferable or subject			
to risk of forfo Grant Date.	The value of the option less any amount paid for the option will be taxed as compensation.	Compensation (ordinary) deduction equal to income amount recognized by employee.	No tax impact.	No tax impact.			
Exercise Date. Lapse Date.	No tax impact.	No tax impact.	No tax impact. The value of the option less any amount paid for the option will be taxed as compensation.	No tax impact. Compensation deduction equal to income subject to withholding or Form 1099 issued to employee or independent contractor.			
Stock Disposition Date.	Capital gain equal to difference between sale price and fair market value at the date of exercise option.	No tax impact.	Gain from exchange or disposition of property equal to difference between sale price of stock and exercise price of option.	No tax impact.			
	NOT have readily ascer risk of forfeiture): '	tainable fair market va	lue on date of grant (op	tion NOT transferable			
Grant Date. Exercise Date.	No tax impact. The value of the option less any amount paid for the option will be taxed as compensation.	No tax impact. Compensation (ordinary) deduction equal to income amount recognized by employee.	No tax impact. No tax impact.	No tax impact. No tax impact.			
Lapse Date.			The value of the option less any amount paid for the option will be taxed as compensation.	Compensation deduction equal to income subject to withholding or Form 1099 issued to employee or independent			
Stock Disposition Date.	Capital gain equal to difference between sale price and fair market value at the date of exercise option.	No tax impact.	Gain from exchange or disposition of property equal to difference between sale price of stock and exercise price of option.	contractor. No tax impact.			

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

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

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

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

Pennsylvania Taxation of Stock Options.

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

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

There is no Pennsylvania Personal Income Tax provision similar to an IRC Section 83(b) election for Federal income tax purposes.

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

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

The income realized will be the difference between the fair market value of the stock at time the

restriction lapses and the fair market value at the time the options are recognized.

8. Examples.

A. Example 1.

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

B. Example 2.

Same facts as above except that there is a five-year restriction imposed on employees' ability to sell the stock. Tom will be taxable on these stock options in five years when the stock options are no longer subject to substantial restrictions.

C. Example 3.

If a stock is "letter stock," it is a substantial restriction for Pennsylvania Personal Income Tax. The substantial restriction lapses after the required two-year period expires.

V. PENNSYLVANIA TAXATION OF CAFETERIA PLANS.

1. Overview – Federal/Pennsylvania Differences.

A. Federal.

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

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

B. Pennsylvania.

If a taxpayer's employer maintains a Federally qualified cafeteria plan pursuant to IRC Section 125, certain amounts deducted from taxpayer's salary (e.g., health/accident insurance) are not subject to Pennsylvania Personal Income Tax to the extent excluded for Federal purposes.

Employer-provided flex dollars that an employee must use to pay for Pennsylvaniaexempt benefits, such as health insurance or life insurance, are excludable from income taxation. Employee contributions to a qualified IRC Section 125 plan for

coverage for hospitalization, sickness, disability or death, supplemental unemployment benefits, or strike benefits, like employer contributions, are exempt, but only to the extent they are exempt for Federal income tax purposes. If an employer has an employee benefit plan that is not a qualified IRC Section 125 plan, employee contributions, even for the same kinds of coverage, are not excludable from Pennsylvania taxable compensation.

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

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

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

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

- 1. Payments made after December 31, 1996, for employee welfare benefit plans under a cafeteria plan qualifying under section 125 of the IRC will be deemed to be an 'employer contribution' for Pennsylvania Personal Income Tax purposes if the following apply:
 - a. They were not actually or constructively received after taking section 125 of the IRC into account;
 - b. They were specified in a written cafeteria plan document as being available to the participant:
 - For the purpose of selecting or purchasing benefits under a plan;
 - ii. As additional cash remuneration received in lieu of coverage under a plan;
 - iii. The benefits selected or purchased are nontaxable under the IRC when offered under a cafeteria plan;
- 2. If these conditions are satisfied, cafeteria plan contributions are taxed under the rules as applied to employer payments for employee welfare benefit plans . . . See 61 Pa. Code §125.28(a)&(b).

Pennsylvania Taxable Benefits.

All benefits other than for death, disability, hospitalization, and sickness are taxable under Pennsylvania Personal Income Tax.

3. Pennsylvania Nontaxable Benefits.

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

VI. PENNSYLVANIA TAXATION OF FRINGE BENEFITS.

Federal Income Tax – Overview.

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

- No additional cost services (i.e. free stand-by flights for airline employees)
- Qualified employee discounts (i.e. reduced prices on goods and services)
- Working condition fringe benefits (i.e. use of a company car for business purposes)
- De minimis fringe benefits (i.e. personal use of a company copy machine)
- Qualified transportation fringe benefits (i.e. commuter highway vehicle, transit passes, and qualified parking)
- Qualified moving expense reimbursements
- On-site athletic facilities provided by and operated by the employer
- Medical Savings Accounts
- Scholarships and fellowship grants for teaching, research, or other services performed as a condition for receiving the grants
- Educational assistance provided for graduate teaching and research assistants and excludable fringe benefits (i.e., *de minimis* fringe benefits, no additional cost services, employee discounts, and working condition fringe benefits)
- Cash and contributions by employers to provide coverage for long-term care services through a flexible spending or similar arrangement.

Pennsylvania Nontaxable – Overview.

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

- a. Employer use of property including, but not limited to:
 - Employer dependent-care facilities
 - ii. Employer office equipment
 - iii. Employer-provided aircraft

- iv. Employer-provided vehicles
- v. Employer recreational facilities
- b. Employer-provided professional services such as accountants and personal financial planners.
- c. Qualified employee discounts.
- d. Any other de minimis fringe benefit defined under IRC Section 132.

3. Tuition Benefits/Educational Assistance Payments – Pennsylvania Rules.

A. Direct.

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

B. Reimbursement.

If the employer reimburses employees for education costs, then the reimbursement is fully taxable as compensation and the employees may deduct only those directly related business expenses allowed on *Pennsylvania Schedule UE*. See discussion under Pennsylvania Schedule UE section of Pennsylvania Personal Income Tax Guide for discussion of eligible business expenses.

VII. EMPLOYEE EXPENSES FOR PENNSYLVANIA.

1. Overview Federal/Pennsylvania Differences.

Under Federal law, employee expenses are accounted for on Federal Form 2106. Under Pennsylvania Personal Income Tax law, employee expenses are accounted for on **Pennsylvania Schedule UE**.

Accountable Plan.

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

3. Unreimbursed Employee Expenses – PA Schedule UE.

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

The PA Schedule UE covers these expenses:

- a. Travel and mileage;
- b. Union dues/agency fees (or collective bargaining expenses, both of which are deductible over the life of the contract)/initiation fees;
- Work clothes not suitable for street wear required to be purchased. This includes cleaning, altering, and repairs;
- d. Small tools and supplies:
- e. Professional license fees, malpractice insurance, and fidelity bond premiums

where required by law or employer;

- f. Moving expenses provided the transfer is from one permanent duty station to another and provided that the net distance difference between the residence and the old duty station and the original residence and the new duty station is 35 miles or more (the 35 mile rule is waived for military personnel and their families). Expenses are limited to those incurred in moving family, self, and household goods from point of departure to point of arrival. Expenses associated with job-hunting trips are not deductible;
- g. Educational expenses. An individual taxpayer's education expenses are deductible if the education maintains or improves the skills used in the taxpayer's employment or trade or business (i.e. continuing education requirements prevalent in many professions or occupations) or is required for the taxpayer to keep his salary, status, or employment. However, the expenses are not deductible if the education qualifies the taxpayer for a new trade or business (i.e. a current teacher qualifying to be a principal of the educational institution), or is required to meet the minimum educational requirements of the taxpayer's current employment, trade, or business.
- h. Office work area expense;
- i. Miscellaneous expenses:
 - Breakage fees
 - Cash shortages
 - Blind employees' costs incurred to pay readers
 - Business gifts
 - Fees on W–2 which must be paid back to employer (e.g. Jury duty where employer continues full wages and requires repayment of monies received for jury duty)
 - Reimbursements received not on W–2 must be deducted from expenses claimed on PA Schedule UE.
 - Depreciation expense
 - Per diem expenses if the taxpayer reports the per diem income.

The **PA Schedule UE** does **not** cover these expenses.

- a. Deductions not allowable as business expenses;
- b. Personal, living, or family expenses;
- Capital expenditures normally are not an allowable business expense except through depreciation. Certain depreciation expense exclusions may be taken. Federal depreciation or cost-recovery deductions are acceptable for Pennsylvania purposes as an administrative convenience to compute allowable business expense deductions;

- Dues to professional or fraternal societies, Chambers of Commerce, or recreational club memberships;
- e. Subscriptions to publications;
- f. Campaign or political contributions;
- g. Charitable contributions:
- h. Commuting expenses;
- Cost of meals while working late except while traveling away from home overnight;
- j. Occupational privilege taxes;
- K. Child care and elderly care expenses;
- Life, disability income, and health service insurance premiums;
- m. Malpractice insurance premiums except where required by law or employer;
- n. Pension contributions;
- Fines, penalties, legal fees (except to recover back wages), and bad debts;
- p. Bribes, kickbacks, or other illegal payments;
- q. Eligible job-hunting expenses and pre-employment expenses or initial agent's fees:
- Residential phone service (however, specific charges for telephone calls required to be made for business purposes may be deducted).
- s. Taxpayer's with multiple W–2s, where expenses are greater than the wages from one employer, are **not** allowed deductions against other compensation from other employers.

4. PA Schedule UE Preparation, including the PA TeleFile Schedule UE.

Separate PA Schedules UE must be completed for each taxpayer and for each employer and occupation. This means that a separate *PA Schedule UE* must be filed for each Form W–2 received by the taxpayer. Additionally, the Department of Revenue has the right to request a detailed breakdown of expenses for each employer or occupation. The total amount of unreimbursed expenses must be entered.

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

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

If the unreimbursed business expenses being claimed for Federal purposes on the Federal

Form 2106 are the same as these being claimed for Pennsylvania, complete Line 1b of *Pennsylvania Schedule I*. This schedule may not be used if there is any amount on Line 4 of the Federal Form 2106 or if there are any differences from the Federal amount being claimed.

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

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

When an employer reimburses its employees for personal and non—business expenses, the entire reimbursement is taxable Pennsylvania compensation. The employees may take any Pennsylvania allowable unreimbursed employee business expenses on Pennsylvania Schedules UE.

5. Allowance for Clothing.

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

- The expenses for which the employee is reimbursed are allowable business expenses; and
- b. The employee is required to and does account for the expenses to his employer; and
- The employee is reimbursed by his employer in the exact amount of the allowable business expenses; and
- d. The employee does not report the expenses on Pennsylvania Schedule UE, 1 or 2.

The costs of purchasing and maintaining uniforms and work clothing to protect you from bodily injury are allowable business expenses under Pennsylvania Personal Income Tax law if the uniforms and clothing are both:

- Of a type required by the employer to be purchased as a condition of continued employment; and
- b. Not adaptable to general usage.

An allowance is considered taxable Pennsylvania income if the employee receiving the allowance can use it at his discretion. An allowance for work clothing is included in Pennsylvania compensation, and, thus, taxed as income. However, a reimbursement paid to the employee for amounts he expended for a particular purpose is not income. Reimbursements for the purchase of work clothing are not income and costs in excess of the reimbursement are deductible to the employee.

Compensation does not include benefits payable by an employer or labor union under a supplemental unemployment benefit plan, whether payable on a periodic basis or in the form of cash, services, or property. See Section 61 Pa. Code §101.6(c)(14).

6. Examples.

Example i. The employer provides leased company cars, each with a value of \$200 per month, to its employees. An employee's use of the car is 75% business and 25% personal. The personal use of the car (\$50 per month) is not taxable Pennsylvania compensation to the employee.

Example ii. The employer provides dependent care for its employees in a facility it leases and pays all the costs. The value of the dependent care is not taxable Pennsylvania compensation to the employees.

Example iii. The employer allows its employees to use the company's plane to go to its recreational property. The value of the use of the plane and the recreational facilities is not taxable Pennsylvania compensation to the employees.

Example iv. An employee leases her own vehicle for \$200 per month. The employer reimburses the employee for the full value of the lease (\$2,400). The employee's use of the car is 75% business and 25% personal. The \$2,400 is taxable compensation on the employee's Form W–2. The employee may deduct \$1,800 on Pennsylvania Schedule UE. Her personal use of the car (\$600) is not deductible.

Example v. The employer reimburses its employees \$50 per month for the dependent care costs they incur. The employer must include \$600 in the employees' Forms W–2 as taxable Pennsylvania compensation.

Example vi. The employer rewards the 'employee of the year' with a paid vacation. The value of the vacation is taxable Pennsylvania compensation to the employee.

Example vii. The employer can elect compensation or to receive reimbursement. The amount is taxable for the employee for Pennsylvania Personal Income Tax.

VIII. DAMAGE AWARDS.

1. Overview – Federal/Pennsylvania Differences.

Federal courts have held that there are no provisions in either Title VII of the Civil Rights Act of 1964 or the ADEA that provide compensatory damages for pain and suffering or for emotional distress. See Supreme Court Decision in United States v. Burke, 112 S.Ct. 1867, 119 L.Ed.2d 34 (1992); Commissioner v. Schlieier, 515 U.S. 323 (1995). For Federal income tax purposes, one could not exclude the settlement proceeds unless he could demonstrate that the award represents "damages received on account of personal injury or sickness." 26 U.S.C. §104(a)(2)

For Pennsylvania Personal Income Tax purposes, damage for personal injury or sickness are excludable from Pennsylvania compensation. This includes emotional distress as well as physical injury.

If a claim was brought under either Title VII of the Civil Rights Act of 1964 or the ADEA, the amounts received are meant to restore the worker to the wage and employment position that the worker would have occupied prior to the unlawful discrimination. Consequently, the sums received from former employers are considered a form of back wages and are taxable as compensation under Pennsylvania's Tax Reform Code.

As mentioned above, damage awards received for personal injury or sickness are not taxable for Pennsylvania Personal Income Tax. This includes Federal taxable punitive damages. Damage award for lost profits or lost capital are taxable for Pennsylvania Personal Income Tax.

- 2. Summary of Pennsylvania Personal Income Tax Treatment of Specific Damage Awards.
 - a. Personal Injury Damage Awards Received Including Punitive Damage Awards. Personal injury damage awards, including punitive damages, are not taxable under Pennsylvania Personal Income Tax law.
 - b. Age Discrimination Under ADEA Damage Awards. Damage Awards received for age discrimination under ADEA are taxable as compensation.
 - c. Sex Discrimination and Title VII of the Civil Rights Act. Damage Awards received for sex discrimination under Title VII of the Civil Rights Act are taxable as compensation.
- 3. Damage Awards for Lost Profits for Pennsylvania Personal Income Tax.

 Damage awards for lost profits are taxable under Pennsylvania Personal Income Tax law.
- 4. Damage Awards for Return of Capital for Pennsylvania Personal Income Tax.
 Damage awards for return of capital are taxable under Pennsylvania Personal Income Tax law.
- Pennsylvania Treatment of Legal Expenses.
 For Pennsylvania Personal Income Tax purposes, legal fees directly associated with the receipt of a damage award or settlement award are offset against the damage award received. The offset occurs only within the class of income.

IX. GUARANTEED PAYMENTS TO A RETIRED PARTNER.

Guaranteed payments to a retired partner are taxable as compensation on the same basis as deferred compensation is taxed to former employees of a partnership if:

- a. Such partner rendered no services with respect to any trade or business carried on by such partnership or its successors during the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received:
- b. No obligations, whether certain in amount or contingent on a subsequent event, exist during the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received except with respect to retirement payments under such plan;
- c. Such partner's share of the capital of the partnership has been paid to him in full before the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received.

However, amounts received by a retiring partner pursuant to a written plan of the partnership that provides for guaranteed payments on account of retirement to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, are excludible retirement benefits if:

- a. The above requirements are met; and
- b. The plan otherwise constitutes a qualifying retirement benefit plan.

Other payments received in liquidation of the interest of a retiring partner shall be considered as:

(I) A distributive share of partnership income if the amount thereof is determined with

regard to the income of the partnership;

(II) A guaranteed payment; or

(III) A distribution made in exchange for the interest of such partner in partnership property, including, unless the partnership agreement provides otherwise, unrealized receivables of the partnership and goodwill of the partnership.

[Insert recent Federal statutory limitation for nonresident partners.]

X. PARTNERS AND SELF-EMPLOYED RETIREMENT PLANS – SEPS, KEOGH.

Overview.

Pennsylvania tax law concerning simplified employee plans differs from federal law. For Pennsylvania income tax purposes, employer contributions to a sep are excludable from the compensation of an employee. However, a self-employed taxpayer cannot deduct payments to his own IRA or Keogh plan.

2. Employer Contributions.

Contributions by a self-employed individual or entity which employs one or more persons for compensation to employee welfare benefit programs on behalf of such employees generally are excludable from the employee's income and are deductible as a business expense to the extent the contributions constitute reasonable compensation for services. Pennsylvania tax law makes no distinction between stockholder-employees or officers of closely held corporations and other employees.

3. Employee Contributions.

When either an employee or self-employed individual invests money in a deferred payment plan *and* such individual did so as a result of his unilateral choice, the courts have held that the amounts placed into the plan or forgone as cash-in-hand were either compensation or net profits reportable in the year of deferral or contribution. *Bernknopf v. Commonwealth*, 425 A.2d 880 (Pa. Cmwlth. 1981); *Amp Products Corp. V. Commonwealth*, 593 A.2d 1 (Pa. Cmwlth. 1991) *aff'd. Per curiam*, 530 Pa. 249, 608 A.2d 25 (1992); *Smith v. Commonwealth*, 684 A.2d 647 (Pa. Cmwlth. 1996), *aff'd. Per curiam*, 549 Pa. 578, 701 A.2d 1360 (1997).

4. Case Law.

In *Kalodner v. Commonwealth of Pennsylvania*, 150 Pa Commw 248, 615 a2d A.2d 900 (1992), the Commonwealth believed that contributions to a Keogh plan or an IRA by a self-employed individual for his or her own benefit are not ordinary expenses incurred in the conduct of a business and, thus, could not be excluded from net profits. The court stated:

Self-employed persons who contribute to their own retirement plan are investing income they have actually received for their retirement. See Bernknopf v. Department of Revenue, 57 Pa. Commonwealth Ct. 57 (1981). On the other hand, in situations where an employee's retirement plan is entirely funded by his or her employer and the contributions are not made by reducing the employee's salary, the employee may not actually or constructively receive income since the receipt of benefits under such a retirement plan could be subject to substantial limitations and restrictions. See 61 Pa. Code § 101.7. Hence, we conclude that the tax code does not offend the federal constitution or the Pennsylvania constitution because there is a rational basis supporting the distinction in the tax code between self-employed persons who make their own contributions to retirement plans and employers who contribute to a retirement plan for their own employees.

XI. GROSS NON-EMPLOYEE COMPENSATION.

Taxable gross compensation is **not** limited to employee compensation. It also includes:

Honorarium.

Honoraria are taxable for Pennsylvania Personal Income Tax purposes.

2. Executor or Administrator Fees.

Executor fees are taxable as compensation. This includes executor's fees paid to nonresident executors and administrators for estates in Pennsylvania. It is presumed that these fees are received for services performed in Pennsylvania by the executor and/or his or her agent (such as an attorney) and the burden of proof falls upon the taxpayer to prove otherwise. Any apportionment must be reported on *Pennsylvania Schedule NRH*.

An executor or executrix for an estate in Pennsylvania would be required to visit Pennsylvania to complete his or her duties. The fact that the executor or executrix may use an agent to do the duties does not take away the fact that they had a presence in Pennsylvania and are subject to tax on that income. The only apportionment to be done is to exclude that portion of the executor fee that represents the services performed outside of Pennsylvania for the convenience of the estate and by necessity out of Pennsylvania. An example would be an appearance in court outside of Pennsylvania involving the estate. The remainder of the fee would be taxable as compensation for Pennsylvania purposes by non-resident executors. Apportionment can only be done by the number of days required out of Pennsylvania over total days spent working on the estate, including the time of the agent. The executor or executrix may be able to get some credit on another state's return for the income taxed by both states.

3. Witness Fees.

Witness fees are taxable compensation for Pennsylvania Personal Income Tax.

4. Jury Fees.

Jury fees are taxable compensation for Pennsylvania Personal Income Tax.

5. Director Fees.

Director fees are taxable compensation for Pennsylvania Personal Income Tax. The taxpayer is entitled to claim unreimbursed employee business expenses that are directly related to that compensation on *PA Schedule UE*.

6. Foster Care.

For taxable years beginning on or after January 1, 1995, remuneration received by a foster care provider for in-home care of foster children received from an agency of the Commonwealth or political subdivision or an organization exempt from Federal income tax under IRC Section 501(c)(3) are not compensation subject to Pennsylvania Personal Income Tax, unless the taxpayer is in the business of providing foster care.

7. Miscellaneous Compensation.

PA Schedule MC, Miscellaneous Compensation, is for reporting nonemployee compensation from sources other than a Form W–2. Enter the payer's EIN and name, Pennsylvania taxable compensation, Pennsylvania tax withheld, Federal taxable income and one of the following codes to identify the type of income:

- (A) Executor fee.
- (B) Jury duty pay.
- (C) Director fee.

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- (D) Expert witness fee.
- (E) Honorarium.
- (F) Covenant not-to-compete.
- (G) Damages or settlement for lost wages other than personal injury.
- (H) Other nonemployee compensation; describe it on this line.
- (I) Early distribution from retirement or pension plan.
- (J) Television Game Show or "Reality" Show winnings.

8. Form 1099–MISC Income.

Fees, commissions, rewards, golden parachute payments, damage awards, termination payments, fringe benefits or other items of non-employee compensation reported on Federal Form 1099–MISC are taxable as compensation.

Pennsylvania Personal Income Tax Treatment of Household Employees.

A household employee, which can include babysitters, caretakers, nannies, health aides, private nurses, housekeepers, cleaning people, drivers, and yard workers, is a person hired to do any sort of household work as long as the employer retains the right to control the details of how the work is done. This differs from house workers obtained through an agency or self-employed workers who retain control of how the work is done. Generally, a self-employed worker provides his or her own tools and offers services to the public as an independent business. These individuals must file and report their income through the appropriate business schedule.

Since household employees are not subject to Federal income tax withholding (although they may be subject to Social Security withholding), they are not subject to Pennsylvania income tax withholding.

XII. NONRESIDENT - ALLOCATION OF PENNSYLVANIA COMPENSATION.

1. Compensation From Sources Within Pennsylvania.

If services are performed within Pennsylvania, the compensation for the services constitutes income from Pennsylvania sources, regardless of the following:

- a. Whether the services were performed as an employee.
- b. Whether the compensation is received in a taxable year after the year in which the services were performed.
- c. Whether the compensation is received by someone other than the person who performed the services.

Some items of compensation may be based upon services relating to a single transaction or piece of work while other items may be based upon multiple transactions or piecework. Some may be based upon services of a continuing nature or services that are frequently recurring; and some constitutes prepaid income. Accordingly, different rules for allocating income to Pennsylvania sources may apply. They are explained below.

Commissions.

A. On Sales Of Real Estate.

A commission payable on a sale of real estate must be allocated to Pennsylvania if it is either the place where the real estate is situate or the place where the greater proportion of the income-producing activity is performed, based upon costs of performance and hours of work.

B. On Sales Of Tangible Personal Property.

A commission payable on a sale of tangible personal property must be allocated to Pennsylvania if it is either the place where the property is delivered to the purchaser, regardless of the f.o.b. point or other conditions of the sale, or the place where the greater proportion of the income producing activity is performed, based upon costs of performance and hours of work.

C. On Sales Of Intangible Personal Property.

A commission payable on a sale of intangible personal property must be allocated to Pennsylvania if it is the place where the greater proportion of the income producing activity is performed, based upon costs of performance and hours of work.

3. Compensation Based Upon Years Of Continued Service.

If the amount of payment is based upon years of service or the total compensation received by the payee during his years of service, the payment shall be apportioned on the basis of the aggregated total number of working days worked within Pennsylvania during such years. This rule applies where, for example, a plan participant is to receive a severance benefit of 2% of his final year's compensation times the years of service performed or a plan participant is to receive a benefit of 2% of the total compensation received during the payee's years of service.

4. Casual Employments; Compensation Paid On A Daily Basis.

Compensation that is based upon services relating to a single transaction or piece of work must be allocated to Pennsylvania if it is the place where the greatest proportion of the income producing activity is performed, based upon costs of performance and hours of work. The same rule applies to compensation paid—or ordinarily paid—on a daily basis.

Compensation Paid On A Weekly, Biweekly, Semimonthly, Monthly, Quarterly, Semiannual Or Annual Basis.

Compensation that is earned and paid—or is ordinarily earned and paid—on a weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual basis shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual period bears to the total number of working days during the period.

6. Miscellaneous Compensation.

Miscellaneous compensation is compensation other than prepaid compensation, commissions, compensation based upon years of continued service, compensation from casual employments or compensation paid on a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual basis. If its payment accrual period is determinable, each payment of miscellaneous compensation shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the payment's payment accrual period bears to the total number of working days during the payment's payment accrual period.

If its payment accrual period is not determinable, each payment of miscellaneous compensation shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the last period of continuous employment preceding the payment bears to the total number of working days during such period.

7. Prepaid Compensation.

Even when conditioned, directly or indirectly, on the future performance (or refraining from performance) of substantial services, payments for services not yet rendered are taxable to cash method taxpayers unless the possibility of forfeiture is substantial or they are repaid within the refundable period. Amounts paid exclusively to provide reasonable compensation for future services such as a covenant not to compete, however, cannot be allocated on a working days basis unless and until all services fixing the right to retain the payment have occurred. Accordingly, if the evidence shows that substantially all of the future services would have been performed in Pennsylvania, then the prepayments are allocable to Pennsylvania. Otherwise, such amounts may be allocated only to the employee, director or officer place of residence at the time of payment.

Amounts that substantially exceed the reasonable value of future services or payments that are intended to provide a "stay bonus" or similar incentive, however, must be treated as compensation for prior and current services. Moreover, if there is no way to determine the portion of a payment attributable to prior or current services and the portion attributable to future services, the entire amount is allocable to prior and current services.

8. Working Day Explained.

A working day is any calendar day upon which compensable work is done, regardless of how short the time. In determining the number of working days:

- No account whatsoever may be taken of nonworking days, including Saturdays, Sundays, holidays, days of absence because of illness or personal injury, vacation days, days of leave with pay, days of leave without pay, days where a person is on call if needed or days when work could not reasonably be expected to proceed because of strikes, weather conditions or other cause.
- The presence within a state or foreign country shall be disregarded if it is solely for the purpose of boarding a plane, ship, train or bus for travel to a destination outside such state or country or while traveling by motor, plane, or train through a state or foreign country to a destination outside such state or country.
- Time spent in commuting or in traveling between work sites shall be disregarded.

9. Working Days Employed Within Pennsylvania Explained.

Where a worker is provided with a suitable office or other workplace within Pennsylvania or is maintaining an office-in-home or other workplace within Pennsylvania, a working day is employed within Pennsylvania if either:

- a. Some of the compensable work done during the calendar day is done in Pennsylvania; or
- b. All of the work done outside Pennsylvania was done there only for the worker's convenience or was not performed there of necessity in the service of the employer.

Conversely, where a worker is provided with a suitable office or workplace outside Pennsylvania or is maintaining an office-in-home or other workplace outside Pennsylvania, a working day is employed within Pennsylvania only if some of the compensable work done during the calendar day is done in Pennsylvania for the convenience, and of necessity in the service, of the employer.

Time spent in performing the following services shall be disregarded in determining working days employed in Pennsylvania:

- a. Services performed by a nonresident individual who performs regularly assigned duties on a railroad in more than one state as an employee of an interstate rail carrier providing transportation.
- b. Services performed by a nonresident individual who performs regularly assigned duties with respect to a motor vehicle in more than one state as an employee of an interstate motor carrier or private carrier.
- c. Services performed by a nonresident individual who performs regularly assigned duties on an aircraft in more than one state as the employee of an interstate air carrier, unless one-half or more of the employee's time in the employ of the employer in the calendar year is spent in performing services in this Commonwealth.

10. The Convenience-Of-The-Employer Doctrine.

Pennsylvania, like many other states, follows the "convenience-of-the-employer" doctrine. It provides that compensation for services performed by nonresidents cannot be allocated to the services' actual places of performance if they were performed there only for the employee's convenience or if they were not performed there "of necessity in the service of the employer". In these instances, the compensation must be allocated only to the state (or among the states) where the employee is of necessity performing actual services in the service, and for the convenience, of the employer.

The only factors considered under this doctrine are:

- a. Whether the services performed by an individual outside the taxing jurisdiction were performed in the service, and for the benefit, of the individual's employer; and
- b. Whether such services were such that they could have been performed at an office of the employer within the taxing jurisdiction (or could have been performed at an office of the employer within the taxing jurisdiction had the employer made suitable accommodations available to the employee).

Consequently, under the "convenience-of-the-employer" doctrine, allocation depends upon whether the services in question are of a character required to be performed away from an office of the employer and outside the taxing jurisdiction or require highly specialized facilities not available at or near an office of the employer.

11. Payment Accrual Period Explained.

A payment accrual period ends when all services fixing the right to receive, or the duty to pay, the payment have occurred. The period begins when any of the activities that is required to establish that right or duty is begun.

In determining payment accrual periods:

- The inability to ascertain the amount of payment with reasonable accuracy or doubts as to ability to collect shall be disregarded; and
- b. It is immaterial whether an immediate right to receive, or duty to pay, has arisen, whether the payment may later be repaid or whether the right to receive payment is subject to forfeiture. It is also immaterial whether the right is enforceable at law or in equity or is unenforceable or the duty is a legal or moral duty.

12. Retirement Income.

A nonresident's "retirement income" as defined at 4 U.S.C. §114 is not allocable to Pennsylvania if it is part of a series of substantially equal periodic payments made not less frequently than annually for the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or a period of not less than 10 years.

XIII. OTHER PENNSYLVANIA COMPENSATION ISSUES.

Discharge of Indebtedness Income for Pennsylvania Personal Income Tax.
 See New PA PIT Guide Chapter 24: CANCELLATION OF DEBT FOR PA PIT PURPOSES.

Insolvent Individuals.

Insolvent individuals not filing for bankruptcy recognize cancellation of debt as income. The reportable amount is the lesser of:

- a. The amount of indebtedness forgiven or discharged, or
- b. The excess over the taxpayer's net worth as computed using generally accepted accounting principals (GAAP) immediately after the cancellation.

If an insolvent individual is not rendered solvent by the cancellation of debt, no income is recognized.

B. Solvent Individuals.

Solvent individuals would report the amount of indebtedness forgiven or discharged as income.

C. Individuals filing for Bankruptcy.

Unless the case is dismissed, an individual bankruptcy filed under Chapter 7, 11, or 12 of the Bankruptcy Act leads to the creation of a bankruptcy estate and no income shall be considered to have been realized by reason of discharge of indebtedness under bankruptcy laws.

2. When is it taxable?

Income from cancellation of debt is taxable in Pennsylvania in only two circumstances:

- Under GAAP, the debt forgiven was considered a liability;
- b. Where the debt forgiven constitutes a quid pro quo or incentive that would be taxable under Pennsylvania Personal Income Tax law if it had been paid to the debtor in cash or in property.

Class of income.

If the debt forgiveness relates to rent, royalty, patent, or copyright income, it is reported in that class.

XIV. ANNUITIES.

1. Employer Annuity Plan [RESERVED].

2. Nonemployee Benefit Annuities.

If you invested in a retirement annuity that is not part of an employer-sponsored program or a commonly recognized retirement program, you have Pennsylvania taxable income when you begin receiving annuity payments. You must report the difference between the amount you

receive and your previously taxed investment as taxable gain on a *PA Schedule D*. If you receive periodic payments, you use the cost-recovery method to report the taxable gain. See PA PIT Guide Chapter 8: INTEREST and PA PIT Guide Chapter 12: NET GAINS OR LOSSES FROM THE SALE, EXCHANGE, OR DISPOSITION OF PROPERTY.

3. Life Insurance Annuity Contracts.

Act 2005-40 provides the taxability of an exchange of life insurance annuity contracts will follow the requirements of Section 1035 of the Internal Revenue Code. Under these rules, if there is no cash involved, the exchange will be tax-free. If the exchange involves cash, the amount of cash received will be taxable as interest income. This shall apply to taxable years beginning after December 31, 2004.

XV. IRC SECTION 401(K) PLANS.

- 1. Criteria for Retirement Plan to Qualify as an Eligible Pennsylvania Retirement Plan.

 Under Pennsylvania law, retirement plans are considered eligible Pennsylvania retirement plans only if the plan meets all of the tests under Eligible Pennsylvania Retirement Plan.
- **Employee Contributions to a Pennsylvania Retirement Plan.**Employee contributions to any Pennsylvania retirement plan are always taxable as wages. (As indicated below, payments received from eligible Pennsylvania retirement plans are nontaxable retirement income).
- Distributions from an Eligible Pennsylvania Retirement Plan at or After Retirement Age or Years of Service.

All amounts withdrawn from under eligible Pennsylvania retirement plans are taxable in the year received to the extent that contributions and income earned on contributions were not taxed previously, except:

- Payments from an eligible Pennsylvania retirement plan to a retired employee by reason of his retirement; or
- Payments paid to the estate or designated beneficiary of a participant by reason of the participant's death; or
- c. Payments received from an eligible Pennsylvania retirement plan which are rolled over into another deferred payment program or IRA, where the transferred amounts are not includable in income for Federal income tax purposes.
- Irreatment of Investment Earnings by an Eligible Pennsylvania Retirement Trust Fund.

 Investment earnings on funds deposited into an eligible Pennsylvania retirement trust fund are not taxable to the employee when earned provided that the employee has not constructively received the earnings. Investment earnings on funds held in an eligible Pennsylvania retirement plan trust fund that are received at retirement age are not taxable retirement income. Investment earnings distributed from a non-qualified deferred compensation plan that is not an eligible Pennsylvania retirement plan are taxable in the year distributed.

 See Personal Income Tax Bulletin 2005-04 Section 457(b) Eligible Deferred Compensation Plans.

XVI. NONQUALIFIED DEFERRED COMPENSATION PLANS.

Pennsylvania has no provision for the reducing of income being placed in a deferred compensation account under a qualified cash or deferral arrangement. This "deferred" income is taxable compensation in the tax year it is earned.

Deferred compensation is subject to tax as compensation for Pennsylvania residents to the extent it was not or would not have been subject to tax. That is, it is subject to tax over and above the amount of the employee's contribution to the plan. The taxable amount is determined by the cost-recovery method. See Personal Income Tax Bulletin 2005-03 Deferred Compensation Under Nonqualified Plans.

XVII. NEW RULES ON NONQUALIFIED DEFERRED COMPENSATION PLANS ADD SPECIAL REQUIREMENTS FOR EMPLOYERS AND TAXPAYERS.

1. General Information.

Act 40 of 2005 changed the definition of constructive receipt for Pennsylvania Personal Income Tax purposes. Specifically, the act's new definition of constructive receipt adopts many of the provisions established by the Internal Revenue Code with respect to what to include and when to include certain deferrals of compensation as income for Pennsylvania Personal Income Tax purposes. The Act also provided that distributions from nonqualified deferred compensation plans attributable to elective deferrals (and earnings thereon) are taxable at the time of the distributions irrespective of retirement.

2. Employer Requirements. For tax years before 2005:

Employers who have nonqualified deferred compensation plans that provide for elective deferrals need to provide plan participants with a letter establishing the amount of elective contributions previously included in Pennsylvania taxable income so that plan participants have an acceptable record of their elective deferrals. The letter should set forth (for each taxable year of elective deferral between July 1, 1971 and December 31, 2004) amounts of elective deferrals of compensation to nonqualified deferred compensation plans that were not taxable for Federal income tax purposes (Box 1 of the W-2), but were included in Medicare Wages (Box 5 of the W-2) and in Pennsylvania taxable wages (Box 16 of the W-2) and were subject to withholding.

For tax year 2005:

Employers should also provide a letter to their plan participants that outlines amounts included in Box 11 of the W-2 that are attributable to: 1) nonqualified deferred compensation plan deferrals that were included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture for prior year services; or 2) earnings from prior year deferrals not previously included in Medicare wages. The letter should set forth the value of each of these amounts.

For tax years after 2005:

Employers that have nonqualified deferred compensation plans for employees and directors must use Box 14 of the W-2 form to indicate additional information regarding these plans in cases where: 1) the employee had a deferred amount of nonqualified deferred compensation that was included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture (for prior year services); 2) the employee had a distribution from the nonqualified deferred compensation plan; 3) the employee had a distribution from the nonqualified deferred compensation plan when the employee had a deferral for prior year services and a distribution in the same year; or 4) the employee had earnings from prior year deferrals not previously included in Medicare wages. Employees with *only* a deferral of nonqualified deferred compensation that is included in Medicare wages that are not subject to a substantial risk of forfeiture for current year services are required by the IRS to have this amount shown in Box 12 of the W-2 with a code Y and do not need to complete Box 14 of the W-2.

Employees who have a deferral of compensation that is included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture (for prior year services)

should have that amount shown in Box 14 of the W-2 along with the code YN. Employees who have a distribution of nonqualified deferred compensation should have that amount shown in Box 14 of the W-2 along with a code YT. Employees who have had a deferral for prior year services and a distribution in the same year should have both the amounts shown in Box 14 of the W-2. The deferral for prior year services will have a code YN next to that amount and the distribution will have a code YT next to that amount. Employees who have earnings from prior year deferrals not previously included in Medicare wages should have these amounts shown in Box 14 of the W-2 with the code ZN.

3. New PA Codes in W–2 Box 14 Nonqualified Deferred Compensation Plans. *Table 7–7*.

Table 7–7 New PA Codes in W-2 Box 14 for Nonqualified Deferred Compensation Plans.

Code When to use:

- Deferrals under Nonqualified Deferred Compensation (NQDC) plans (coded as a Y in Box 12 of the W-2).
- YN Deferrals under a NQDC plan included in social security and Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture and are for prior year services.
- YT Distributions from a NQDC plan included in Box 1 of the W-2.
- ZN Earnings from prior year deferrals now included in social security and Medicare wages.
 - 4. Withholding requirements.

When distributions exceed the amount of elective deferrals previously taxed by the Commonwealth, inclusion of the amounts in Pennsylvania taxable compensation and withholding on the excess is required. Employers are required to withhold PA Personal Income Tax from nonqualified deferred compensation plan distributions when payment is made to employees (except for distributions of deferrals for taxable years prior to January 1, 2005, if the deferrals were previously included in Pennsylvania taxable compensation).

5. Taxpayer Requirements.

Amended returns for tax years between 2003 and 2005:

Taxpayers do not have to file amended returns for tax years between 2003 and 2005. Taxpayers who paid tax on elective deferrals of nonqualified deferred compensation for such vears will not be subject to tax on such deferrals when such amounts are distributed from the nonqualified deferred compensation plan. However, if a taxpayer elects to do so, amended returns can be filed to remove the elective deferrals of nonqualified deferred compensation plans previously included in Pennsylvania taxable compensation from such taxable compensation. As a result, special processing procedures and supporting documentation are needed to establish and validate the reduction to compensation. Therefore, the Department of Revenue will require that taxpayers, who amend their returns and remove the deferrals from Line 1a, Gross Compensation, of the PA-40 return, write the words "Deferred Compensation" across the top of the amended return. They must also provide a copy of the letter to them from their employer establishing the amount of deferrals previously included in Pennsylvania taxable compensation for each tax year along with a copy of the original W-2 from their employer. Taxpayers with distributions and deferrals within the same tax year should also include a worksheet with their amended return reconciling the Federal wages (Box 1) shown on their W-2 to the Medicare wages (Box 5) on their W-2 as well as to their PA wages (Box 16) on their W-2 by clearly indicating on that schedule each category of compensation included in each of the

three aforementioned areas. A sample of the worksheet to be provided is included at the end of this article and is available on the Department's Web site at www.revenue.state.pa.us. Go to the Forms and Publications link at this site and click on 2005 under the Income Tax heading and then on PA-40 W-2 Reconciliation Worksheet.

For tax year 2005:

The PA-40 W-2 Reconciliation Worksheet should be included with taxpayers' returns if they have not yet filed their 2005 returns. This worksheet should indicate whether the amount is due to a distribution or as a result of the amount no longer being subject to a substantial risk of forfeiture for prior year services and/or from earnings from prior year deferrals. The worksheet will also indicate whether any distributions were previously taxed as Pennsylvania compensation. Taxpayers should also obtain a letter from their employer indicating each of these amounts as previously discussed in the employer section of this article. For taxpayers who have already filed their returns for 2005, the Department will request PA-40 W-2 Reconciliations on an as needed basis.

For tax years after 2005:

Taxpayers whose employers do not include codes in Box 14 of their W-2s may be requested to provide additional information and reconciliations of PA Gross Compensation if there is an amount reported in Box 11 of the W-2 or if the Department is not able to reconcile the PA wages with Medicare and/or Federal wages from their W-2 forms. If an employer does not provide the new codes in Box 14 of the W-2, the PA-40 W-2 Reconciliation Worksheet should be provided with the return.

Any taxpayer who receives distributions from their nonqualified deferred compensation plans must include the distributions from nonqualified deferred compensation plans in their Pennsylvania Gross Compensation to the extent that they have not already paid tax on their deferrals. Taxpayers who have already paid tax on any deferrals should complete the PA-40 W-2 Reconciliation Worksheet and include it with their return along with a copy of the letter from their employer indicating the amounts previously taxed.

6. Proof deferrals were previously taxed.

In addition to the letter from their employers showing the amounts previously included in Pennsylvania compensation, taxpayers may also be requested to provide proof that the deferrals were previously taxed. Proof of tax paid may include, but may not necessarily be limited to: copies of W-2s for the tax years showing the deferrals were included in Pennsylvania compensation; copies of the tax returns for the tax years showing the amount included in the reported gross compensation for those tax years; copies of any Departmental assessments showing that the compensation amount reported for the taxpayer was adjusted by the Department to included the deferred amount; and copies of any amended returns including or excluding the compensation from taxation.

Important: Taxpayers and practitioners should keep the above listed tax records and all other related tax records for deferrals of compensation (or other contributions to retirement plans) indefinitely with their permanent tax records for purposes of documenting their recoverable costs and previously taxed contributions and deferrals.

For additional information regarding the taxation of Deferred Compensation, please see PA Personal Income Tax Bulletins 2005-03 and 2005-04 available on our Website at www.revenue.state.pa.us.

XVIII. ESOPS [RESERVED].

XIX. PROFIT-SHARING PLANS.

1. Overview.

Under Pennsylvania case law, including *Gosewisch v. Commonwealth*, 40 Pa Commw. 565, 397 A2d 1288 (1979), profit-sharing plans are taxable as Pennsylvania Compensation. In Gosewisch, a distribution was made to the taxpayer from the "Profit-sharing Trust" and was considered to be remuneration received for services rendered. Since it was a severance, not a retirement benefit, the court held that the payment was compensation as defined in the Code and the regulations.

Pursuant to the Gosewisch case, during 2001, the Department adopted provisions in Regulation Section 1.101 which provide that "Severance Pay" under Pennsylvania Personal Income Tax law is defined as follows:

Severance pay – A payment made upon separation from employment under:

- (iv) A plan, including a stock bonus or profits sharing plan formed by a trust that meets the requirements for qualification described in section 401 of the IRC (26 U.S.C.A. §401) or employee stock ownership plan, with one or more of the following attributes:
 - (A) The amount of earnings on contributions (or allocations of contributions or earnings) and the amount of benefits are determined with regard to the current or accumulated profits or losses of the employer.
 - (B) The employer can contribute only in those years when it has current or accumulated profits.
 - (C) The employer's contributions can fluctuate depending on the level of its profits.
 - (D) The employer's contributions are made out of current or accumulated profits.
 - (E) Distributions are paid with respect to stock of a corporation that is held by an employee stock ownership plan.
- Employee Contributions.
 Employee contributions are taxable in the year of contributions or deferral.
- Employer Contributions.
 Employee contributions are not taxable if held in trust and no there is constructive receipt.
- 4. Distributions [Reserved].

XX. INDIVIDUAL IRAS.

1. Regular IRA.

Treatment of Contributions.

No exclusion is provided for contributions to an Individual Retirement Account except:

- i. Direct employer contributions; and/or
- ii. Amounts rolled over from another IRA or from a qualifying old age or retirement benefit program where the transferred amounts are not includable as income for Federal income tax purposes.

B. Treatment of Distributions.

Amounts withdrawn from an IRA are includable in income to the extent that contributions and income earned on such contributions were not taxed previously except:

- i. Payments, including lump sum distributions, made on or after retirement and reaching the age of 59½ years;
- Payments received at regularly recurring intervals during periods of disability by reason of disability;
- iii. Payments paid to the estate or designated beneficiary of the participant by reason of the plan participant's death;
- iv. Payments that are rolled over into another IRA or into an eligible retirement benefit program where the transferred amounts are not includable in income for Federal income tax purposes.

Note: Distribution of an IRA (or any other retirement plan) pursuant to a divorce is taxable to the extent it has not previously been taxed. This income is reported as compensation.

Any amount distributed from an IRA pursuant to a Qualified Domestic Relations Order is treated as though distributed to the plan participant.

C. IRA Investment Appreciation.

Undistributed income on assets held is not includable in income.

2. Roth IRA.

A. General Rules.

Most of the personal income tax rules that apply to individual retirement accounts or annuities or simplified employee pensions also apply to Roth IRAs. For example:

- An exclusion is allowed for payments made by employers directly to Roth IRA trustees or issuers for the benefit of employees.
- ii. No exclusion or deduction is allowed for contributions to a Roth IRA made by, on behalf of, or attributable to, an employee or self-employed person, directly or indirectly, whether through payroll deduction, a salary reduction agreement, or otherwise.
- iii. Income on assets held in a Roth IRA is not taxable.
- iv. Distributions are includable in income to the extent that contributions were not previously included if made before the individual for whom the account is maintained obtains age 59 1/2 and retires from service or if the plan makes no provision for payments at regularly recurring

intervals continuing at least until the participant's death.

v. The cost-recovery method is used to determine the portion of a distribution to be included in income.

B. Transfers to Roth IRAs.

For Federal tax purposes, amounts rolled over into Roth IRAs from regular IRAs are includable in income, but the income from rollovers before January 1, 1999, may be spread out over four tax years beginning with the distribution year. However, for personal income tax purposes, the following rules apply:

- i. Amounts rolled over into a Roth IRA from an individual retirement plan other than a Roth IRA are includable in income for the year of distribution to the extent that contributions were not previously included, unless the plan provides that the distributee may elect to have such distribution paid directly to another Federally qualified retirement plan maintained for his benefit and such distribution is made in the form of a direct trustee-to-trustee transfer to the Roth IRA.
- ii. Amounts rolled over into a distributee's Roth IRA from a Federally qualified retirement plan other than an individual retirement plan are includable in income for the year of distribution to the extent that contributions were not previously included, unless the entire amount received is paid into the Roth IRA not later than the 60th day after the day on which the distributee receives the payment of distribution.
- iii. If either of the foregoing exceptions applies, the amounts rolled over shall be excludable from Federal Personal Income Tax.

C. Converting Regular IRAs to Roth IRAs.

For Pennsylvania Personal Income Tax purposes, the conversion of a regular IRA to a Roth IRA is not treated as a distribution and is not otherwise taxable if the individual for whom the regular IRA and Roth IRA are maintained receives no payment or distribution.

Inasmuch as financial service companies report only the full amount of the withdrawal on the 1099R they issue to the state without breaking down the contributions that have already been taxed, the Pennsylvania Department of Revenue may request proof that the tax has been paid or the IRA has been rolled over.

XXI. EMPLOYER WELFARE PLANS.

1. Overview.

Employee welfare benefit programs are established by employers to provide welfare benefits to employees (or their beneficiaries), such as dependent care assistance; life-; accident- or health insurance coverage; local services; medical benefits; supplemental unemployment compensation (SUB); tuition reductions; disability benefits; strike benefits and dismissal pay.

2. Taxation of Certain Benefits for Pennsylvania Personal Income Tax.

A. Employee Welfare Benefit Program Benefits.

All welfare benefit program benefits are taxable in the year received to the extent they are attributable to contributions by the employer that were not includable in the income of the employee or were paid by the employer except:

i. Amounts received for the permanent loss or loss of use of a part or

function of the body or permanent disfigurement or in reimbursement of expenses incurred for medical care; or

- ii. Amounts which are computed with reference to the nature of a sickness or injury and without regard to the period the employee is absent from work; or
- iii. Amounts (other than regular wages or sick-leave pay) which are computed with record to the period that the employee is absent from work due to sickness or disability; or
- iv. Strike benefits: or
- v. Supplemental Unemployment Compensation (SUB). For a payment to qualify as SUB pay, it must be made periodically during the period of actual unemployment and must continue only for the period of actual unemployment. Lump sum payments are taxable; or
- vi. Amounts paid to the beneficiaries or the estate of an employee by reason of the death of the employee; or
- vii. The fair market value of employer-provided dependent care facilities.

B. Plan Requirements for Qualifying as an Eligible Pennsylvania Welfare and Benefit Plan.

Employers establish and maintain employee welfare benefit plans to provide miscellaneous benefits to eligible employees or their beneficiaries. Unless specifically excluded, box 16 of your Form W–2 includes the cost of the Pennsylvania taxable benefits that your employer provides. Your employer must include the value of these benefits, regardless of the type of plan your employer has.

Employee Contributions – Taxable.

Deferred-payment program or welfare benefit program contributions deducted from the compensation of an employee; voluntary employee contributions; and contributions made by an employer pursuant to a cash or deferred arrangement under which the employee may unilaterally elect to have the employer either make the payments as contributions to the profit-sharing or stock bonus plan, money purchase plan, Federal Employee's Thrift Savings Plan or 401(k) Plan or 403(b) plan or other program on behalf of the employee or to the employee directly in cash, are not excludable from the employee's Pennsylvania income.

4. Pennsylvania Taxation of Contributions to and Distributions from Eligible Pennsylvania Retirement Plans Table 7 – 8.

		Pennsylvania Retirement Plans	
	Type of Compensation	Taxable	Nontaxable
		Description	Description
	Employer contributions to:		
1)	Employer-Sponsored eligible Pennsylvania retirement plans; and/or	Employer contributions to plans or trust are taxable if constructive receipt by employee.	Employer contributions are not taxable when contributed, provided there is no constructive receipt under the Pennsylvania Personal Income Tax Rules.

2) Nonqualified deferred		
compensation plans that are non-eligible Pennsylvania retirement plans and/or	1) Same as above.	2) Same as above.
Federal qualified plans that are not eligible Pennsylvania retirement plans.	Treated as a nonqualified deferred compensation plan.	3) Same as above.
Distributions of employer contributions and investment earnings on non-eligible employer contributions from employer sponsored nonqualified deferred compensation plan.	Always taxable as compensation.	
Distributions of employer contributions and investment earnings on employee contributions from employer sponsored nonqualified deferred compensation plan meeting the requirements of an eligible Pennsylvania retirement plan.	Any payment of employer contribution and investment earnings prior to retirement age are taxable Pennsylvania compensation.	Not taxable if the amounts are received at or after retirement age.
Distributions of employer contributions from employer sponsored qualified Federal retirement plan that is non-eligible Pennsylvania retirement plan (e.g., profit-sharing plan providing no option to receive an annuity or an employer stock ownership plan).	Taxable as compensation. The fact that the plan is a qualified plan for Federal income taxpayers is not controlling. The plan is not an eligible Pennsylvania retirement plan. ESOPs may be qualified Federal plans, but they are non-eligible Pennsylvania retirement plans.	
Distributions of employee contributions and investment earnings on employee contributions.	Distributions received before retirement age.	
Distributions of employee contributions from an eligible Pennsylvania retirement plan.	Taxable to extent of excess determined under the cost-recovery method for amounts received prior to retirement.	After retirement age, not taxable.
2) Distribution of employee contribution from a nonqualified deferred comp plan that is not an eligible Pennsylvania retirement plan.	Taxable to extent of excess determined under the cost-recovery method.	2) Not taxable only to extent of amounts previously included in income on prior Pennsylvania Personal Income Tax PA-40 returns and/or amounts contributed.
Distribution of employee contributions from a qualified Federal plan which is not an eligible Pennsylvania retirement plan (e.g., profit-	Taxable to extent of excess determined under the cost-recovery method.	Not taxable only to extent of amounts previously included in income on prior Pennsylvania Personal

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sharing plan not providing an option for an annuity or ESOP employee stock ownership plan).		Income Tax PA-40 return and/or amounts contributed.
p.m.y.	If you invested in a retirement annuity that is not part of an employer-sponsored program or a commonly recognized retirement program, you have Pennsylvania taxable income when you begin receiving annuity payments. You must report the difference between the amount you receive and your previously taxed investment as taxable gain on a Pennsylvania Schedule D. (If you receive periodic payments, you use the cost-recovery method to report the taxable gain.)	
Annuities (other than employer sponsored retirement plan annuities).		To the extent of previously taxed investment.
Roth IRA – Federal.	Contributions not deductible.	Distributions are includable in income to the extent that contributions were not previously included if made before the individual for whom the account is maintained obtains age 59 1/2 and retires from service or if the plan makes no provision for payments at regularly recurring intervals continuing at least until the participant's death.
Traditional IRA – Federal.	Contributions not deductible.	Amounts withdrawn from an IRA are includable in income to the extent that contributions and income earned on such contributions were not taxed previously except:
		Payments, including lump sum distributions, made on or after retirement and reaching the age of 59½ years;
		Payments received at regularly recurring intervals during periods of disability by reason of disability;

	3)	Payments paid to the estate or designated beneficiary of the participant by reason of the participant's death;
	4)	Payments that are rolled over into another IRA or into a qualifying old age or retirement benefit program where the transferred amounts are not includable in income for Federal income tax purposes.
Nondeductible IRA – Federal.		

XXII. FORM 1099R RECONCILIATION FOR PENNSYLVANIA PERSONAL INCOMETAX.

Federal Form 1099R is used to report income received from pensions, annuities, profit sharing plans, IRAs, insurance contracts, etc. The form designates the taxable amount for IRS purposes but not for Pennsylvania. You have to apply Pennsylvania rules described in **Form 1099R Reconciliation For Pennsylvania Personal Income Tax** – *Table 7–8* to determine what portion, if any, is taxable for Pennsylvania.

1. Form 1099R Reconciliation For Pennsylvania Personal Income Tax – Table 7–9.

	Table 7–9. Form 1099R Reconciliation For Penns	sylvania Personal Income Tax.
Form 1099R Box Number	Federal Treatment	PA PIT Treatment
1	Shows the total amount you received this year. The amount may have been a direct rollover, a transfer, or conversion to a Roth IRA, a recharacterized IRA contribution; or you may have received it as periodic payments, as non-periodic payments, or as a total distribution. Unless this amount is from a Coverdell Education Savings Account, report it on Form 1040 or 1040A on the line for "IRA distributions" or "Pensions and annuities" (or the line for "Taxable amount"), and on Form 8606, whichever applies. However, if this is a lump-sum distribution, report it on Form 4972, Tax on Lump-Sum Distribution. If you have not reached minimum retirement age, report your disability payments on the line for "Wages, salaries, tips, etc." Also report on that line corrective distributions of excess deferrals, excess contributions, or excess aggregate contributions. If a life insurance, annuity, or endowment contract was transferred tax free to another trustee or contract issuer, an amount will be shown in this Box and Code 6 will be shown in Box 7. You need not report this on your tax return.	Under PA PIT law, this distribution is taxable for Pennsylvania purposes if (1) your pension or retirement plan was NOT an eligible plan for PA PIT purposes or (2) you retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution. Cost Recovery Method – Residents: The "cost recovery method" provides for tax-free distribution of all prior employee contributions (since they were previously taxed) before distribution of employer contributions and investment appreciation (which are subject to tax). Cost Recovery Method – Non-Residents: (i) Persons who reside outside of Pennsylvania but have worked in Pennsylvania and receive retirement benefits from such Pennsylvania employer must use the "cost recovery method" as indicated under "Cost Recovery Method – Residents" above. (ii) Persons who contributed to a retirement plan while a Pennsylvania resident, but have moved out of Pennsylvania, are subject to tax on the income allocable to Pennsylvania over and above their contributions.

		(iii) Residents who contributed to a retirement plan while a nonresident are subject to tax only on the amount received over and above their contributions, regardless of whether tax was paid to another state on the retirement income. Cost Recovery Method: Annuities and Insurance Contracts: To determine prior employee contributions paid on annuities or insurance contracts, consult you plan administrator as to your full cost of the annuity.
2a	This part of the distribution is generally taxable. If there is no entry in this Box, the payer may not have all the facts needed to figure the taxable amount. In that case, the first Box in Box 2b should be checked. You may want to get one of the following publications from the IRS to help you figure the taxable amount: Pub. 560, Pub. 571, Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations, Pub. 575, Pub. 590, Pub. 721, Tax Guide to U.S. Civil Service Retirement Benefits, or Pub. 939, General Rule for Pensions and Annuities. For an IRA distribution, see IRAs and Roth IRAs above. For a direct rollover, zero should be shown, and you must enter zero (-0-) on the "Taxable amount" line of your tax return. If this is a total distribution from a qualified plan (other than an IRA or tax-sheltered annuity) and you were born before 1936 (or you are the beneficiary of someone born before 1936), you may be eligible for the 10-year tax option. See the Instructions for Form 4972 for more information.	Not applicable to PA PIT/see PA PIT treatment in Box 1 above.
2b	If the first checkbox is checked, the payer was unable to determine the taxable amount, and Box 2a should be blank. However, if this is a traditional IRA, SEP, or SIMPLE distribution, then see IRAs above. If the second checkbox is checked, the distribution was a total distribution that closed out your account.	Not applicable to PA PIT/see PA PIT treatment in Box 1 above.
3	If you received a lump-sum distribution from a qualified plan and were born before 1936 (or you are the beneficiary of someone born before 1936), you may be able to elect to treat this amount as a capital gain on Form 4972 (not on Schedule D (Form 1040)). See the Instructions for Form 4972. For a charitable gift annuity, report as a long-term capital gain on Schedule D (Form 1040).	Under PA PIT law, a lump sum distribution is taxable if: (1) Your pension or retirement plan was NOT an "eligible Pennsylvania retirement plan," or (2) You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable under either of the two rules above, then you may use the "cost recovery method" to report the

		taxable portion of this distribution. For PA PIT there are no provisions for capital gain. The distribution is reported as gross compensation not as sale, exchange, or disposition of property.
4	This is the amount of Federal income tax withheld. Include this on your income tax return as tax withheld, and if Box 4 shows an amount (other than zero), attach Copy B to your return. Generally, if you will receive payments next year that are not eligible rollover distributions, you can change your withholding or elect not to have income tax withheld by giving the payer Form W-4P, Withholding Certificate for Pension or Annuity Payments.	Not applicable to PA PIT/see PA PIT treatment in Box 1 above.
5	Generally, this shows the employee's investment in contract (after-tax contributions), if any, recovered tax free this year; the part of premiums paid on commercial annuities or insurance contracts recovered tax free; or the nontaxable part of a charitable gift annuity. This Box does not show any IRA contributions.	Generally, this shows the employee's investment in an annuity contract (after-tax contributions – see below), if any, recovered tax free this year; the part of premiums paid on commercial annuities or insurance contracts recovered tax free; or the nontaxable part of a charitable gift annuity. This Box does not show any IRA contributions. Cost Recovery Method of Taxation of Retirement Distributions (if applicable) PA PIT law provides for the cost recovery method of taxation of retirement distributions if such distributions are: (1) From a non-eligible retirement plan, and (2) Distributed prior to the participant meeting the: (i) Retirement age or (ii) Years of service, requirements under the plan. The cost recovery method provides for recovery of all prior employee contributions. To determine prior employee contributions consult your plan administrator as to your full cost of the annuity. "After-tax contributions" employee means contributions (usually deducted from pay) that the employee makes to his or her plan, annuity, etc. Since the employee has already been subject to tax on his or her contributions, these contributions are referred to as after tax contributions.
6	If you received a lump-sum distribution from a qualified plan that includes securities of the	Under PA PIT law, provided there is no constructive receipt, unrealized

	employer's company, the net unrealized appreciation (NUA) (any increase in value of such securities while in the trust) is taxed only when you sell the securities unless you choose to include it in your gross income this year. See Pub. 575 and the Instructions for Form 4972. If you did not receive a lump-sum distribution, the amount shown is the NUA attributable to employee contributions, which is not taxed until you sell the securities.	appreciation from securities held in trust is not taxable unless the securities are sold.
7	The following codes identify the distribution you received. 1—Early distribution, no known exception (in most cases, under age 59½). See Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. For a rollover to a traditional IRA of the entire taxable part of the distribution, do not file Form 5329. See the Form 1040/1040A instructions.	The following codes identify the distribution you received. 1 – Under PA PIT law, this distribution is taxable for Pennsylvania purposes if: (1) Your pension or retirement plan was NOT an eligible plan for PA PIT purposes or (2) You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution. Cost Recovery Method – Residents: The "cost recovery method" provides for tax-free distribution of all prior employee contributions (since they were previously taxed) before distribution of employer contributions and investment appreciation (which are subject to tax). Cost Recovery Method – Non-Residents: (i) Persons who reside outside of Pennsylvania but have worked in Pennsylvania and receive retirement benefits from such Pennsylvania employer must use the "cost recovery method" as indicated under "Cost Recovery Method – Residents" above. (ii) Persons who contributed to a retirement plan while a Pennsylvania resident, but have moved out of Pennsylvania, are subject to tax on the income allocable to Pennsylvania over and above their contributions. (iii) Residents who contributed to a retirement plan while a nonresident are subject to tax only on the amount received over and above their contributions, regardless of whether tax was paid to another state on the retirement income.

	Cost Recovery Method: Annuities and Insurance Contracts: To determine prior employee contributions or amounts paid on annuities or insurance contracts, consult you plan administrator as to your full cost of the annuity.
2—Early distribution, exception applies (under age 59 ½)*.	 2 – Under PA PIT law, this distribution is taxable for Pennsylvania purposes if: (1) Your pension or retirement plan was NOT an eligible plan for PA PIT purposes or (2) You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.
3—Disability*.	3—Under PA PIT law, a distribution due to disability generally is not taxable.
4—Death*.	4—Under PA PIT law, a distribution due to death is not taxable.
5—Prohibited transaction.	5—Not applicable to PA PIT. PA PIT has no provisions for prohibited transactions.
6—Section 1035 exchange (a tax-free exchange of life insurance, annuity, or endowment contracts).	6—For taxable years beginning after December 31, 2004, Act 40 of July 7, 2005 provides that exchanges of insurance contracts listed under IRC Section 1035 that are tax exempt for Federal income tax purposes are also tax exempt for Pennsylvania Personal Income Tax purposes. Therefore, do not report the gain (loss) on the sale, exchange or disposition of any insurance contracts that include: An exchange of a life insurance
	contract for another life insurance contract, an endowment contract, or an annuity contract;
	 An exchange of an annuity contract for another annuity contract;
	 An exchange of an endowment contract for an annuity contract;

	 An exchange of one endowment contract for another endowment contract if the dates for payments begin on or before the original contract's payment dates.
	If the exchange of contracts has the effect of transferring property to a non-US person, the gain or loss is not tax exempt. If cash or other boot is involved with the exchange of the contracts, the gain or loss is also not tax exempt. The amount of cash or other boot received will be taxable as interest income. (See PIT Guide Chapter 08: INTEREST for additional information).
7—Normal distribution.	 7—Under PA PIT law, a normal distribution is not taxable if and only if: (1) Your pension or retirement plan was an "eligible Pennsylvania retirement plan", and (2) You have met the retirement age or years of service requirement (as applicable) under such plan. If you or your plan does not meet the two requirements above, the taxation of this distribution is determined under the cost recovery method.
8—Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 2002.	8—Under PA PIT law, an excess contribution is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable.
9—PS 58 costs (premiums paid by a trustee or custodian for current insurance protection, taxable to you currently).	9—Under PA PIT law, PS 58 costs are taxable.
A—May be eligible for 10-year tax option. See Form 4972.	A—Under PA PIT law, there is no provision for 10-year tax options.
D—Excess contributions plus earnings/excess deferrals taxable in 2000.	D—Under PA PIT law, an excess contribution is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable.
E—Excess annual additions under section 415 and certain excess amounts under section 403(b) plans. Report on Form 1040/1040A on the line for taxable pension or annuity income*.	E— Under PA PIT law, an excess annual addition is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable.

F—Charitable gift annuity.	F— Under PA PIT law, charitable gift annuities from retirement plans are not taxable to the extent that such amounts are distributed after retirement under the retirement plan.
G—Direct rollover to IRA*.	G—Under PA PIT law, direct rollovers are not taxable.
H—Direct rollover to qualified plan or tax-sheltered annuity or a transfer from a conduit IRA to a qualified plan*.	H—Under PA PIT law, direct rollovers are not taxable.
J—Early distribution from a Roth IRA, no known exception (in most cases, under age 59 ½) Report on Forms 1040 and 8606 and see Form 5329.	J—Under PA PIT law, the taxation of a distribution from a Roth IRA prior to reaching 59 ½ is determined under the cost recovery method.
L—Loans treated as distributions.	L— Under PA PIT law, this distribution is taxable for PA purposes if: (1) Your pension or retirement plan was NOT an eligible plan for PA PIT purposes or (2) You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.
M—Distribution from a Coverdell ESA. Report any taxable amount on Form 1040. If your education expenses during 2003 were not equal to or more than your distribution, part or all of your distribution may be taxable and subject to an additional 10% tax.	M—Not applicable to PA PIT/Under PA PIT law, there is no provision for Coverdell ESA distributions.
N—Recharacterized IRA contribution made for 2003 and recharacterized in 2003. Report on 2003 Form 1040/1040A and Form 8606, if applicable.	N—Under PA PIT law, employee contributions to an eligible retirement plan are always taxable.
P—Excess contributions plus earnings/excess deferrals taxable in 2002.	P—Under PA PIT law, an excess contribution is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable.
R—Recharacterized IRA contribution made for 2002 and recharacterized in 2003. Report on 2002 Form 1040/1040A and Form 8606, if applicable.	R—Under PA PIT law, Employee contributions to an eligible retirement plan are always taxable.
S—Early distribution from a SIMPLE IRA in first 2 years, no known exception (under age 59 ½). May be subject to an additional 25% tax. See Form	S—Under PA PIT law, an early distribution from a SIMPLE IRA is taxable under the cost recovery method.

	5329.	
	T—Roth IRA distribution, exception applies. Report on Forms 1040/1040A and 8606. You are either age 59 ½ or over or an exception (code 2, 3, or 4) applies.	T—Under PA PIT law a Roth IRA distribution is not taxable if you are at least 59 ½ so long as the Roth IRA is considered an "eligible retirement plan." If you are not 59 ½, the taxation of this distribution is determined under the cost recovery method.
	If the IRA/SEP/SIMPLE Box is checked, you have received a traditional IRA, SEP, or SIMPLE distribution.	
8	If you received an annuity contract as part of a distribution, the value of the contract is shown. It is not taxable when you receive it and should not be included in Boxes 1 and 2a. When you receive periodic payments from the annuity contract, they are taxable at that time. If the distribution is made to more than one person, the percentage of the annuity contract distributed to you is also shown. You will need this information if you use the special 10-year tax option (Form 4972).	This is a distribution from an insurance policy or annuity purchased for your retirement. Such distributions are not taxable if (1) Your insurance policy or annuity was an eligible plan for PA PIT purposes, and (2) You retired after meeting the age or years of service conditions of the insurance policy or annuity. If you do not meet these requirements, a distribution may be taxable as a gain on Schedule D, not compensation on Line 1a. Consult you plan administrator as to your cost in the annuity.
9a	If a total distribution was made to more than one person, the percentage you received is shown.	This Box is your percentage of the total distribution listed.
9b	For a life annuity from a qualified plan or from a tax-sheltered annuity (with after-tax contributions), an amount may be shown for the employee's total investment in the contract. It is used to compute the taxable part of the distribution. See Pub. 575.	Under PA PIT law, this distribution is taxable for Pennsylvania purposes if: (3) Your pension or retirement plan was NOT an eligible plan for PA PIT purposes or (4) You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then this distribution may be taxable as a gain on Schedule D, not compensation on Line 1a. Consult you plan advisor as to your cost of the annuity.
10	State tax withheld.	This Box lists the amount of withholdings applicable to PA PIT. This amount should be added to any other withholdings and listed on your PA-40.
11	State/Payer's state no.	EIN or Box number of payee.

12	State distribution.	Not applicable for PA PIT.
13	Local tax withheld.	Not applicable for PA PIT.
14	Name of locality.	Not applicable for PA PIT.
15	Local distribution.	Not applicable for PA PIT.