

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 9: DIVIDENDS

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CHAPTER 9: DIVIDENDS

I. OVERVIEW

A. Gross Income Class

Dividend income is a gross taxable income class under Pennsylvania law. Consequently, Pennsylvania law does not permit the deduction of any expenses that a taxpayer incurs to realize dividend income. However, income that can reasonably be classified either as dividend income or as another taxable class of income is to be classified into that other class of income. For instance, dividends earned from the short-term investment of working capital funds would be classified as net income (loss) from the operation of a business, profession or farm. Refer to Pennsylvania Personal Income Tax Guide, Chapter 11, Net Income or Loss from the Operation of a Business, Profession, or Farm.

B. Dividends Defined

Dividends are defined under Pennsylvania personal income tax law as any distribution in cash or property made by a corporation, association, investment company, or business trust: (1) out of accumulated earnings and profits, or (2) out of earnings and profits of the year in which such dividend is paid. The term dividends specifically excludes stock dividends which are pro-rata distributions of additional shares issued to existing shareholders of a corporation on account of a shareholder's shares. The term also excludes certain constructive dividends.

C. Nonresidents

Nonresidents are not subject to Pennsylvania income tax on dividend income from investments from sources within Pennsylvania.

D. Dividend Income - Residents and Nonresidents – Table 9-1

Table 9-1

Dividend Income - Residents and Nonresidents		
Type of Dividend	Pennsylvania Residents	Pennsylvania Nonresidents
Distributions made by an investment company out of earnings and profits derived from nontaxable interest in Pennsylvania state and local government obligations	Not taxable	Not taxable
Distributions made by an investment company out of earnings and profits derived from nontaxable interest in U.S. government obligations	Not taxable	Not taxable

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Table 9-1

Dividend Income - Resident and Nonresident		
Type of Dividend	Pennsylvania Resident	Pennsylvania Nonresident
Distributions by a public utility corporation that are treated as a return of capital	Not taxable ¹	Not taxable
Paid in property	Taxable at fair market value of property	Not reportable for Pennsylvania personal income tax
Stock dividends and stock rights	Not taxable	Not taxable
Distributions in lieu of money (TR Reg. §1.305-2)	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Disproportionate distribution (TR Reg. §1.305-3)	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Convertible preferred stock (TR Reg. §1.305-3)	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Distribution of common and preferred stock (TR Reg. §1.305-6)	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Capital gain distribution from regulated investment company	Taxable as a dividend	Not reportable for Pennsylvania personal income tax
Dividend income not reported as working capital in arriving at net profits for a business, profession, or farm	Taxable as a dividend	Not taxable as a dividend, however, taxable as net profits
Dividend income allocated to net profits from a business, profession or farm	Taxable as a dividend	Not reportable for Pennsylvania personal income tax

¹ Distributions after the basis in the stock has been reduced to zero are taxable on PA-40 Schedule D as net gain(loss) from the sale, exchange or disposition of property.

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II. INDIVIDUALS

A. Dividend Income

An individual taxpayer classifies dividends earned from investments as dividend income.

B. Expenses Incurred to Generate Dividend Income

Pennsylvania law does not permit the deduction of any expenses that an individual taxpayer incurs to realize dividend income.

C. Uniform Gifts to Minors Act

Interest, dividends, or any other income earned by accounts set up under the Uniform Gifts to Minors Act must be reported on the tax return of the child.

III. CAPITAL GAIN DISTRIBUTIONS

Capital gain distributions received from mutual funds or other regulated investment companies are taxable as dividend income. Generally, capital gain distributions are listed on a federal Form 1099B which a taxpayer receives from his or her broker or mutual fund manager.

IV. RETURN OF CAPITAL DISTRIBUTIONS

A. Return of Capital Distribution – Resident

A return of capital distribution is any distribution that is not made or credited by a business corporation or association out of its earnings and profits. A resident shareholder must report as taxable gain for the tax year in which it was received or credited, the excess of the fair market value (FMV) of any return of capital distribution over the adjusted basis of the stock on the *PA-40 Schedule D, Sale, Exchange or Disposition of Property*. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains or Losses From the Sale, Exchange or Disposition of Property.

B. Distributions Designated as Return of Capital by Utility Companies or Other Corporations

Distributions designated as return of capital by utility companies or other corporations serve to reduce the basis of stock in the utility company or other corporation. Once a taxpayer's basis is reduced to zero, any further distributions are taxed as net gain (loss) from the sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains or Losses From the Sale, Exchange or Disposition of Property.

C. Basis

The basis of stock shares held by a shareholder is not decreased by any distribution that is a dividend. The basis of stock shares held by a resident shareholder is decreased (but not below zero) by any distribution that is not a taxable dividend. Once the basis of the stock shares is reduced to zero, any further distributions are taxed as net gain (loss) from the sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains or Losses From the Sale, Exchange or Disposition of Property.

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V. NONTAXABLE OR PARTIALLY TAXABLE DIVIDENDS

A. Exempt-Interest Dividend Funds

An exempt-interest dividend paid after Jan. 1, 1993 is not taxable under Pennsylvania personal income tax law. Taxpayers should exclude that portion of the total dividend designated as being from exempt Pennsylvania and federal obligations. Any amount designated as capital gain is fully taxable as dividend income for Pennsylvania purposes.

An ordinary dividend paid by a fund and designated as being an exempt-interest dividend for Pennsylvania purposes is not considered to be interest under Pennsylvania personal income tax law. Such income is dividend income but is not taxable. Taxpayers must determine what percentage of the dividends is from Pennsylvania-exempt obligations using the statements the fund provides.

If a fund invests 100 percent in Pennsylvania-exempt obligations, none of the exempt-interest dividend income is taxable for Pennsylvania purposes. However, the amount designated as capital gains is fully taxable as dividend income for Pennsylvania personal income tax purposes. Refer to Pennsylvania Personal Income Tax Guide, Chapter 8, Interest.

B. Stock Dividends

A stock dividend is not taxable for Pennsylvania personal income tax purposes. A stock dividend is a *pro rata* distribution by a corporation to its stockholders in the form of stock if the distribution is not treated as income for federal income tax purposes. If the stock distribution is not taxable, the tax basis of the old stock is adjusted to reflect the additional shares.

It should also be noted that any gain derived from the sale, exchange or disposition of the underlying shares in the fund or trust will be a taxable gain for Pennsylvania personal income tax purposes. Any loss incurred from the sale, exchange or disposition of the underlying shares is recognized but may only be offset against a shareholder's taxable gain for the taxable year.

Under a stock dividend reinvestment plan (DRIP), a shareholder elects to receive dividends in the form of stock, rather than cash or other property. A taxpayer must report the stock's fair market value as taxable dividend income as of the date paid. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains or Losses From the Sale, Exchange or Disposition of Property.

C. Money Market or Mutual Funds and Investment Trusts

Taxable distributions from the earnings and profits of money market or mutual funds and investment trusts and companies must be reported as dividend income, not interest income.

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D. Mutual Insurance Companies

Dividends paid by mutual insurance companies are a return of premium only and cannot be reported as taxable. Dividends paid by other than mutual insurance companies are taxable dividends.

E. Savings and Loan Associations, Mutual Savings Banks, Cooperative Banks, and Credit Unions

Do not report as taxable any dividends paid by savings and loan associations, mutual savings banks, cooperative banks, and credit unions on deposits or withdrawals from accounts. They must be reported as interest income. Refer to Pennsylvania Personal Income Tax Guide, Chapter 8, Interest.

F. Regulated Investment Company

Do not report any dividends from undistributed capital gains made by a regulated investment company.

G. Insurance Companies

Interest income on dividends from insurance companies, whether disbursed or not, is taxable as interest income. Refer to Pennsylvania Personal Income Tax Guide, Chapter 8, Interest.

H. Constructive Dividends

Constructive dividends such as a corporate expenditure incurred for the personal benefit of the shareholder or the personal use of corporate property or corporation-provided services are excluded from tax. However, a corporate loan to a shareholder where there is no intent to create a bona fide creditor-debtor relationship, a sale of property by a corporation to its shareholders for less than fair market value, or excessive payments made by the corporation on purchasing or leasing a shareholder's property, are taxable as dividends, even if a distribution to shareholders has not been formally declared by the corporation.

I. Charitable Gift Annuity

Dividends distributed under a charitable gift annuity are not taxable. However, after a taxpayer recovers the amount donated, further distributions must be reported as taxable gains on *PA-40 Schedule D, Sale, Exchange or Disposition of Property*.

VI. TAXABLE DIVIDENDS

A. Distributions to Shareholders Out Of Earnings And Profits Made By Personal Holding Companies Or Subchapter S Corporations That Are Not PA S Corporations

These distributions are taxable as dividends. A Pennsylvania resident shareholder in another state's Subchapter S corporation that has elected not to be treated as a PA S

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corporation must include the cash or property actually received out of the corporation's earnings and profits. Distributions in excess of the corporation's earnings and profits are reported on *PA-40 Schedule D, Sale, Exchange or Disposition of Property*. Do not report the amount of distributable income, and do not submit the federal Schedule K-1.

A shareholder may not claim a credit for income tax paid to another state by an S corporation that elected not to be treated as a PA S corporation. If the entity does business entirely within another state, then the entity is also required to file a *PA-20S/PA-65, PA S Corporation/Partnership Information Return* as a result of having a Pennsylvania resident shareholder.

B. Excessive Salaries Paid To a Shareholder

Excessive salaries paid to a shareholder are taxable as dividends rather than compensation.

VII. PA-40 SCHEDULE B

A. Dividends Reported On PA-40 Individual Income Tax Return

All dividend income must be reported on the *PA-40, Individual Income Tax Return*. The substitution of a federal Schedule B for PA-40 Schedule B is not allowed.

B. PA-40 Schedule B Required If Dividend Income Exceeds \$2,500

When dividend income exceeds \$2,500, a *PA-40 Schedule B, PA-Taxable Dividend and Capital Gains Distributions Income* must be completed and filed.

C. Report All Dividends Received

All dividend income is reported on PA-40 Schedule B, Line 3. A resident shareholder must report as taxable dividend income for the taxable year in which it is received or credited, any distribution by a business corporation or business association out of its earnings and profits without regard to the manner in which the business derived the income. For Pennsylvania tax purposes, a business association is an unincorporated business enterprise that is organized in a manner similar to a business corporation. Business corporations or business associations include business trusts, agricultural cooperatives, electric cooperatives, federally-qualified real estate investment companies, mutual funds and other federally-regulated investment companies. A business entity is required to file a *PA-20S/PA-65, PA S Corporation/Partnership Information Return* as a result of having a Pennsylvania resident shareholder or engaging in business activity in Pennsylvania. The entity should provide PA Schedules RK-1 or NRK-1 to each resident or nonresident shareholder.