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OVERVIEW

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 may in certain situations be classified into that other class of income.

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.

Nonresidents and Part-Year Residents

Nonresidents are not subject to Pennsylvania personal income tax on dividend income paid on investments in corporations or mutual funds headquartered or located within Pennsylvania. Part-year residents are not subject to tax on dividend income received while a nonresident of Pennsylvania. Refer to DIVIDEND INCOME – RESIDENTS AND NONRESIDENTS.

Dividend Income - Sourcing

Dividend income is generally derived from intangible personal property. Therefore, dividend income is generally not sourceable to PA (or any other state). Dividend income is only sourced to PA if it is from intangible personal property employed in a trade, profession, occupation or business carried on in PA.

Dividends are Classified in a Separate Income Class

Under Pennsylvania law, income and expenses are generally classified according to the activity in which they are earned or incurred. Dividends are normally classified as dividend income if they are generated by investments of an individual taxpayer from investments in stocks, mutual funds or registered investment companies. Generally, federal Form 1099-DIV, issued by corporations, mutual funds or registered investment companies, will indicate the amount of interest received or credited from or by such payers.

In certain situations, dividends are classified in another class of income. A taxpayer may classify dividends earned in the normal and regular operation of a business, profession or farm as net income (loss) from operation of a business, profession or farm as net income or loss, not as ordinary dividend income, if the dividends are earned from investment of business working capital. Refer to PA Personal Income Tax Guide - Net Income or Loss from the Operation of a Business, Profession, or Farm.

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.

Uniform Gifts to Minors Act

Dividends earned by accounts set up under the Uniform Gifts to Minors Act must be reported on the tax return of the child.

PA TAXATION OF SPECIFIC DISTRIBUTIONS AS DIVIDEND INCOME

Capital Gains 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.

Return of Capital Distributions

- **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 PA Personal Income Tax Guide - Net Gains or Losses From the Sale, Exchange or Disposition of Property.

- **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 PA Personal Income Tax Guide - Net Gains or Losses From the Sale, Exchange or Disposition of Property.

- **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 PA Personal Income Tax Guide - Net Gains or Losses From the Sale, Exchange or Disposition of Property.

Nontaxable or Partially Taxable Dividends

- **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. Exempt interest dividends from states other than Pennsylvania or other than exempt federal obligations are taxable income for Pennsylvania personal income tax purposes.

An ordinary dividend paid by a mutual 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 PA Personal Income Tax Guide – Interest.

The amount of Pennsylvania exempt-interest dividends should be reported on Line 4 of PA-40 schedule B, PA-Taxable Dividend and Capital Gains Distributions Income and the amount of federal exempt-interest dividends should be reported on Line 7 of PA-40 Schedule 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.

- **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.
- **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.
- **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 PA Personal Income Tax Guide - Interest.
- **Regulated Investment Company**
Do not report any dividends from undistributed capital gains made by a regulated investment company.
- **Insurance Companies**
Interest income on dividends from insurance companies, whether disbursed or not, is taxable as interest income. Refer to PA Personal Income Tax Guide - Interest.
- **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.
- **Charitable Gift Annuity**
For tax years beginning after Dec. 31, 2004, distributions from a charitable gift annuity are taxable for Pennsylvania personal income tax purposes to the extent the distributions are taxable for federal income tax purposes as interest income. Refer to PA Personal Income Tax Guide – Interest.

Prior to Jan. 1, 2005, dividends distributed under a charitable gift annuity were not taxable. However, after a taxpayer recovered the amount donated, further distributions were reported as taxable gains on PA-40 Schedule D, Sale, Exchange or Disposition of Property.

Taxable Dividends

- **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 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.

The amount of the distributions should be reported as dividend income on Line 7 of PA-40 Schedule B, PA-Taxable Dividend and Capital Gains Distributions Income.

- **Excessive Salaries Paid to a Shareholder**

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

The amount of the excessive salary not reported as dividend income for federal income tax purposes should be reported as dividend income on Line 7 of PA-40 Schedule B, PA-Taxable Dividend and Capital Gains Distributions Income.

Nominee Dividends or Capital Gains Distributions

For federal income tax purposes, a nominee who holds the legal title to an account for another person (principal/beneficiary) and receives notification of the dividend income or capital gains distributions belonging to the principal/beneficiary must include the dividend income or capital gains distributions on the nominee's income tax return. The income is then removed from the nominee's return by a reduction entry on the return. Pennsylvania allows the same treatment for personal income tax purposes. However, the Social Security number of principal/beneficiary must be included on PA-40 Schedule B, PA-Taxable Dividend and Capital Gains Distributions Income.

Since nominee dividends or capital gains distributions are included as an adjustment to the amount of federal dividend income, the Pennsylvania nominee dividend amount is deducted on Line 4 of PA-40 Schedule B, PA-Taxable Dividend and Capital Gains Distributions Income, while the nominee amount taken for federal income tax purposes is added back on Line 7 of PA-40 Schedule B.

PA-40 SCHEDULE B**Dividends Reported on PA-40 Individual Income Tax Return**

For tax years beginning on or after Jan. 1, 2014, dividend income reporting on PA Schedule B will begin by reporting the amount of dividend income taxable for federal income tax purposes. Dividend income taxable for Pennsylvania personal income tax purposes will then be ascertained by determining if any adjustments must be made to the federal dividend income amount. All Pennsylvania-taxable 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.

PA-40 Schedule B Required if Adjustments to Federal Dividend Income

For tax years beginning on or after Jan. 1, 2014, a taxpayer with any adjustments to the dividend income reported for federal income tax purposes must complete and file a PA-40 Schedule B, PA-Taxable Dividend and Capital Gains Distributions Income, with the PA-40, Individual Income Tax Return. Any adjustments included on Lines 2, 3, 4, 7, 8, and/or 9, of PA-40 Schedule B, regardless of the amount, triggers the requirement for including the schedule.

For tax years beginning before Jan. 1, 2014, PA-40 Schedule B, PA-Taxable Dividend and Capital Gains Distributions Income, is required to be completed and filed when a taxpayer receives taxable dividend income of more than \$2,500.

DIVIDEND INCOME – RESIDENTS AND NONRESIDENTS

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

- (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.
- (2) Dividends and capital gains distributions income for a part-year resident that are received while the taxpayer is a nonresident should be adjusted out of the total dividends and capital gains distribution income taxable for PA personal income tax purposes by including the nontaxable amount on Line 4 of PA-40 Schedule B, PA-Taxable Dividend and Capital Gains Distributions, for tax years beginning on or after Jan. 1, 2014.