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DIFFERENCES BETWEEN PENNSYLVANIA PERSONAL INCOME TAX AND FEDERAL INCOME TAXATION**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 when:

- 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;
- The entity is a dealer in real property; or
- The property held out for rent typically has short-term rental periods of less than 30 days.

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*.

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.

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.

Carryover of Losses

For PA personal income tax purposes, there are no carryovers of unused losses.

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.

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.

Timber and Coal

Refer to PA Personal Income Tax Guide - Natural Resources.

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.

DEFINITIONS**Rental Income**

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

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 Personal Income Tax Guide - Natural Resources.

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 for:

- 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
- 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.

DEDUCTIONS AGAINST GROSS RENTS, ROYALTIES, COPYRIGHTS AND PATENTS**Allowable Expenses**

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

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

Allowable rental property expenses include such expenses as advertising, cleaning and maintenance, agent commissions, insurance, legal fees, management fees, interest, repairs, supplies, utilities, and depreciation.

Oil and gas royalty expenses are also deductible. Expenses against income derived from subsurface mineral or oil and gas rights may include costs associated with the negotiation of a lease, in addition to production costs, transmission costs or gathering fees deducted from royalty payments by the lessee. Cost depletion may also be deducted when the landowner has clearly identifiable costs of mineral rights included in a purchase agreement. However, percentage depletion is not permitted for Pennsylvania personal income tax purposes.

In addition, finance costs attributable to the purchase of the mineral rights may also be deductible expenses against oil and gas royalty income. However, expenses such as real estate taxes, land improvement costs and finance costs allocated to the purchase of land are related to the surface rights to a property and are not deductible.

With the exception of start-up expenses, depletion is an allowable deduction against income for Pennsylvania personal income tax purposes. Refer to Section 125 of Title 61 of the Pennsylvania Code. Also, refer to PA Personal Income Tax Guide - Natural Resources.

Deductions Not Allowed Against Gross Rents, Royalties, Copyrights, and Patents

- **Owner's Labor, Capital or Improvements**
No deduction is allowed for a taxpayer's own labor, capital investment or capital improvements.

- **Personal Expenses**

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

Depreciation and IRC Section 179 Property Deductions

There are some significant differences between federal and Pennsylvania personal income tax depreciation rules. Refer to PA Personal Income Tax Guide - Net Income (Loss) from the Operation of a Business, Profession or Farm, for detailed rules regarding reporting depreciation for Pennsylvania personal income tax purposes.

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 Personal Income Tax Guide - Interest.

RENTS VERSUS NET PROFITS**Determination of Rents or Net Profits**

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

- The average period of customer use is 30 days or less; or
- The property is customarily made available for use only during defined business hours; or
- In addition to the property, the taxpayer also provides significant services (see explanation below) to the lessee; or
- The taxpayer incurs significant operating expenses in making the property available for lease; or
- The leasing activity is incidental to a real estate sales business; and
- The taxpayer offers the use of his or her property with the intention of realizing a profit; and
- The leasing of the property is characterized by regularity and continuity of activities.

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.

- **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.

- **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.

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. See *Wettach v. Commonwealth*, 153 Pa Commw 293, 620 A2d 730 (1992) (holding The losses of a real estate partnership

which were made up of partners in a law firm, were rents rather than business profits and thus could not be set off against the profits from a law firm partnership.). 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. Refer to PA Personal Income Tax Guide - Net Income (Loss) From the Operation of a Business, Profession or Farm.

Dealer in Real Property

For Pennsylvania personal income tax purposes, a dealer in real property as 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 grading, 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.

Short-Term Rentals

For Pennsylvania personal income tax purposes, properties with rental periods of less than 30 days are considered to be short-term rentals. Short-term rentals occurring on Pennsylvania properties are required to have hotel occupancy tax collected and remitted to the department for such rentals. Property owners who rent their property for rental periods of less than 30 days are required to obtain a sales tax license number in order to collect and remit the hotel occupancy tax. Typically, vacation home rentals and/or rentals of a taxpayer's home, either directly or using online vacation or home rental websites, are short-term rentals. Net income or loss from short-term rentals are reported as Net Income from the Operation of a Business, Profession or Farm on Line 4 of the PA-40, Personal Income Tax Return. Taxpayers should obtain a sales tax license number by registering with the department's e-TIDES system.

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*.

RENTS VERSUS SALES

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*.

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 Personal Income Tax Guide - Natural Resources.

ALLOCATION OR APPORTIONMENT OF RENTS AND ROYALTIES FROM THE EXTRACTION OF MINERALS OR FROM COPYRIGHTS AND PATENTS

Rents

- **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.

- **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.

- **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.

- **Property Damage Payments as Rents**

A property damage reimbursement resulting from the construction of temporary structures such as staging areas is taxable as rental income on PA-40 Schedule E. Most contracts require the lessor to mitigate damage and restore the property to its original condition, thus no “damage” actually occurs. Payments received for the granting of a permanent right of way or an express easement of 15 years or more should be reported on PA-40 Schedule D as a gain of the sale or disposition of property. Otherwise, payments received for temporary access to another property for a temporary easement or right of way are included as rental income.

Royalties

- **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. Taxpayers who receive an upfront payment for the lease of oil or gas mineral rights and in subsequent years receive royalty payments for the production of oil or gas from producing wells should report the income on PA-40 Schedule E. When reporting royalty income from federal Form 1099-MISC, the gross amount reported in Box 2 should be used. Do not use the net amount of royalties received. Include any expenses deducted from royalty income separately. Refer to Allowable Expenses. Also refer to PA Personal Income Tax Guide - Natural Resources.

- **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 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.

REPORTING REQUIREMENTS

PA-40 Schedule E

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

Federal Schedule E

Federal Schedule E, Part 1, is NOT an acceptable substitute for the PA-40 Schedule E. However, there may be adjustments to federal rental income as follows:

- Passive rental/royalty loss must be claimed in full rather than carried over to future years as the federal government allows;
- Any capital gains/distributions must be added;

- 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); and/or
- Taxpayer's share of gain (loss) from partnerships, PA S corporations or other entities must be shown separately.

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.

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 Personal Income Tax Guide - Credits.

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 Personal Income Tax Guide - Compensation, Reciprocal Compensation Agreements.

PENNSYLVANIA DEPRECIATION RULE

Refer to PA Personal Income Tax Guide - Pass Through Entities.