

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**CHAPTER 13: NET INCOME (LOSS) FROM RENTS, ROYALTIES, COPYRIGHTS AND PATENTS**

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## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

### CHAPTER 13: NET INCOME (LOSS) FROM RENTS, ROYALTIES, COPYRIGHTS AND PATENTS

#### I. DIFFERENCES BETWEEN PENNSYLVANIA PERSONAL INCOME TAX AND FEDERAL INCOME TAXATION

##### A. Rents Classified as Net Income (Loss) from the Operation of a Business, Profession or Farm

Rental income may be classified as net income from the operation of a business, profession or farm if the lessor provides significant services to the lessee-

1. A lessor provides significant services when he or she provides services for the lessee's convenience and such services are not ordinarily or customarily incurred in leasing property.
2. The entity is a dealer in real property.

##### B. Treatment of Gain (Loss) From the Sale, Exchange or Disposition of Property

The gain (loss) from the sale, exchange or disposition of property used to produce net income (loss) from rents, royalties, copyrights and patents should generally be reported as income from the sale, exchange or disposition of property on *PA-40 Schedule D*.

##### C. Passive Loss Rules

Under Internal Revenue Service (IRS) regulations, passive loss rules apply to individuals, trusts and estates, personal service companies, and closely held corporations. Pennsylvania personal income tax (PA PIT) does not follow the federal passive loss rules. Therefore-

1. Rental activities are not subject to federal passive loss limitation rules for Pennsylvania personal income tax;
2. Rental activity losses may be used to offset other income under Pennsylvania personal income tax which is classified as rental, royalty, copyright or patent income;
3. Pennsylvania personal income tax does not include any "grouping" concepts which are contained in the federal passive loss rules; and
4. Pennsylvania personal income tax does not provide that upon disposition, losses are offset against other classes of income.

##### D. Lease versus Sale Determinations [Reserved]

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### **E. IRC Section 467 Rule**

IRC section 467 imposes accrual accounting on lease transactions providing for increasing rent and requires rent to be leveled for tax purposes in the case of certain "disqualified leasebacks and long-term agreements." Pennsylvania personal income tax does not have similar provisions. Consequently, there will be timing differences for Pennsylvania personal income tax purposes.

### **F. Treatment of Construction Allowances**

A tenant may receive a build-out allowance that the landlord grants (but does not actually pay to the tenant) to be used for build-outs designed to the tenant's specifications.

IRC section 110 provides that cash (or an amount treated as a rent reduction) received by a retail tenant is not gross income if the amount is used for qualifying construction of leasehold improvements. For Pennsylvania personal income tax purposes the amount received is treated as gross income.

### **G. Timber and Coal [Reserved]**

Refer to PA PIT Guide Chapter 23 Natural Resources.

### **H. Prepaid Rental Income**

Rental income is reported according to the lessor's method of accounting. If a cash method is used then rental income is reported when received. If an accrual method is used then rental income is reported when earned.

## **II. DEFINITIONS**

### **A. Rental Income**

Rental income is income the taxpayer receives for the use of his or her real or tangible property.

#### **1. Federal Passive Loss Rules**

For Pennsylvania personal income tax purposes, there are no passive loss rules as defined under IRC section 469; consequently, there will be both timing and permanent differences for Pennsylvania personal income tax purposes. The federal passive loss rules described below are not applicable.

IRC section 469(j)(8) defines rental activities as activities where payments are received principally for the use of tangible property. The regulations exclude from this definition a number of situations in which substantial services are provided in connection with the use of property-

- a. Hotels and similar properties where the average period of each customer's use does not exceed seven days;

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- b. The average period of each customer's use is no more than 30 days and significant personal services are provided by or on behalf of the owner to customers;
- c. Extraordinary personal services are provided and these services render the use of the property almost incidental, such as a hospital;
- d. Rentals are incidental to non-rental activity because either—
  - The property is held primarily for appreciation and gross rentals are less than 2 percent of the lesser of the adjusted basis or fair market value of the property, or
  - The property is used in a trade or business owned by the taxpayer and the rentals are less than the 2 percent test above;
- e. The property is customarily available during defined business hours for use by the public; or
- f. The property is provided for use in a non-rental activity conducted by a pass through entity that the taxpayer owns an interest in.

If any of the above exceptions apply, the rental activity is not *per se* passive and individual taxpayers may avoid passive loss limitations by materially participating in the activity.

If insubstantial rental activities are conducted as part of a larger economic unit, the net rental income can simply be combined with the dominant trade or business activity. Similarly, if an insubstantial non-rental business is conducted in conjunction with a dominant rental activity, the entire economic unit may be considered rental for purposes of IRC section 469.

The Revenue Reconciliation Act of 1993 added a provision to the federal law that operates to exempt qualifying real estate professionals from the *per se* passive rule. Such taxpayers will not be guaranteed non-passive treatment but instead will be subject to the material participation standard like taxpayers in non-real estate activities.

If the unadjusted basis of depreciable property involved in a rental activity constitutes less than 30 percent of the total unadjusted basis, any net income from the activity is re-characterized as portfolio income and, therefore, unable to free up passive losses from other activities. For example, the net income from a stand-alone ground lease or a parking lot rental is likely to be subject to this re-characterization rule. The rules for a relatively common real estate structure are illustrated by *Wiseman v. Commissioner*, 69 T.C.M. 2564 (1995). In this case, the taxpayer owned interests in two partnerships; one owned land leased to the

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other that operated a shopping center. The taxpayer attempted to aggregate the activities in order to offset the shopping center losses against the ground lease profits. However, the IRS prevailed in segregating the ground lease income in the portfolio basket under the above re-characterization rule. Pennsylvania personal income tax has no concept as to groupings.

The general rule of IRC section 469 is that gain from the sale of an asset or activity is classified in the same basket as income (loss) previously generated from that asset or activity. Accordingly, gain from the sale of a rental activity will generally be passive unless IRC section 469(c)(7) applied to the activity. However, IRC section 469(l) authorized regulations re-characterizing certain gain as non-passive.

For Pennsylvania personal income tax there are no similar rules.

### **2. Federal-At-Risk Rules**

For Pennsylvania personal income tax purposes there are no at risk rules as defined under IRC section 465. Consequently, there will be timing differences for Pennsylvania personal income tax purposes.

For Pennsylvania personal income tax purposes, a nonresident partner or nonresident shareholder cannot deduct losses in excess of his or her economic investment.

For Pennsylvania personal income tax purposes, a resident partner or resident shareholder basis in an entity cannot be less than zero. A resident partner or resident shareholder is required to have an economic investment to deduct losses for Pennsylvania personal income tax purposes.

### **B. Royalty Income**

Royalty income is income that a taxpayer receives upon the extraction of coal, oil, gas, or other minerals or for the use of the taxpayer's copyright or patent. Additionally, royalty income includes any amounts a taxpayer receives from licensing his or her secret process, franchise, know-how, assembled workforce, trade brands and similar property.

Refer to PA PIT Guide Chapter 23 Natural Resources.

### **C. Gross Rents, Royalties, Copyrights and Patents**

Gross rents and royalties includes all items of gross income from receipts from rents, royalties, copyrights, patents, secret processes, formulas, goodwill, trademarks, trade brands, franchises and similar property derived in the form of rents and royalties except-

1. Income or receipts from the sale, exchange, or other disposition of rental property, royalty rights, copyrights, secret processes, patents, formulas, goodwill, trademarks, trade brands, franchises and similar property; and

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

Refer to Personal Income Tax Bulletin 2005-02 Gain (Loss) Derived From The Disposition Of A Going Concern in PA PIT Guide Chapter 30.

### III. DEDUCTIONS AGAINST GROSS RENTS, ROYALTIES, COPYRIGHTS AND PATENTS

#### A. Allowable Expenses

Allowable expenses include only expenses paid or incurred during the taxable year which are ordinarily incurred in and necessary for—

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

Allowable expenses include such expenses as advertising, cleaning and maintenance, agent commissions, insurance, legal fees, management fees, interest, repairs, supplies, utilities, depreciation and depletion. With the exception of start-up expenses, depletion is an allowable deduction against income for Pennsylvania personal income tax purposes. Refer to Personal Income Tax Statement of Policy 2004-01 Depletion as published in Section 125 of Title 61 of the Pennsylvania Code.

Also, refer to PA PIT Guide Chapter 30 Pennsylvania Department of Revenue Personal Income Tax Policy Guidance and Chapter 23 Natural Resources.

#### B. Deductions Not Allowed Against Gross Rents, Royalties, Copyrights, and Patents

##### 1. Owner's Labor, Capital or Improvements

No deduction is allowed for a taxpayer's own labor, capital investment or capital improvements.

##### 2. Personal Expenses

No deduction is allowed for personal expenses or for any part of an allowable deduction that is personal.

#### C. Depreciation

There are some significant differences between federal and Pennsylvania personal income tax depreciation rules.

##### 1. ACRS and MACRS

Deductions allowable under the Federal Accelerated Cost Recovery System (ACRS) and Modified Accelerated Cost-Recovery System (MACRS), including the

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IRC section 179 deductions, in effect on Jan. 1, 1986, additional first-year depreciation allowance for individuals and certain small businesses, are acceptable depreciation deductions for Pennsylvania purposes.

Pennsylvania tax law allows ACRS or MACRS only when-

- They are also used for federal tax purposes, and
- The property, when placed in service, has the same adjusted basis for Pennsylvania and federal tax purposes.

Moreover, deductions under ACRS and MACRS are allowable only to the extent allowable under the version of the IRC in effect on Jan. 1, 1986 as amended to Jan. 1, 1997, whichever is less.

Additionally, for any year in which an ACRS or MACRS deduction is allowed or allowable-

- The taxpayer, S corporation or partnership must reduce its basis in the depreciable property by the amount by which the deduction reduced its net income; and
- Each owner must reduce outside basis by the owner's share of net loss or the amount of the owner's share of depreciation allowed or allowable using the straight-line method of depreciation.

### **2. Thirty Percent or Fifty Percent Additional First-Year Depreciation Not Allowed**

For federal purposes, Congress enacted legislation during 2002, 2003 and 2005 that contained provisions providing for additional first-year depreciation on purchases of certain tangible personal property, computer software, and certain leasehold improvements acquired after Sept. 10, 2001. Pennsylvania personal income tax does not follow these federal provisions. Accordingly, neither the 30 percent additional first-year depreciation deduction for 2002 nor the 50 percent additional first-year depreciation deduction for 2003 and 2005 is permitted against income (loss) from rents, royalties, copyrights and patents for Pennsylvania personal income tax purposes. Further federal legislation extended or modified these special depreciation rules. For Pennsylvania personal income tax purposes, individuals, business owners, partnerships, limited liability companies, PA S corporations, estates and trusts cannot take this additional depreciation. However, taxpayers may continue to calculate depreciation on the same basis they would have calculated it under the Internal Revenue Code in effect at the time the property or asset was placed in service, or the Internal Revenue Code of 1986, as amended to Jan. 1, 1997, whichever is earlier. If a taxpayer took the bonus depreciation allowable under federal law for any tax year, they must file an amended PA-40 Individual Income Tax return.

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### 3. IRC Section 179 Property Deductions

Pennsylvania tax law allows IRC section 179 property deductions on a limited basis. They are allowable with respect to the entity and each owner only to the extent allowable under the IRC in effect on Jan. 1, 1997. For example, the aggregate dollar limitation is \$25,000 less the amount by which the cost of IRC section 179 properties placed in service during the taxable year exceeds \$200,000. Federal increases enacted after 1997 are disregarded for Pennsylvania personal income tax purposes.

Additionally, for any year in which an IRC section 179 property deductions is claimed, basis must be reduced by the amount of the deduction, regardless of whether the deduction results in a reduction of net income.

Refer to Personal Income Tax Bulletin 2010-01 Section 179 Expense Deductions (to be issued in February 2010) for a more detailed explanation of Pennsylvania personal income tax rules.

## IV. INTEREST FROM SECURITY DEPOSITS

Interest earned on the deposit of rents (i.e. tenant security deposits) is classified as interest income unless the interest earned is used to operate or maintain the rental property and is not returnable with the return of escrow funds. If the interest earned is actually used to operate or maintain the rental property, then such interest is classified as net income (loss) from rents, royalties, copyrights and patents. Likewise, expenses incurred to operate or maintain a rental property are classified as net income (loss) from rents, royalties, copyrights and patents.

Refer to PA PIT Guide Chapter 8 Interest.

## V. RENTS VERSUS NET PROFITS

### A. Determination of Rents or Net Profits

The leasing of tangible property would constitute operating a business only if-

1. The taxpayer offers the use of his or her property on a commercial basis to others in a marketplace and at least one of the following applies-
  - a. The average period of customer use is 30 days or less; or
  - b. The property is customarily made available for use only during defined business hours; or
  - c. In addition to the property, the taxpayer also provides significant services (see explanation below) to the lessee; or
  - d. The taxpayer incurs significant operating expenses in making the property available for lease; or
  - e. The leasing activity is incidental to a real estate sales business; and

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2. The taxpayer offers the use of his or her property with the intention of realizing a profit; and
3. The leasing of the property is characterized by regularity and continuity of activities.

### **B. Significant Services**

Rental income may be classified as net income from the operation of a business, profession, or farm if the lessor provides significant services to the lessee. A lessor provides significant services when he or she provides services for the lessee's convenience and such services are not ordinarily or customarily incurred in leasing property.

#### **1. Examples of Services That Do Not Constitute Significant Services**

Providing heat, lighting, electric service, elevators, cleaning public access and exit areas, collecting trash and maintenance of the property in a condition suitable for use and rental are not usually significant services.

#### **2. Examples of Services That Constitute Significant Services**

Significant services generally are provided with rooms in hotels, boarding houses, apartment houses furnishing hotel services, tourist homes, motor courts, or motels and assisted living facilities. Additionally, providing maid service, room service, valet parking, decorating assistance, delivery services, transportation services and concierge services are significant. Providing food and nursing care are also significant. Payments for parking cars usually are not rents. Payments for warehousing of goods or the use of personal property are not rents if significant services are provided in connection with the payments.

### **C. Classification as Rental Income versus Net Income from the Operation of a Business, Profession or Farm**

The Pennsylvania Department of Revenue's position is that self-rented property or related-party rents do not constitute a "commercial enterprise" as that term is defined under Pennsylvania personal income tax law. A rental property constitutes a commercial enterprise only when the taxpayer offers the use of the property on a commercial basis to others (*i.e.* the public) in a marketplace.

In *Wettach v. Commonwealth*, 153 Pa Commw 293, 620 A2d 730 (1992), the court stated:

The first issue presented is whether the income (loss) of M & M is properly classified as "business profits" under Section 303(a)(2) or "rents" under Section 303(a)(4) of the [Pennsylvania Tax Reform Code of 1971], in view of the nature and origin of M & M's activity and the interrelationship between RSSM and M & M. Section 303(a)(2) states:

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### NET PROFITS

The net income from the operation of a business, profession or other activity, after provision for all costs and expenses incurred in the conduct thereof, determined either on a cash or accrual basis in accordance with accepted accounting principles and practices but without deduction of taxes based on income.

Section 303(a)(4) states: "Net gains or income derived from or in the form of rents, royalties, patents, and copyrights."

The Taxpayers argue first that the operation of the building is the "business" of 435 Sixth Avenue Associates, which through its hired manager provides significant services: it cleans the building, provides security and 24-hour access, makes repairs, and performs maintenance.

The Taxpayers argue in the alternative, by analogy to cases interpreting municipal net profits taxes, that the courts essentially have discarded the "provision of services" standard and look instead to the purpose for and method of the acquisition. If the property is deliberately acquired for the purpose of rental, then the rental is a business activity. *Oseroff v. City of Pittsburgh*, 70 Pa. Commonwealth Ct. 294 (1982) (property deliberately acquired for rental subject to city's tax on net profits and gross receipts, even though lessor did not provide even minimal service to lessee); *Philadelphia Tax Review Board v. Weiner*, 211 Pa. Superior Ct. 229 (1967) (owners who deliberately acquired one-half interest in a building and then leased it were engaged in a "business" within the meaning of the Philadelphia Wage and Net Profits Tax, rather than merely receiving passive income). The Taxpayers argue that the sole purpose for M & M's existence and its participation in the acquisition of the building is the rental of that building to RSSM, therefore M & M's profit (loss) comes from a business activity.

In response, the Commonwealth urges the court to focus on the limited and exclusive nature of M & M's rental activity, rather than on the provision of services or M & M's intent to rent the building. It cites *Morgan v. Commonwealth*, 42 Pa. Commonwealth Ct. 557 (1979). There an individual bought and sold securities for the purpose of making profit for himself; he held no license and did not offer his services to anyone else. He claimed certain expenses from his personal money management activity as expenses deductible from his operation of a business pursuant to Section 303(a)(2) of the [Pennsylvania Tax Reform Code of 1971]. This court disagreed, quoting the definition of "business" in Section 301(c) of the [Pennsylvania Tax Reform Code of 1971], 72 P.S. § 7301(c), as " 'an enterprise, activity, profession, vocation, trade, joint venture, commerce or any other undertaking of any nature when engaged in as commercial enterprise ...' " *Morgan*, 42 Pa. Commonwealth Ct. at 561, 400 A.2d at 1386 (emphasis added in *Morgan*). We held that the sine qua non of a commercial enterprise is the rendering of goods and services to others in the marketplace, which clearly excluded the petitioner's activity.

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We are constrained to agree with the Commonwealth. These two entities, although enjoying a separate legal existence, work very much "hand in glove," and their relationship reflects the nature of the rental activity in which M & M is involved. As the taxpayers admit in the stipulations, M & M was created for the sole purpose of acquiring ownership of the space in which RSSM conducts its law practice. In *Morgan* this court interpreted the statutory definition of "business" as the rendering of goods and services in the marketplace. Applying this definition to the situation presented, we must conclude that M & M's activity does not equate to doing "business." The income that M & M earns (and the losses that it generates) does not result from engaging in a "commercial enterprise" in the rental real estate market so as to render the activity a "business" within the meaning of Section 301(c) of the [Pennsylvania Tax Reform Code of 1971].

Refer to PA PIT Guide Chapter 11 Net Income (Loss) From the Operation of a Business, Profession or Farm.

### **D. Dealer in Real Property**

For Pennsylvania personal income tax purposes, a dealer in real property is defined for federal income tax purposes, generally receives net profits for a business, profession or farm. For federal income tax purposes, if the property is subdivided or improved by guarding, drainage, paved roads, the installation of utilities or similar activity, the taxpayer gravitates towards dealer status since these changes are comparable to the functions performed by a manufacturer. *See Jersey Land and Development v. U.S.*, 539 F.2d 311. The more numerous, frequent and regular the sales, the more likely it is the property is held for sale to customers in the ordinary course of a trade or business. Extensive advertising, active solicitation, and promotional activities, whether by the taxpayer in person or by employees and brokers are inconsistent with investor status and are evidence that the property is held for sale to customers in the ordinary course of a trade or business. If a dealer has rental property held for the purpose of renting and not for sale, the class of income shall be rental.

A dealer's management of its properties is net profits from a business, profession or farm.

## **VI. TREATMENT OF GAIN (LOSS) ON THE SALE, EXCHANGE OR DISPOSITION OF PROPERTY FROM RENTS, ROYALTIES, COPYRIGHTS AND PATENTS**

The gain (loss) from the sale of investment property used to produce net income (loss) from rents, royalties, copyrights and patents should generally be reported as net gain (loss) from sale, exchange or disposition of property on *PA-40 Schedule D*.

## **VII. RENTS VERSUS SALES**

### **A. Lease with Option to Buy**

A lease with an option to buy real property in Pennsylvania may be a purchase contract. If so, the payments received are reportable as net gain (loss) from the sale, exchange or other disposition of property. The taxpayer must complete and file a *PA-40 Schedule D*.

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### **B. Giving up Mineral Rights or Ownership**

If a taxpayer gives up mineral rights or ownership rights to Pennsylvania property or patents or copyrights, the payments the taxpayer receives are reportable as net gain (loss) from the sale, exchange or other disposition of property. The taxpayer must complete and file a *PA-40 Schedule D*.

Refer to PA PIT Guide Chapter 23 Natural Resources.

## **VIII. ALLOCATION OR APPORTIONMENT OF RENTS AND ROYALTIES FROM COPYRIGHTS AND PATENTS**

### **A. Rents**

#### **1. Specific Allocation**

Rents received from real estate and tangible personal property (not employed in the operation of a business) and the costs, expenses and liabilities incurred in producing and collecting such rents are allocable to Pennsylvania only if the property is located in Pennsylvania.

#### **2. Formulary Apportionment**

If the property is used both within and outside Pennsylvania, the net income allocable to Pennsylvania is determined by multiplying the net income by a fraction, the numerator being the number of days the property was in Pennsylvania during the rental period and the denominator being the total number of days in the rental period.

#### **3. No Apportionment**

Rents received from real estate located outside Pennsylvania and the costs, expenses, and liabilities incurred in producing and collecting such rents are allocable to the jurisdiction where the property is located. As such, no Pennsylvania apportionment is allowed.

### **B. Royalties**

#### **1. Allocation of Royalties from Extraction of Minerals**

Royalties received from the extraction of minerals and the costs, expenses, and liabilities incurred in generating such royalty income are allocable to Pennsylvania when the property is located in Pennsylvania and the income is not derived from the operation of a business.

Refer to PA PIT Guide Chapter 23 Natural Resources.

#### **2. Allocation of Royalties from Patents and Copyrights**

Royalties received from patents and copyrights (not employed in the operation of a business) and the costs, expenses and liabilities incurred in producing and collecting such royalty income are allocable to Pennsylvania only if, and to the extent that, the patent or copyrighted material is employed by the payer in

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production, fabrication, manufacture or other processing in Pennsylvania, the patented products are produced by the payer in Pennsylvania or the printing or publication by the payer originates in Pennsylvania.

### IX. REPORTING REQUIREMENTS

#### A. PA-40 Schedule E

If making Pennsylvania adjustments to federal rent, royalty, copyright or patent income, attach an explanation.

#### B. Federal Schedule E

Only Part 1 of federal Schedule E will be accepted with the following adjustments-

1. Passive rental/royalty loss must be claimed in full rather than carried over to future years as the federal government allows.
2. Any capital gains/distributions must be added.
3. Depreciation expense on sales tax that the taxpayer elected to currently expense for personal income tax purposes cannot be claimed (same as for PA-40 Schedule C).
4. Taxpayer's share of gain (loss) from partnerships, PA S corporations or other entities must be shown separately.

#### C. PA-40 Individual Income Tax Return

Net income (loss) from rents, royalties, patents and copyrights is reported on the *PA-40 Individual Income Tax* return. Total the net income (loss) from all PA-40 Schedule(s) E and all PA-40 Schedule(s) RK-1 or NRK-1 or federal Schedule(s) K-1, if the correct Pennsylvania schedule is not provided. However, spouses may not offset each other's income and losses in this class.

#### D. Nonresidents

Nonresidents are subject to Pennsylvania tax on net income from rents, royalties, copyrights, or patents from property located and/or used within Pennsylvania. Married taxpayers may not offset income (loss) from separately owned property.

Partnerships and S corporations with nonresident partners or shareholders must remit tax on income from sources within this Commonwealth, which is allocable to a nonresident. The nonresident partner or shareholder may take a credit on their PA-40 Individual Income Tax return for the tax remitted by the partnership or S corporation.

Refer to PA PIT Guide Chapter 17 Credits.

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### **X. RECIPROCAL COMPENSATION AGREEMENTS**

Reciprocal agreements apply to compensation only and not any other class of income. For example: In 1996, Joe, a resident of West Virginia, worked in Pennsylvania. He also owned a rental property in Pennsylvania. Joe must report as Pennsylvania-taxable income only the rental income realized on the rental property. Because of the reciprocal agreement with West Virginia, he is not subject to tax on his compensation in Pennsylvania.

Refer to PA PIT Guide Chapter 4 Filing Requirements For Pennsylvania Personal Income Tax Returns.

### **XI. TAX BENEFIT RULE**

The Pennsylvania Department of Revenue does not follow the federal tax benefit rule. Pennsylvania law requires depreciation to be calculated under the straight-line method even if the depreciation did not provide any tax benefit.

If a taxpayer does not utilize the loss from the Schedule E, then the assets of the rental property must be depreciated using straight-line depreciation.

There are no carryovers of losses.