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PARTNERSHIPS**Definition of a Partnership**

A partnership, for Pennsylvania personal income tax purposes, is any unincorporated entity that is classified as a “partnership” for federal income tax purposes, such as:

- **Partnership For Pennsylvania Personal Income Tax Purposes**

A domestic or foreign general partnership, joint venture, limited partnership (LP), limited liability partnership (LLP), limited liability company (LLC), business trust, investment club or other unincorporated entity that for federal income tax purposes is classified as a partnership.

- **Organizations Not Treated as a Partnership**

The term “partnership” does not include the following kinds of organizations:

- Condominium management associations, residential real estate management associations, or similar organizations provided that no part of the income inures, other than by enhancing the value of the property of the association or its members, to the benefit of any member;
- Political organizations; or
- Organizations described in IRC §501(c).

Note: For tax year 2005 and forward, an investment club that derives all of its receipts for the taxable year from either federally taxable portfolio interest income or dividends or from the sale and exchange of securities, is considered a partnership for Pennsylvania purposes and is required to file a PA-20S/PA-65 Information Return.

Differences Between Federal Tax Law and Pennsylvania Tax Law

For each class of income, there are differences in reporting requirements for federal income tax and Pennsylvania personal income tax.

Within each class of income, there are certain IRC sections, including elections for federal income tax, that are not allowed in arriving at reportable income for Pennsylvania personal income tax purposes.

Within each class of income, there are specific rules for Pennsylvania personal income tax purposes that differ from federal income tax rules.

Within each class of income, there are circumstances where Pennsylvania will accept the use of federal tax accounting rules provided they are consistently used and applied. Refer to Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for Partnerships, for specific circumstances where Pennsylvania may accept the use of consistently applied federal treatment.

PA-20S/PA-65 PA S Corporation/Partnership Information Return and Schedules

- **Filing Requirements – Partnership**

Every domestic or foreign partnership (72 P.S. § 7335(c)) or an entity formed as a limited liability company that is classified as a partnership for federal income tax purposes must file the *PA-20S/PA-65 PA S Corporation/Partnership Information Return (PA-20S/PA-65 Information Return)* if either of the following apply:

- During the taxable year, the partnership earned, received, or acquired any gross taxable income (loss) allocable or apportionable to Pennsylvania, regardless of the amount of its income (loss) and/or whether or not the income was distributed;
- The partnership, at year end, had at least one partner that was a Pennsylvania resident individual, estate, trust, or disregarded entity owned by a resident individual.

A partnership must file a PA-20S/PA-65 Information Return to report the income, deductions, gains, losses etc. from their operations. The partnership passes through any profits (losses) to the resident and nonresident

partners. Partners include their share of the income (loss) on form *PA-40 Individual Income Tax Return*, *PA-41 Fiduciary Income Tax Return*, or other Pennsylvania returns.

A partnership with operations within Pennsylvania whose partners are all C corporations must provide to the department a complete copy of its federal Form 1065. Such a partnership must submit a *PA-65 Corp, Directory of Corporate Partners*, and **does not** complete a PA-20S/PA-65 Information Return. See [PA-65 Corp.](#)

Each partnership must submit with the PA-20S/PA-65 Information Return a complete copy of its federal income tax return including all schedules, statements, federal Schedules K-1, and PA-20S/PA-65 Schedules RK-1 and NRK-1 received as an owner in other pass through entities such as a partnership, PA S corporation or limited liability company. With the PA-20S/PA-65 Information Return, the partnership must also submit copies of the PA-20S/PA-65 Schedules RK-1 that it provides to resident partners and copies of the PA-20S/PA-65 Schedules NRK-1 that it provides to nonresident partners. The partnership must submit copies of both Schedule RK-1 and Schedule NRK-1 it provides to trust and entity owners.

A partnership or limited liability partnership (LLP), jointly owned by husband and wife that elects to file on federal Form Schedule C, E or F with the Internal Revenue Service (IRS) files PA-40 Schedule C, E, or F with the *PA-40 Pennsylvania Income Tax Return*.

Partners are not employees and are not issued a W-2 form. The partnership must furnish copies of PA-20S/PA-65 Schedule RK-1 and/or NRK-1 to the partners before the PA-20S/PA-65 Information Return is required to be filed, including extensions.

The taxable year of a partnership with respect to a partner ends at the close of business on the day of:

- Disposition, when the partner sells his or her entire interest in the partnership;
- Redemption, when the partner liquidates his or her entire interest in the partnership; or
- The date of death of the partner.

The partnership apportions items of income, gain and expense or loss to a partner only for that portion of the partnership year when the partner was a member. It may be necessary to divide the partnership year into daily or other segments and treat each such segment as a separate accounting period in order to satisfy this rule.

- **PA-65 Corp – Directory of Corporate Partners**

A partnership, or limited liability company filing as a partnership, must complete the PA-65 Corp, Directory of Corporate Partners, if the partnership has income (loss) from operating a business, profession or farm within Pennsylvania, and/or income (loss) from the ownership of property within Pennsylvania and either of the following applies:

- If the entity has any partner that is a nonfiling corporation subject to corporate net income tax, and the partnership is making corporate net income tax withholding payments on behalf of its nonfiling corporate partner; or
- All of its partners are corporations.

Refer to the *PA-65 Corp* instructions on the department's website.

The PA-65 Corp, Directory of Corporate Partners, must be mailed separate from all other PA returns. Do not send corporate net income tax withholding payments to the Bureau of Corporation Taxes. See **Where To File** in the instructions for the PA-65 Corp, Directory of Corporate Partners on the department's website.

Any excess withholding will be refunded when the corporation's RCT-101, PA Corporate Net Income Tax Report, is filed and processed. The refund will be sent to the corporate partner and not the partnership

submitting the payment.

Processible Returns

The PA-20S/PA-65 Information Return for a partnership must satisfy all requirements found in the PA-20S/PA-65 instructions. The applicable PA-20S/PA-65 Schedules RK-1 and NRK-1 are required attachments for resident and nonresident owners' share of income, deductions, credits, etc. The partnership must also submit the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other entities. Refer to *Miscellaneous Tax Bulletin 2008-02 Reproduced Forms and Substitute Forms*.

Withholding of Estimated Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Resident Individual, Estate or Trust

Individual resident partners are subject to the estimated quarterly tax provisions under the Pennsylvania Personal Income Tax Act. Resident partners must make declarations and estimated quarterly Pennsylvania tax payments if they reasonably expect income, other than compensation on which Pennsylvania tax is withheld, to exceed \$8,000. Individual partners should refer to *REV-413I, Instructions for Estimating PA Personal Income Tax for Individuals Only*.

Withholding of Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Nonresident Individual, Estate or Trust

Under Act 22 of 1991, a partnership with partners or members who are nonresident individuals, nonresident estates, or nonresident trusts (owners) must withhold and pay Pennsylvania personal income tax on each owner's expected share of distributable Pennsylvania-source taxable income. If making a quarterly withholding payment for the first time, use *PA-40 ESR (F/C) Declaration of Estimated or Estimated Tax or Estimated Withholding Tax For Fiduciaries or Partnerships & Other Pass Through Entities*. The partnership makes the initial quarterly withholding payment and all future quarterly withholding payments under the employer identification number, name and address of the partnership.

The entity should refer to *REV-413P/S, Instructions for Estimating PA Personal Income Tax Nonresident Owners by Partnerships and PA S Corporations*.

Note: An entity may not withhold Pennsylvania personal income tax for another entity or a Pennsylvania resident individual and should not withhold Pennsylvania personal income tax on income from intangibles such as interest, dividends, or sale of stock.

Final/Catch-Up Payment of Nonresident Withholding Tax

If the Pennsylvania personal income tax due on the taxable income allocable to nonresidents exceeds the tax withheld, the final payment is due on the date prescribed for the filing of the PA-20S/PA-65 Information Return, PA-40 NRC, Nonresident Consolidated Income Tax Return or with an extension request.

If the tax of the nonresident owners exceeds the nonresident withholding tax payments, the partnership must pay the deficiency by the date prescribed for filing the entity's PA-20S/PA-65 Information Return or if the nonresident owners elect to file a PA-40 NRC, Nonresident Consolidated Income Tax Return, the entity may make the final/catch-up payment with the PA-20S/PA-65 Information Return, PA-40 NRC, Nonresident Consolidated Income Tax Return or with an extension request.

Refer to the PA-20S/PA-65 instructions on how to make a final withholding tax payment or final catch-up payment for nonresident owners that are individuals, estates, or trusts.

Mailing Address for the Nonresident Withholding Payment

When submitting the final withholding payment or final "catch-up" payment with the PA-20S/PA-65 Information Return, with or without the 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280502
HARRISBURG PA 17128-0502

When submitting the final withholding payment or final "catch-up" payment with the PA-40 NRC, Nonresident Consolidated Income Tax Return, with or without the 20XX Nonresident Withholding Payment substitute voucher,

send to:

PA DEPARTMENT OF REVENUE
CONSOLIDATED RETURN
PO BOX 280418
HARRISBURG PA 17128-0418

When submitting the final withholding payment or final “catch-up” payment with an extension request for any Pennsylvania tax return, send form REV-276, Application for Automatic Extension of Time to File, to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280504
HARRISBURG PA 17128-0504

Operations of a Partnership

- **Elections**

Pennsylvania law determines income (loss) under accepted accounting principles and practices. The partnership, not the partners, makes the choices for calculating income (loss) from the partnership’s activities. The partnership chooses the recognized methods of accounting, methods of calculating depreciation, capitalization of organizational fees, and the use of the installment sales provisions if eligible. All partnership elections are applicable equally to all partners but any election made by the partnership will not apply to any partner’s other income or gain outside the partnership. Pennsylvania law does not provide for all the elections that partnerships and partners may make for federal purposes, including the elections under IRC §§ 614; 1031; 732(d); 734(b); 754; 743(b); 59(e); 108; 617; 901, and 6222(b).

- **Federal Optional Adjustments to Basis**

For Pennsylvania purposes, the partnership may **not** adjust the basis of its property in the manner provided in IRC § 734(b) or IRC § 743(b). Pennsylvania does not permit the IRC § 732(d) or IRC § 754 election.

- **Determining a Partner’s Distributive Share**

The partnership must allocate each item of income (loss) by class to the partners in the same proportion that it uses for federal purposes. The partnership must submit a statement with its PA-20S/PA-65 Information Return explaining the reason for a different allocation method.

- **Guaranteed Payments to Partners**

There are differences between federal tax law and Pennsylvania tax law for reporting guaranteed payments to partners. The partnership characterizes guaranteed payments to partners in the following manner:

- To the extent paid for services rendered directly in the production of income from a business, profession or farm, the guaranteed payments to the recipient are gross income from that specific income class. If the partnership does not deduct these guaranteed payments on its federal return, it may deduct them to determine net profits on the PA20-S/PA-65 Information Return, Part I.

For nonresidents a guaranteed payment is allocable or apportionable to Pennsylvania to the same extent as the net profits are allocable or apportionable to Pennsylvania.

- To the extent paid for services rendered directly in the production of rental or royalty income, the guaranteed payments are gross income from that income class to the recipient. If the partnership does not deduct these guaranteed payments to determine rental income and royalty income on its federal return, it may deduct them to determine rental and royalty income on the PA20-S/PA-65 Information Return, Part III.

For nonresidents a guaranteed payment is allocable to Pennsylvania to the same extent as the rental and royalty income is allocable to Pennsylvania.

- To the extent paid for other services or for the use of capital, Pennsylvania classifies such distributions as:
 - A withdrawal proportionately from the capital of all partners.
 - A return of capital by the recipient to the extent derived from his/her own capital. The distributions that the partnership makes that represent repayments of the partner's own capital are not income for Pennsylvania personal income tax purposes.
 - A gain from the disposition of the recipient's partnership interest and a loss from the disposition of the other partners' partnership interests, to the extent derived from the capital of the other partners. The gain is taxable as follows:
 - Residents are taxed on 100 percent of their taxable gain.
 - For nonresidents a guaranteed payment for other services or for the use of capital is allocable to their state of residence. Nonresidents are not taxed on a guaranteed payment for the use of capital for Pennsylvania personal income tax purposes.

The partnership does not receive a deduction for a guaranteed payment if the guaranteed payment is for capital or other services.

- **Guaranteed Payments Example**

Andy, Betty, and Carl are equal partners in ABC partnership. Andy manages the rental activities of the partnership and receives an annual guaranteed payment of \$5,000 for such services. Betty contributed the rental property to the partnership. She receives an annual guaranteed payment of \$15,000 for its use. ABC partnership received net rents of \$80,000 for the taxable year. The \$5,000 guaranteed payment to Andy is an allowable deduction from the net rents of the partnership and is taxable to Andy as gross rents. The partnership calculates Andy's total rental income as follows:

Guaranteed payment		\$ 5,000
Share of partnership net rents	$(\$80,000 - 5,000) \div 3$	<u>\$25,000</u>
Total		\$30,000

Betty and Carl each have total rental income of \$25,000 $(\$80,000 - 5,000) \div 3$.

The guaranteed payment to Betty is a gain on the disposition of her partnership interest to the extent it is from Andy and Carl's capital. To the extent that the guaranteed payment is a return of Betty's own investment, it is a return of capital distribution. The partnership reflects this amount as guaranteed payments for capital on the *PA-20S/PA-65 Schedules RK-1 and NRK-1*. The return of capital distribution is not taxable if it does not exceed Betty's basis in the partnership.

- **Guaranteed Payments to a Retired Partner**

If the guaranteed payments to a retired partner meet the requirements of IRC § 1402, then the guaranteed payments to a retired partner may constitute nontaxable retirement benefits. 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:

- The above requirements are met; and
- 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:

- A distributive share of partnership income if the amount thereof is determined with regard to the income of the partnership;
 - A guaranteed payment; or
 - 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.
- **Federal Limitations on the Taxation of Retirement Income of Nonresident Partners**

Recent federal statutory changes prohibit states from taxing some retirement income of nonresidents. Public Law 109-264, signed Aug. 3, 2006, amends § 114 of Title 4 of the U.S. Code. The law provides that retirement payments made under a nonqualified plan maintained by a partnership and meeting specific criteria are taxable only by a state where the retired partner is a resident or where the retired partner is domiciled at the time the payments are received. To qualify for this tax treatment, the retirement payments must meet all of the following criteria:

 - The payments must be provided for in a written plan, program, or arrangement that was in effect before the partner's retirement;
 - The payments must be in recognition of prior service performed by the partner for the partnership; and
 - The payments must be made over the life or life expectancy of the recipient or over a period of at least 10 years, must be paid at least annually, and must be paid in substantially equal periodic payments.
 - **Cancellation of Indebtedness Income**

For additional information concerning cancellation of indebtedness, please refer to Pennsylvania Personal Income Tax Guide - Cancellation of Debt for Pennsylvania Personal Income Tax Purposes and related PIT Tax Bulletins 2009-02 through 2009-06.
 - **Allocation of Partnership Income and Losses**

A partner is taxed on ". . . his share, whether or not distributed, of the income or gain received by the partnership ", 72 P.S. § 7306. The partner's share of income (loss) is the same percentage as for federal income tax purposes. Because Pennsylvania does not have special partnership and partner rules or definitions, the department relies on the federal definition of "substantial economic effect." Where the allocation is consistent with the underlying economic arrangement of the partners and the allocation will substantially affect the dollar amount to be received by the partners, independent of any tax consequences, it is used or accepted. Absent such an effect, the department uses the partner's ownership interest for the allocation of income (loss).

Formation and Termination of a Partnership

- **Tax Free Formation of a Partnership**

Federal law permits the tax-free formation of a partnership under IRC § 721. IRC § 721 is generally followed for Pennsylvania tax purposes.
- **Contributions in Exchange for an Interest in a Partnership**

Neither the partnership nor its partners or members recognize gain or loss in the case of a contribution in exchange for an interest in the partnership, unless:

 - The purpose of the contribution was to affect an exchange of property between two or more partners, or
 - The contributing partner receives, in exchange for its contribution, an interest in the partnership plus other property or cash.
- **Partnership Distributions in Complete Liquidation**

Generally the amounts received by a partner in the complete actual winding up of a partnership and distribution of its assets (or the proceeds from the sale of its assets) shall be treated as in full payment in

exchange for the partner's interest in the partnership. Accordingly, if property is received in such a distribution, generally, the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

If a complete liquidation results in a loss to a partner on the partner's investment in the partnership, the loss is sourced to the partner's state of residence. The loss is classified as a net loss from a disposition of property.

A non-resident partner may not offset this non-Pennsylvania-source loss against Pennsylvania-source net gain or loss from dispositions of property. For example, if the partnership recognizes partnership gain in a foreclosure of partnership property, the non-resident partner may not apply the loss from liquidation of his or her investment against the gain resulting from the foreclosure on partnership property.

The amounts received in a complete liquidation are taxed under the above rules even if the distributions are not made in connection with settling the accounts and liquidating the assets of a partnership for the purpose of dissolving the partnership. The concept of an actual distribution of assets to its partners in the course of complete liquidation is distinct from the legal termination of the partnership.

An existing partnership continues until it terminates. A partnership terminates only when neither the partnership nor any of its partners continue the business, financial operation, or venture of the partnership.

- **Dissolving a Partnership**

Partnerships should visit PA Business One-Stop Shop (<http://business.pa.gov/>) for the appropriate procedures and applicable forms to complete when dissolving a partnership.

Basis of a Partner's Interest in a Partnership

To determine the basis of a partner's interest in a partnership, there are certain federal IRC sections, relating to basis adjustments that Pennsylvania personal income tax law does not allow. In addition, there are certain rules for Pennsylvania personal income tax purposes that are exclusive to Pennsylvania.

Note: A nonresident partner does not adjust basis, however he must determine whether he has sufficient economic investment to be able to utilize losses. [Refer to General Rules -Nonresident Partner.](#)

- **Definition of Outside Basis**

- **Partner's Outside Basis**

The purpose of outside tax basis is to keep track of the partner's adjusted basis in his or her partnership interest. It is the partner's after tax investment. It is also used to determine gain (loss) on the sale or other disposition of a partnership interest.

Outside basis is the individual partner's adjusted basis in his or her partnership interest. In general, a partner's outside basis is his or her separate tax capital account, which reflects adjusted basis, plus his or her share of the partnership's debt.

Initially, outside basis is determined by including the amount of the adjusted basis in the property contributed plus any cash contributed by the partner. If there are liabilities, outside basis includes the partner's share of all liabilities. In subsequent years, the outside basis is increased and decreased by partnership operations.

Outside basis is maintained by each individual partner outside of the partnership books. Outside basis is the calculation that most partners are concerned with because it is the basis that the taxpayer uses to limit losses, determine the taxability of partnership distributions, and calculate gain (loss) on the disposition of their partnership interest. Outside basis is calculated at the end of each partnership tax year.

The following is the calculation of a partner's outside basis based on IRC § 722 and IRC § 705(a).

o **Outside Basis – Adjusted Basis of a Partner’s Interest**

Adjusted basis in asset or cash contributed by the partner
- Liabilities of the partner assumed by the partnership
+ Partner’s share of partnership liabilities
+ Any gain recognized by the partner on the contribution of assets to the partnership
= Beginning Tax Basis

Then partnership operations during the year,

+ Taxable Income
+ Tax exempt Income
- Distributions from the partnership of cash or property
- Partnership expenditures that are neither deductible or capitalized by the partnership
- Oil and gas depletion, calculated at the partner’s level
- Losses
+/- Change in partner’s share of partnership’s liabilities
= Tax Basis at year-end

The year ending tax basis cannot be a negative balance.

• **Definition of Inside Basis**

o **Partner’s Inside Basis**

Inside basis is the partnership’s tax basis in its assets. For tax purposes, a partnership takes a carryover basis in the contributed property equal to the contributing partners’ adjusted basis in the property at the time of the contribution. Inside basis is the aggregate adjusted basis of all property contributed by all partners.

There is a close relationship between inside and outside basis. They both reflect the adjusted basis of the assets versus the fair market value. However, outside basis deals with each partner’s interest in the partnership assets they contributed and inside basis deals with all partners’ interests in the partnership assets aggregated together.

• **General Rules – Resident Partner**

Generally, the initial outside basis of a resident partner’s interest in the partnership is the amount of cash and the adjusted basis of property that the partner contributes.

If a partner contributes property that is subject to indebtedness or if the partnership assumes a partner’s debt, the contributing partner must reduce basis by the amount of the debt assumed by the other partners. The partnership’s assumption of the debt is a distribution of money to the contributing partner.

The assumption by the other partners of a portion of the contributing partner’s debt is a contribution to the partnership, and therefore, increases their basis.

If a partner’s interest in the partnership’s capital is for rendering past, present, or future service, the partner’s basis equals the income for those services. The partner recognizes that income when the partner performs the services and the partnership removes any restrictions on withdrawal or disposition of the income.

A partner’s outside basis in a partnership can never be less than zero.

A partner that acquires a partnership interest, other than by contributing money, property, or both, determines his or her basis in the partnership under general basis rules.

Important: The basis of a partnership interest acquired by purchase is the purchase price paid. The basis of

a partnership interest acquired by inheritance is the fair market value on the decedent's date of death. The basis of a partnership interest acquired by gift or otherwise, such as a joint tenant with right of survivorship, is the donor's basis.

- **Examples**

Example 1:

Tim acquired a 20 percent interest in a partnership by contributing property. At the time of Tim's contribution, the property had a fair market value of \$10,000 and an adjusted basis of \$4,000. The property was subject to a mortgage of \$2,000. The partnership assumed payment of the mortgage. Tim's basis in the partnership is \$2,400, calculated as follows:

Adjusted basis of the property contributed		\$4,000
Less the portion of the mortgage assumed by the other partners that must be treated as a distribution to Tim	(\$2,000 x 80%)	(\$1,600)
Basis of Tim's partnership interest		<u>\$2,400</u>

Example 2:

Use the facts from Example 1 above except that the mortgage on the property was \$6,000. Tim's basis in the partnership would be zero, calculated as follows:

Adjusted basis of the property contributed		\$4,000
Less the portion of the mortgage assumed by the other partners that must be treated as a distribution to Tim	(\$6,000 x 80%)	(\$4,800)
Basis of Tim's partnership interest		(\$800)

Since

Tim's basis cannot be less than zero, the \$800 in excess of basis is a distribution of money and a gain from the sale or exchange of Tim's partnership interest in excess of basis.

Example 3:

Facts: ABC partnership is formed. "A" contributes land with a basis of \$200. "B" contributes a building with a basis of \$300. "C" contributes \$400 cash. "A's" outside basis is \$200. "B's" outside basis is \$300. "C's" outside basis is \$400. ABC has an inside basis in the partnership assets of \$900 (\$200 in the land, \$300 in the building, and \$400 in cash).

- **Basis Calculation**

A partnership ordinarily determines its outside basis at the end of each taxable year. A partner must separately determine their outside basis. This amount may differ from the amount shown in the partnership's books as the partner's capital, equity, or similar account, or the partner's outside basis for federal income tax purposes.

The department requires the partnership to provide each partner with the information that each partner needs to calculate the Pennsylvania personal income tax outside basis of their partnership interest. Pennsylvania does not require partnerships to account for each partner's Pennsylvania personal income tax basis. Each partner must determine their Pennsylvania personal income tax basis, appropriately applying the Pennsylvania tax rules. The partner is responsible for tracking Pennsylvania personal income tax outside basis. The department requires *PA-40 Schedules RK-1* and/or *NRK-1* and a *PA-40 Pennsylvania Income Tax Return* be submitted for all years in which they were a partner.

- **Increase in Basis**

The original basis of a resident partner's interest increases by:

- Additional contributions to the partnership; and

- The partner's distributive share of:
 - The accumulated partnership taxable income;
 - The partnership's accumulated tax-exempt gross income (such as, permanent items having a nontaxable difference between book income and taxable income; interest on PA municipal bonds; or life insurance proceeds); and
 - Basis is increased when the partner's share of partnership liabilities is increased.
- **Decrease in Basis**

The basis of a partner's interest decreases, but not below zero, by:

 - Distributions by the partnership, which is the amount of money and the adjusted basis of property distributed to a partner. In computing the partner's adjusted basis, the partnership takes into account all distributions to a partner before any losses;
 - The sum of the partner's distributive share of partnership losses if the losses enabled the partner to reduce their Pennsylvania-taxable income or income tax liability to another state;
 - Nondeductible partnership expenditures that are not capital expenditures, i.e., partner's retirement contributions and partner's life and health insurance premiums; and
 - Basis is decreased when the partner's share of partnership liabilities is decreased.
- **Basis - Ordering Rules**

In calculating the partner's adjusted basis, the partner takes into account all distributions before any losses.
- **No Carry-Forward or Carry-Back of Losses**

For Pennsylvania purposes, neither the partnership nor the partners may carry-forward or carry-back any losses to other tax years.
- **No Offsetting Income (Loss) in More than One Class of Income**

Per Reg. 121.13 (a), "a person shall not be allowed to offset a gain in one class of income with a loss in another class of income".

Therefore neither the partnership nor the partner may offset income or gain in one class of income with a loss in another class of income.
- **General Rules – Nonresident Partner**

To determine the economic interest of a nonresident partner's interest in a partnership, there are certain rules for Pennsylvania personal income tax purposes that are specific and exclusive to the Pennsylvania nonresidents.

 - The economic investment of a nonresident partner's interest in the partnership is the amount of cash and the adjusted basis of property that the nonresident partner contributes.
 - If a nonresident partner contributes property that is subject to indebtedness or if the partnership assumes a nonresident partner's debt, the contributing nonresident partner must reduce economic investment by
 - the amount of the debt assumed by the other partners. The partnership's assumption of the debt is a distribution of money to the contributing nonresident partner. The

assumption by the other partners of a portion of the contributing nonresident partner's debt is a contribution to the partnership, and therefore, increases their basis or economic investment.

- If a nonresident partner's interest in the partnership's capital is for rendering past, present, or future service, the partner's economic investment equals the income for those services. The partner recognizes that income when the nonresident partner performs the services and the partnership removes any restrictions on withdrawal or disposition of the income.
 - All distributions to nonresident partners reduce the nonresident partners' economic investment in the partnership.
 - A nonresident partner cannot utilize losses of a partnership against other income in the same class of income if the nonresident partners' economic investment in the partnership is less than zero.
- **PA-20S/PA-65 Schedules RK-1 and NRK-1**
A partnership reports distributions on the partner's PA-20S/PA-65 Schedules RK-1 and/or NRK-1. Each resident partner must reflect distributions from the PA-20S/PA-65 Schedules RK-1 on the form [REV-999, Partner's Outside Tax Basis in a Partnership Worksheet](#) to determine whether such distributions are taxable.

Important: The partnership must provide information to the partner on straight-line depreciation so the partner can calculate basis in accordance with 72 P.S. § 7303(a.2).

Distributions of Cash, Property and Marketable Securities

- **Income to Partner**
Distributions that the partnership makes that represent cash, marketable securities, and other property that are not guaranteed payments may represent Pennsylvania-taxable income to the extent the distributions exceed the resident partner's adjusted outside basis.
- **Non-liquidating Distributions from Partnership to Partner**
With respect to non-liquidating distributions from a partnership to a resident partner, the partner's outside basis in their partnership interest is decreased to the extent of the partnership's Pennsylvania personal income tax adjusted basis in the property distributed to the partner. In non-liquidating distributions, a resident partner will recognize taxable income to the extent that the partnership's adjusted basis in the property distributed exceeds the resident partner's outside basis in the owner's partnership interest. Although not taxable to a nonresident partner, the nonresident partner reduces his or her economic investment by the partnership's adjusted basis in the property distributed.
- **General Rules Regarding the Treatment of Partner or Partnership Liabilities**
Pennsylvania law generally follows IRC § 752:
 - If the liabilities of a partnership increase, then each partner's share of the liabilities increases. Each partner's share of the increase is treated as a contribution of money to the partnership.

Example: Amy and Bob are equal partners in AB partnership. The partnership borrows \$1,000. Each partner's interest in the partnership increases by \$500. The partnership uses this rule regardless of its method of accounting.
 - If the liabilities of a partnership decrease, then each partner's share of the liabilities

decreases. Each partner's share of the decrease is treated as a distribution of money to the partners by the partnership. The partnership's distributions decrease the economic interest of the non resident partners in the partnership.

- If a decrease in liabilities exceeds the resident partner's basis in their partnership interest, then the excess constitutes a gain.
- A partner's percentage share of partnership liabilities ordinarily is the same as their percentage share of losses, unless the partnership agreement establishes otherwise, or by an express undertaking of a liability, such as a note.
- A decrease in a partner's personal liabilities, because the partnership assumes a portion of them, is a distribution of money to the partner. The contributing partner's basis decreases and the assuming partner's basis increases.
- When a partner contributes encumbered property, the corresponding decrease in the contributing partner's liability is a distribution of money to such partner. In addition, the liability attributable to the other partners is an increase in each other partner's basis.

Example: Ed, a resident partner, contributes property with a basis of \$10,000 in exchange for a one-third interest in a partnership. The property has a mortgage of \$1,500. Ed reduces the \$10,000 basis for the contributed property by \$1,000; two-thirds of his original liability of \$1,500 attributable to the other partners which reduces his basis in the partnership to \$9,000. The liability attributable to each of the other partners increases their basis.

- When a partner receives a non-liquidating distribution of partnership property subject to liability:
 - The receiving partner is treated as if he/she contributed money to the partnership by reason of the partner's assumption of the liability; and
 - All partners are treated as if they received money because of a decrease in the partner's share of partnership liabilities that occurred when the recipient partner assumed the debt from the partnership.
- When a partner sells or exchanges their partnership interest, the general rule for the treatment of liabilities applies.

Example: Alice, a resident partner, sells her partnership interest for \$750. At the same time she transfers to the buyer her pro rata share of the partnership's recourse liabilities of \$250 and the partnership's non-recourse liabilities of \$500. Alice's sale price is \$1,500. This is the amount she applies against the outside basis of her partnership interest to determine her gain (loss).

- A partnership's obligations for the payment of its outstanding trade accounts, notes, and accrued expenses are liabilities whether or not recorded on the partnership books under its method of accounting. Contingent liabilities, however, are not liabilities until they become fixed or liquidated.

Important: Take into account distributions and decreases in basis, before losses, in determining a resident partner's outside basis. Partners may not reduce their outside basis below zero for Pennsylvania personal income tax purposes.

- A partnership determines a partner's share of its partnership liabilities in accordance with the partner's ratio for sharing losses under the partnership agreement. However, where none of the partners have any personal liability with respect to a partnership non-

recourse liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage) then all partners, including limited partners, share this liability in the same ratio as they share the profits.

Example: In the GL partnership, Gene is a general partner, and Larry is a limited partner. Each made equal contributions of \$20,000 to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally. The partnership agreement limits Larry's liabilities to the extent of his contributions. The partnership pays \$10,000 for real property that is subject to a \$5,000 mortgage. Neither the partnership nor either partner assumes any liability for the mortgage. Gene and Larry increase their partnership interests by \$2,500 each, since each partner's share of the \$5,000 mortgage partnership liability increased by that amount. However, if the partnership assumed the mortgage so that Gene was personally liable, Gene's basis increases by \$5,000, and Larry's basis remains unchanged.

Debt Limitation

The partnership may take an amount of indebtedness into account only once. This rule applies even though the partner, in addition to being liable for the indebtedness as a partner, may be liable in a capacity other than as a partner.

IRS Investment Tax Credits

For Pennsylvania personal income tax purposes, a partnership need not reduce the basis of an asset by that percentage of the federal investment tax credit taken as required under the IRC.

Basis Reduction Rules for Depreciation

The PA Department of Revenue does not follow the federal tax benefit rules. 72 P.S. § 7303(a.2) states that the basis in property shall be reduced, but not below zero, for depreciation by the greater of:

- The amount deducted on the return and not disallowed, but only to the extent the deduction results in a reduction of income; or
- The amount allowable, using the straight-line method of depreciation, regardless of whether the deduction results in a reduction of income. The same useful life and salvage value used to calculate the depreciation claimed on the return should be used in the calculation of straight-line depreciation.

This adjustment is applied at the Pennsylvania personal income tax taxpayer level (*PA-40 Pennsylvania Income Tax Return, PA-41 PA Fiduciary Income Tax Return*).

- **Sole Proprietor**
The individual sole proprietor is required to reduce his basis in the assets used in the business by the amount deducted on the tax return. However, if the business incurs a loss in which the individual owner has no other income to offset, he is only required to reduce his basis in the assets by straight-line depreciation.
- **Partner**
For Pennsylvania personal income tax purposes, a partner must reduce his outside basis in the partnership by losses, but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income subject to the tax of another state or country. If the partner does not get the benefit of the losses from the partnership, the statute still requires him to reduce his outside basis in the partnership by his share of straight-line depreciation in the assets of the partnership.

The Pennsylvania basis reduction rule for depreciation applies to nonresident partners only to the

extent to verify that they have sufficient basis to reduce their PA-source income by their share of partnership loss. It does not apply to nonresident partners upon disposal of the partnership interest. Nonresidents are not taxed on the gain from the sale of intangibles nor allowed the loss. A partnership interest is an intangible asset. Losses from the sale of a partnership interest are not sourced to Pennsylvania for nonresidents.

This issue is addressed in *PIT Tax Bulletin 2005-02, Section 2*.

The partnership must provide the amount of straight-line depreciation on the PA-20S/PA-65 Schedules RK-1 and/or NRK-1.

Refer to [Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for Partners Outside Basis Calculation](#).

PENNSYLVANIA S CORPORATIONS

Definition of a PA S Corporation

- **Statutory Definition**

72 P.S. § 7301(n.1) states a "Pennsylvania S Corporation means any small corporation as defined in § 301(s.2) which does not have a valid election under § 307 in effect."

- **Small Corporation**

Per 72 P.S. § 7301(s.2), "Small corporation means any corporation which has a valid election in effect under subchapter S of chapter 1 of the IRC of 1986, as amended to January 1, 2005." For purposes of determining whether a corporation qualifies as a small corporation:

- A qualified subchapter S subsidiary (QSSS) owned by a small corporation shall not be treated as a separate corporation, and all gross receipts and passive investment income of such qualified subchapter S subsidiary shall be treated as earned by the parent corporation; and
- All inter-corporate payments or distributions between the parent corporation and any qualified subchapter S subsidiary owned by such corporation shall be disregarded.

Note: A corporation includes a business trust or limited liability company that the IRS classifies as a corporation for federal purposes except a business trust that qualifies as a real estate investment trust or a regulated investment company.

Differences Between Federal Tax Law and Pennsylvania Tax Law

For each class of income there are differences in reporting for federal income tax and Pennsylvania personal income tax. Within each class of income there are certain IRC sections including elections for federal income tax, which are not allowed in arriving at reportable income for Pennsylvania personal income tax purposes.

Within each class of income there are specific rules for Pennsylvania personal income tax purposes.

Within each class of income there are circumstances where Pennsylvania will accept the use of federal tax accounting rules provided they are consistently used and applied.

Refer to Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for PA S Corporations.

PA-20S/PA-65 PA S Corporation/Partnership Information Return and Schedules - Filing Requirements – PA S Corporation

Every domestic or foreign PA S corporation (72 P.S. § 7330.1) or an entity formed as a limited liability company that is classified as a PA S corporation for federal income tax purposes must file the *PA-20S/PA-65 PA S Corporation/Partnership Information Return (PA-20S/PA-65 Information Return)* if either of the following apply:

- During the taxable year, the PA S corporation or its qualified subchapter S subsidiary earned, received, or acquired any gross taxable income (loss) allocable or apportionable to Pennsylvania, regardless of the amount of its income (loss) and/or whether or not the income was distributed; and/or
- During the taxable year, the PA S corporation had at least one shareholder that was a Pennsylvania resident individual, estate, trust, disregarded entity owned by a resident individual or another pass through entity such as a PA S corporation or limited liability company.

PA S corporations must file a PA-20S/PA-65 Information Return to report the income, deductions, gains, losses etc. from its operations. The PA S corporation passes through any profits (losses) to the resident and nonresident shareholders. Shareholders include their share of the income (loss) on the *PA-40 Pennsylvania Income Tax Return*, *PA-41 Fiduciary Income Tax Return*, or other Pennsylvania returns.

Each PA S corporation must submit with the PA-20S/PA-65 Information Return a complete copy of its federal income tax return including all schedules, statements, federal Form 1120S Schedules K-1, along with the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other pass through entities, such as a partnership or limited liability company. With the PA-20S/PA-65 Information Return, the entity must also submit copies of the *PA-20S/PA-65 Schedule RK-1* that it provides to resident shareholders and copies of the *PA-20S/PA-65 Schedule NRK-1* that it provides to nonresident shareholders. The S corporation must submit copies of both a Schedule RK-1 and a Schedule NRK-1 to its trust owners.

Processible Returns

The PA-20S/PA-65 Information Return for an S corporation must satisfy all requirements found in the PA-20S/PA-65 instructions. The applicable PA-20S/PA-65 Schedules RK-1 and NRK-1 are required attachments for resident and nonresident owners' share of income, deductions, credits, etc. The S corporation must also submit the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other entities. Refer to *Miscellaneous Tax Bulletin 2008-02 Reproduced Forms and Substitute Forms*.

Withholding of Estimated Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Resident Individual, Estate or Trust

Individual resident shareholders are subject to the estimated quarterly tax provisions under the Pennsylvania Personal Income Tax Act. Resident shareholders must make declarations and estimated quarterly Pennsylvania tax payments if they reasonably

expect income, other than compensation on which Pennsylvania tax is withheld, to exceed \$8,000.

Individual shareholders should refer to *REV-413I, Instructions for Estimating PA Personal Income Tax for Individuals Only*.

Withholding of Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Nonresident Individual, Estate or Trust

Under Act 22 of 1991, a PA S corporation with shareholders who are nonresident individuals, nonresident estates, and nonresident trusts (owners) must withhold and pay Pennsylvania personal income tax on each owner's expected share of distributable Pennsylvania-source taxable income. If making a quarterly withholding payment for the first time, use *PA-40 ESR (F/C) Declaration of Estimated Tax or Estimated Withholding*

Tax for Fiduciaries, Partnerships & Other Pass Through Entities. Associations and PA S corporations may also use this form. The PA S corporation makes the initial quarterly withholding payment and all future quarterly withholding payments under the employer identification number, name, and address of the PA S corporation.

The entity should refer to *REV-413P/S, Instructions for Estimating PA Personal Income Tax Nonresident Withholding by Partnerships and PA S Corporations*.

Note: An entity may not withhold Pennsylvania personal income tax for another entity or a Pennsylvania resident individual, and should not withhold Pennsylvania personal income tax on income from intangibles such as interest, dividends, or sale of stock.

Final/Catch-Up Payment of Nonresident Withholding Tax

If the Pennsylvania personal income tax due on the taxable income allocable to nonresidents exceeds the

tax withheld, the final payment is due on the date prescribed for the filing of the PA-20S/PA-65 Information Return, PA-40 NRC, Nonresident Consolidated Income Tax Return or with an extension request.

If the tax of the nonresident owners exceeds the nonresident withholding tax payments, the PA S corporation must pay the deficiency by the date prescribed for filing the entity's PA-20S/PA-65 Information Return or if the nonresident owners elect to file on a PA-40 NRC, Nonresident Consolidated Income Tax Return, the entity may make the final/catch-up payment with the PA-20S/PA-65 Information Return, PA-40 NRC, Nonresident Consolidated Income Tax Return or with an extension request.

Refer to the PA-20S/PA-65 instructions on how to file a final withholding tax payment or final catch-up payment for nonresident owners that are individuals, estates, or trusts.

Mailing Address for the Nonresident Withholding Payment

When submitting the final withholding payment or final "catch-up" payment with the PA-20S/PA-65 Information Return, with or without the 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280502
HARRISBURG PA 17128-0502

When submitting the final withholding payment or final "catch-up" payment with the PA-40 NRC, Nonresident Consolidated Income Tax Return, with or without 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
CONSOLIDATED RETURN
PO BOX 280418
HARRISBURG PA 17128-0418

When submitting the final withholding payment or final "catch-up" payment with an extension request for any Pennsylvania tax return, send form REV-276 to-

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280504
HARRISBURG PA 17128-0504

Operations of a PA S Corporation

- **How Does a Corporation Become a PA S Corporation**
Effective for tax years beginning on or after Dec. 31, 2005, any corporation with a valid federal S corporation election is automatically a PA S Corporation.
- **Effect of PA S Corporation Status**
S corporation shareholders include their share of the corporation's separately stated items of income, deduction, loss, and credit, and their share of non-separately stated income (loss) on their tax returns.

A PA S corporation will only be subject to the corporate net income tax on its net recognized built-in gain reported on federal Schedule D, federal Form 1120S. If any tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation) pursuant to § 1374 of the IRC of 1986, the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

The PA S corporation passes its income (loss), and credits to its shareholders in the applicable

class of income taxable under the Pennsylvania personal income tax rules and regulations.

- **Election Not to Be Taxed as a PA S Corporation**

Starting with tax years beginning on or after Dec. 31, 2005, a corporation with a valid federal S election is no longer required to file *REV-1640, PA S Corporation Election and Shareholders' Consent* in order to be a PA S corporation. Under Act 67 of 2006, Senate Bill 300 PN 1986, all federal S corporations are PA S corporations. Act 67 also includes a provision for federal S corporations to make an election NOT to be taxed as a PA S corporation. To make this election, the taxpayer is required to file *REV-976, Election Not to be Taxed as a Pennsylvania S Corporation* on or before the due date or extended due date of the report for the first period in which the election is to be in effect.

Example: A federal S corporation that does not want to be a PA S corporation for the tax year ending Dec. 31, 20X1 must file *REV-976, Election Not to be Taxed as a Pennsylvania S Corporation* on or before April 15, 20X2. If the taxpayer has a valid extension to file the *RCT-101, PA Corporate Net Income Tax Report*, then *REV-976* would be due on or before Oct. 15, 20X2.

Note: *REV-1640, PA S Corporation Election and Shareholders' Consent*, became an obsolete form as of Dec. 31, 2005.

- **Pennsylvania Resident Shareholders of S Corporations in Another State**

Any federal S corporation that does not make this election and is an S corporation in another state that has a Pennsylvania resident shareholder will be taxed as a PA S corporation and is required to file a PA-20S/PA-65 Information Return. The entity is not required to file the *RCT-101, PA Corporate Net Income Tax Report* as was previously reported in June/July 2006, *PA Tax Update #121*. In addition, each shareholder will be subject to Pennsylvania personal income tax on each shareholder's pro rata share of the S corporation income, whether distributed or not.

- **Revocation of Election Not To Be Taxed as a PA S Corporation**

First, it is important to remember the election to not be taxed as a Pennsylvania S corporation may not be revoked for five years from the date it went into effect. A revocation received within this five year period will be effective for the first tax period for which the taxpayer is eligible to revoke the election.

Elections which first went in effect in 2006 may be revoked for 2011. To revoke the election the corporation must send a letter signed by shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made. This letter must contain the name of the corporation, the federal employer identification number (FEIN), the Revenue ID number and the effective date of the revocation. If no effective date is provided

the revocation will be effective for the first tax period for which the revocation was timely submitted. In the case of a corporation with qualified subchapter S subsidiaries, the letter must include the names and Revenue ID numbers of all qualified subchapter S subsidiaries doing business in Pennsylvania. Mail the letter to:

PA DEPARTMENT OF REVENUE
BUREAU OF CORPORATION TAXES
PROCESSING DIVISION
PO BOX 280705
HARRISBURG PA 17128-0705

The deadline for revocation of an election not to be taxed as a Pennsylvania S corporation is the 15th day of the third month of the year in which the revocation is to be in effect. A revocation submitted after the due date will be in effect for the next tax period.

- **Qualified Subchapter S Subsidiaries (QSSS)**
Pennsylvania personal income law does not treat a qualified subchapter S subsidiary (QSSS) owned by a PA S corporation (parent) as a separate corporation for personal income tax.

Pennsylvania personal income tax law treats all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary as assets, liabilities, and items of income, deduction, and credit of the parent PA S corporation for income tax purposes.

The parent PA S corporation must report the assets, liabilities, and items of income, deduction, and credit of the qualified subchapter S subsidiary on the parent's PA-20S/PA-65 Information Return.

Note: Shareholders receive the income distribution from the parent corporation not from each qualified subchapter S subsidiary.

The following provisions apply only to a qualified subchapter S subsidiary in Pennsylvania:

- A qualified subchapter S subsidiary cannot elect corporation treatment independent of its parent corporation.

If a qualified subchapter S subsidiary and/or parent of a qualified subchapter S subsidiary does not desire to be taxed as a PA S corporation, the parent must file form REV-976, Election Not to be Taxed as a Pennsylvania S Corporation, for itself and all qualified subchapter S subsidiary (s). The parent corporation submits a schedule with the election, identifying the name, address, Revenue ID if applicable, and federal employer identification number (FEIN) of each qualified subchapter S subsidiary owned by the corporation and doing business in Pennsylvania.

- The parent corporation is not required to register with the Department of State if its only activity in Pennsylvania is its investment in the qualified subchapter S subsidiary that is registered in Pennsylvania. If the qualified subchapter S subsidiary is not registered, then either the parent or the qualified subchapter S subsidiary must register.

Additionally, the parent is required to file a PA-20S/PA-65 Information Return and list the qualified subchapter S subsidiary(s) on Part IX and include all qualified subchapter S subsidiaries' items of income, deduction and credit on the return. There is no ownership percentage for the qualified subchapter S subsidiary because it is a division of the parent company.

Since the qualified subchapter S subsidiary is a division of the parent company, the qualified subchapter S subsidiary is not included on the Partner/Member/Shareholder Directory. Only the owners of the parent company are listed on the directory.

Note: The parent PA S corporation may also file the PA-40 NRC, Nonresident Consolidated Income Tax Return, for its nonresident individual owners if the nonresident individual owners meet the parameters. Refer to the PA-40 NRC instructions on the department's website for further information.

Termination of a PA S Corporation - Corporate Distributions in Complete Liquidation

Generally, the amounts received by a shareholder in the complete actual winding up of a PA S corporation and distribution of its assets (or the proceeds from the sale of its assets) shall be treated as a full payment in exchange for the shareholder's stock. Accordingly, if property is received in such a distribution, generally, the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution. However, if the amounts are received pursuant to a tax-free reorganization to which the PA S corporation is a party, no sale, exchange or other disposition is recognized, and the basis of the property in the hands of the

distributee shall be the corporation's adjusted basis at the time of the distribution.

The amounts received in a complete liquidation are taxed under the above rules even if the distributions are not made in connection with settling the accounts and liquidating the assets of a corporation for the purpose of dissolving the corporation. The concept of an actual distribution of assets to its shareholders in the course of complete liquidation is distinct from the legal termination of the entity.

Termination of PA S Corporation Status

A corporation's PA S corporation status remains effective until it is terminated by the IRS or the federal election was revoked. If the corporation is no longer a federal S corporation, the PA S status is automatically terminated. No separate revocation of the PA S status is required.

PA S Corporation Revocation or Termination Year

A PA S corporation revocation or termination year is the tax year of a PA S corporation in which the corporation is treated as a PA S corporation for part of the tax year and a corporation subject to corporate net income tax for the balance of the tax year.

The PA S corporation revocation or termination year is divided into two periods for filing tax returns. These periods are known as:

- The PA-20S/PA-65 Information Return short taxable year; and
- The RCT-101, PA Net Income Tax Report short taxable year.

The corporation must file two returns to cover the revocation or termination year; one that covers the PA-20S/PA-65 Information Return short taxable year and one that covers the RCT-101, PA Corporate Net Income Tax Report short taxable year and includes:

- **PA-20S/PA-65 Information Return Short Taxable Year Return**

The *PA-20S/PA-65 Information Return* short taxable year is the part of the termination year that begins on the first day of the corporation's tax year and ends the day before the termination is effective.

The PA-20S/PA-65 Information Return that is due for the short taxable year is due 3½ months after the last day of the tax year.

- **RCT-101, PA Corporate Net Income Tax Report Short Taxable Year Return**

The RCT-101, PA Corporate Net Income Tax Report, short taxable year is the part of the PA S corporation revocation year that begins on the day the termination is effective and ends on the last day of the corporation's tax year. The *RCT-101, PA Corporate Net Income Tax Report*, is due for the corporate net income tax short year.

The *RCT-101, PA Corporate Net Income Tax Report*, for the short taxable year is due 30 days after the date on which the corporation's federal tax return is due.

- **Division of Income**

After the PA S corporation termination year is divided into two periods, the separately stated items of income, loss and credit, and the amount of the non-separately calculated income or loss must be divided between the periods. There are two methods that can be used to make this division:

- **Pro Rata Allocation**

This method of allocation must be used unless the shareholders and the PA S corporation specifically choose the other allocation method discussed under [Allocating Based on Normal Accounting Rules](#).

The pro rata allocation is made as follows:

- First determine the amount of each separately stated item of income, deduction,

loss or credit, and the amount of the non-separately calculated income or loss.

- Then divide each amount by the number of days in the PA S corporation revocation or termination year (total tax year).
 - Multiply the amounts from the second step above by the number of days in the S corporation's short taxable year. Use these amounts to file the PA-20S/PA-65 Information Return for the short taxable year.
 - Multiply the amounts from second step above by the number of days in the *RCT-101, PA Corporate Net Income Tax Report* short taxable year. Use these amounts to file the RCT-101, PA Corporate Net Income Tax Report for corporate net income tax short year.
- **Allocation Based on Normal Accounting Rules**
A normal accounting rules basis is the alternate method of allocation. The corporation must choose this method and all persons who are shareholders during the PA S corporation revocation or termination year must consent to the choice. The corporation will then report all items of income, loss, or credit based on the corporation's books and records (including worksheets). Therefore, the items will be split between the PA-20S/PA-65 Information Return short taxable year and the RCT-101, PA Corporate Net Income Tax Report short taxable year according to the time they were realized or incurred based on the books and records of the corporation.

Allocation of Income

Shareholders who are nonresident individuals, estates, or trusts are taxed only on taxable income allocable or apportionable to Pennsylvania. Items of income (loss), cost, expense, and liability not allocable to Pennsylvania are ignored in computing the PA-taxable income of such shareholders.

Special allocation rules apply to each of the following:

- Net income or loss from trusts, estates, partnerships, and other PA S corporations;
 - Net income or loss from business, profession or farm activities;
 - Net gains or losses from the sale, exchange or disposition of tangible or real property;
 - Net gains or losses from the sale, exchange or disposition of intangible personal property;
 - Net rental income or loss from ownership of property.
- **Cancellation of Debt Income**
For additional information concerning cancellation of indebtedness income, please refer to the PA Personal Income Tax Guide - Cancellation of Debt for PA Personal Income Tax Purposes and PIT Tax Bulletins 2009-02 through 2009-06.
 - **Built-In Gains**
If any tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation) pursuant to § 1374 of the IRC of 1986, the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax. The built-in gains taxes imposed on the PA S corporation are treated as losses to be reported to the shareholders. The losses are allocated to the class of income that gave rise to the built-in gain and may be deducted by the shareholders. Tax for built-in gains is reported on the *RCT-101, PA Corporate Net Income Tax Report*.

- **Gain Rules**

There are differences between federal income tax reporting and Pennsylvania personal income tax reporting. Refer to the *PA-20S/PA-65 Schedule D instructions* on the department's website.

Ordering Rules for Adjustments to Shareholders' Stock and Debt Basis

Each shareholder must adjust his or her basis of stock and basis of indebtedness in a PA S corporation in the following order:

- **Income Items**

Each shareholder's pro rata share of the following items increases the basis of stock or is applied to restore their basis of indebtedness:

- Non separately stated net profits from business, profession, and farm that are passed through to the shareholder;
- Separately stated other personal income items passed through to the shareholder; and
- Nontaxable income.

- **Distributions**

- Distributions other than dividend distributions

- **Items of Loss and Deduction**

Each shareholder's pro rata share of the following items decreases the basis of stock and debt, but not below zero:

- Non separately stated losses from business, profession or farm activities that are passed through to the shareholder;
- Separately stated other personal loss items that are passed through to the shareholder; and
- Nondeductible expenses.

Basis is reduced only to the extent that the losses reduce the shareholder's income subject to Pennsylvania personal income tax or a tax on or measured by income imposed on the shareholder by any other state.

If losses are not used, basis must be reduced by the shareholder's share of straight-line depreciation. Percentage of unused loss is multiplied by the shareholder's share of straight-line depreciation.

Basis of a Shareholder's Interest in a PA S Corporation

There are differences between federal income tax and Pennsylvania personal income tax reporting at the entity level. Section 307.11 of the Tax Reform Code of 1971, 72 P.S. § 7307.11, provides rules for how the basis of the stock or debt of a shareholder in a Pennsylvania S corporation must be adjusted. The shareholder's basis and debt are adjusted in the order specified above in the Ordering Rules for Adjustment to Shareholders' Stock and Debt Basis.

- **Limitation on Losses and Loss Carryovers**

The aggregate amount of losses taken into account by a shareholder is limited to the sum of the adjusted basis of the shareholder's stock for the tax year and the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder figured after increases for items of income and decreases for non-dividend distributions. A shareholder may not claim loss and deduction items in excess of their adjusted stock and debt basis. Loss and deduction items not allowable in the current year are foregone. There is no provision allowing for carryover of losses by the shareholders of the corporation.

- **No Carry-Forward or Carry-Back of Losses**

For Pennsylvania purposes, neither the S corporation nor the shareholders may carry-forward or carry-back any losses to other tax years.

- **No Offsetting Income or Losses in More than One Class of Income**

Per Reg. 121.13 (a), “a person shall not be allowed to offset a gain in one class of income with a loss in another class of income”.

Therefore neither the S corporation nor the shareholders may offset income or gain in one class of income with a loss in another class of income.

Shareholder Adjustments to Basis of Indebtedness (Shareholder’s Loans to PA S Corporations)

- **Reduction in Basis of Indebtedness**

If the shareholder’s basis of stock in a PA S corporation is decreased to zero, any amount of excess losses shall be used to reduce the shareholder’s basis of indebtedness of the PA S corporation to the shareholder, but not below zero.

- **Repayment of Shareholder Loans**

If an S corporation repays a shareholder loan, part or all of the repayment triggers a taxable gain to the shareholder. If the entire loan is repaid, the portion of the debt basis that has been used to take losses against other income is then taxable. If a portion of the loan is repaid, the taxable portion of the repayment is calculated as follows: $((\text{Face amount of the loan} - \text{debt basis}) / \text{Face amount of the loan}) \times \text{Amount of loan repayment} = \text{Taxable gain}$.

- **Restoring Basis**

If the shareholder’s basis in indebtedness is reduced under “1” above, the reduction shall be restored before the shareholder’s basis in the stock of the PA S corporation is increased.

Adjustments to Basis for PA S Corporation Distribution

- **Determine Stock and Loan Basis**

Determine the year-end stock basis excluding all tax year distributions. This is the adjusted basis figure used in the determination of the tax treatment of any distributions during the tax year.

- **PA S Corporations with no Pennsylvania Personal Income Tax Accumulated Earnings and Profits (AE&P)**

Distributions from a corporation with no accumulated earnings and profits for Pennsylvania personal income tax purposes are a nontaxable reduction to the stock basis.

- **PA S Corporations with C Corporation Accumulated Earnings and Profits**

Distributions from a corporation in excess of accumulated adjustments account (AAA) with earnings and profits for Pennsylvania personal income tax purposes is handled as follows:

- Reduce the distribution by the pro rata share of the accumulated adjustments account;
- The excess of the distribution over the members share of accumulated adjustments account is a taxable dividend to the extent of the shareholder's pro rata share of the accumulated earnings and profits of the corporation;
- The excess of the distribution beyond accumulated adjustments account and accumulated earnings and profits is a nontaxable reduction to the basis; (Cannot go below zero.)
- Any distributions in excess of basis calculated above are treated as gain from the sale, exchange or disposition of property.

For a nonresident, all distributions are nontaxable. The nonresident's economic investment is reduced by the fair market value of the distribution. A nonresident cannot deduct losses in excess of his/her/its economic investment.

In summary, distributions are:

- Nontaxable to the extent of the accumulated adjustments account to the extent of basis;
- Taxable as dividends to the extent of corporate accumulated earnings and profits;
- Nontaxable return of capital to the extent of basis;
- Taxable as a gain from the sale, exchange or distribution of property.

PA S Corporation Distributions

- **Distributions to Residents**

A distribution that a PA S corporation pays from the accumulated earnings and profits of the corporation before it elected PA S status is dividend income to its resident shareholders. All other distributions represent a nontaxable return of the resident shareholders' basis in its stock.

Nontaxable return of basis distributions will reduce each resident shareholder's basis in the stock. If the distribution exceeds the shareholder's basis in the stock, the resident shareholder must report a gain from the disposition of property.

- **Distributions to Nonresidents**

All distributions to nonresident shareholders reduce the nonresidents' economic investment in the PA S corporation. Distributions are nontaxable.

- **Distribution of Appreciated Property**

If the PA S corporation distributes appreciated property, it must treat the distribution as if it had sold the property to the shareholders at fair market value. Such a distribution will produce a gain from the sale of property that the PA S corporation will have to report as net gain (loss) from the sale, exchange, or disposition of property.

- **PA-20S/PA-65 Schedule RK-1 and NRK-1**

A PA S corporation must report distributions on the shareholder's *PA-20S/PA-65 Schedules RK-1 and NRK-1*.

- **Residents**

Each resident shareholder must reflect distributions on the *PA-20S/PA-65 Schedule RK-1* and on form [REV-998 Shareholder Tax Basis in PA S Corporation Stock Worksheet](#) to determine whether such distributions are taxable.

- **Nonresidents**

Distributions to nonresidents are not taxable.

Accumulated Adjustments Account

- **Pennsylvania Personal Income Tax Accumulated Adjustments Account**

Pennsylvania accumulated adjustments account should not equal the federal accumulated adjustments account because of the differences between the federal tax law and Pennsylvania personal income tax law. Pennsylvania generally parallels federal rules for the PA S corporation's accumulated adjustments account with these significant differences:

- The PA S corporation accumulated adjustments account only reflects the income (loss) or distribution from the inception of PA S corporation status.
- The PA S corporation does not make an adjustment for any income (loss) that is not

enumerated in Pennsylvania personal income tax law or any nondeductible expense. For example, for Pennsylvania personal income tax purposes, tax-exempt income is not added to the Pennsylvania personal income tax accumulated adjustments account.

- The Pennsylvania accumulated adjustments account is based on the Pennsylvania personal income tax income (loss) or distributions.
- **Distributions from Pennsylvania Accumulated Adjustments Account**
Distributions to a resident shareholder from Pennsylvania accumulated adjustments account are tax free to the resident shareholder unless the Pennsylvania accumulated adjustments account exceeds the resident shareholder's basis in his/her/its stock.

The resident shareholder will recognize taxable income to the extent that the Pennsylvania accumulated adjustments account distribution exceeds the shareholder's basis in his/her/its stock. Although not taxable to a nonresident shareholder, the nonresident shareholder reduces his/her/its economic investment by the fair market value of the property distributed.

- **Distributions of Cash, Marketable Securities, and Property (other than distribution from Pennsylvania Accumulated Earnings and Profits)**
Distributions of cash, marketable securities and property (in excess of Pennsylvania accumulated adjustments account) are considered a tax-free return of investment to the extent of the resident shareholder's basis in his/her/its stock. The resident shareholder will recognize taxable income to the extent that the fair market value of such distribution exceeds the shareholder's basis in his/her/its stock. Although not taxable to a nonresident shareholder, the nonresident shareholder reduces their economic investment by the fair market value of the property distributed.
- **Accumulated Adjustments Account Distributions May Exceed Shareholder Basis**
Distributions that the PA S corporation makes that represent cash, marketable securities, and other property may represent Pennsylvania-taxable income to the extent the distributions exceed the resident shareholder's basis in his/her/its stock.
- **Negative Accumulated Adjustments Account**
Pennsylvania follows the federal rule in that the PA S corporation's accumulated adjustments account may become negative because of losses not distributions.

The accumulated adjustments account is a corporate account. Future income must be used to restore the negative closing balance of Pennsylvania accumulated adjustments account before the PA S corporation can make PA tax-free distributions.

Accumulated Earnings and Profits

Pennsylvania follows the federal tax laws regarding the calculation of accumulated earnings and profits. Accumulated earnings and profits is a measure of the undistributed earnings of a C corporation, but from a tax point of view. C corporations generate positive or negative accumulated earnings and profits each year, calculated by making annual adjustments to taxable income.

When a C corporation becomes a PA S corporation, the accumulated earnings and profits retains its character. The PA C corporation's accumulated earnings and profits is frozen on the date the corporation converts to PA S status. The accumulated earnings and profits generally will not increase except when the corporation acquires another corporation with accumulated earnings and profits. However, it can be reduced by distributions from accumulated earnings and profits and the payment by the PA S corporation of C corporation period tax.

The tax treatment of distributions made by an S corporation is partially determined based on whether the corporation has accumulated earnings and profits. The shareholder's stock basis must also be considered because distributions in excess of basis always result in taxable income to the shareholder.

Federal subchapter S corporations that have been Pennsylvania S corporations throughout their corporate existence always should have tracked their Pennsylvania adjustments account and Pennsylvania accumulated earnings and profits, if applicable, to provide the information required for resident shareholders to correctly report distributions.

Federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006 similarly should track Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits. However, it may be extremely difficult to obtain the necessary information to calculate the initial Pennsylvania accumulated earnings and profits.

There are significant differences among the federal accumulated adjustments account, Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits calculations.

The Pennsylvania Department of Revenue will allow a transitional election by federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006. The department may allow a "new" Pennsylvania S corporation taxpayer to elect to use its federal accumulated adjustments account as the functional equivalent of its Pennsylvania accumulated earnings and profits.

This election may be filed with the *PA-20S/PA-65 PA S Corporation/Partnership Information Return*. Attach a statement indicating the PA S corporation elects to use its federal accumulated adjustments account to calculate the amounts reported as dividends from accumulated earnings and profits. Report those amounts on PA-20S/PA-65 Schedule RK-1, Line 15 and PA-20S/PA-65 Schedule NRK-1, Line 13.

Both C corporations and PA S corporations can distribute taxable dividends to the extent they have accumulated earnings and profits. Although PA S corporations do not generate accumulated earnings and profits, they can have accumulated earnings and profits from:

- C corporation operations during any period in which the corporation did not have a valid S corporation election in effect, or
- Being a party to a reorganization whereby the S corporation acquires the assets of another corporation that has accumulated earnings and profits.

Accordingly, a PA S corporation will not have accumulated earnings and profits if it:

- Was never a C corporation, or
- Has not acquired another corporation with accumulated earnings and profits.

Refer to [Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for PA S Corporations Outside Basis Calculation](#).

IRC Section 338(h)(10) Elections Not Permitted

IRC § 338(h)(10) election is an election whereby a selling group and buying corporation can elect jointly to have the selling group recognize gain or loss as if the target corporation sold its assets while still a member of the selling group. There is no income tax on the sale of the stock to the acquiring company. The income tax attributes of the target company stay with the selling parent company, which is responsible for taxes on the deemed sale of asset. The deemed sales price is determined under the modified aggregate deemed sales price method, which depends on the actual purchase price of the stock, adjusted for liabilities and other relevant items.

Pennsylvania personal income tax law does not recognize IRC § 338(h)(10) elections. Accordingly, the sale of a share of stock in a PA S corporation is never treated as a sale of the shareholder's proportionate interest in each asset of that corporation; nor is there any basis under Pennsylvania personal income tax law for treating a target PA S corporation as if it had sold all of its assets at the close of the acquisition

date at fair market value in a single transaction and then repurchased all of the assets at the beginning of the day after the acquisition date if no such sale and repurchase actually occurred.

For Pennsylvania personal income tax purposes, gain recognized by shareholders under IRC § 338 is “deemed gain” from the sale of assets that is not to be taken into account.

However, the resident shareholders must report their gain or loss on the sale of stock on *PA-40 Schedule D, Sale, Exchange, or Disposition of Property*.

A resident shareholder may claim a resident credit for taxes paid to another state on Schedule D gain resulting from an IRC § 338(h)(10) transaction. Refer to PA Personal Income Tax Guide – Deductions and Credits.

Treatment of Life Insurance Proceeds Received by a PA S Corporation Where S Corporation Paid Premiums

- **Proceeds Used to Fund a Buy or Sell Arrangement**
No expense deduction is allowed for life insurance premiums if the life insurance proceeds are to be used to fund a buy or sell arrangement. The proceeds payable upon death are not taxable at the shareholder level.
- **Proceeds Used to Buy-Out a Decedent’s Interest**
No expense deduction is allowed to free up funds to buy-out a decedent’s interest. The proceeds are not taxable at the shareholder level.
- **Proceeds Used to Continue Business or Secure Loans**
72 P.S. § 7303(a)(6) defines interest income as any amount paid under contract of life insurance...which is includable for federal income tax purposes. However, if the exclusive purpose of the policy is to keep the business going, including the use of the insurance policy to secure business loans, the insurance premiums are deductible by the PA S Corporation and the life insurance proceeds are taxable. These proceeds are included in the PA S Corporation’s business income from operations.

BONUS DEPRECIATION

Under Pennsylvania personal income tax law, a PA S corporation or partnership may not use any of the bonus depreciation elections enacted for federal purposes.

Other Depreciation Expense Difference

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 as amended to Jan. 1, 1997.

Additionally, for any year in which an ACRS or MACRS deduction is allowed or allowable and regardless of the method of accounting:

- The S corporation or partnership must reduce its basis in the depreciable property by the amount of depreciation regardless if it 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.

IRC Section 179 Property Deductions

Pennsylvania tax law allows IRC § 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 Internal Revenue Code in effect on Jan. 1, 1997. For example, the aggregate dollar limitation is \$25,000 less the amount by which the cost of IRC § 179 property placed in service during the taxable

year exceeds \$200,000. Federal increases enacted after 1997 are disregarded for personal income tax purposes.

The deduction limits apply both to the business entity and the owner. Each entity calculates its § 179 expenses and applies the limit. The expenses (subject to the limit) are then passed through to the owner. The owner then adds up all § 179 expenses passed through to him/her from all business entities. The owner then applies the § 179 limit to the sum. The result is the owner's allowable § 179 deduction.

Additionally, for any year in which an IRC § 179 property deduction 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 Informational Notice- Personal Income Tax 2012-05.

APPORTIONMENT

How to Apportion Income From a Business, Profession or Farm Derived From Sources within Pennsylvania, Wholly Outside Pennsylvania, or Partly Within Pennsylvania

- **Operation Wholly Within Pennsylvania**

If the operation of the business is wholly within Pennsylvania, the entity allocates income (loss) exclusively to Pennsylvania. The operation of a business is wholly within Pennsylvania if, during the entire taxable year:

- The entity, or its representative, maintained or operated within Pennsylvania an office, shop, store, warehouse, factory, agency, or
- Commercial establishment where it systematically and regularly conducted or managed such business; and
- The entity, or its representative, did not maintain and operate outside Pennsylvania any office, shop, store, warehouse, factory, agency, or commercial establishment where it systematically and regularly conducted or managed such business.

For purposes of this rule, do not take into account any establishment maintained or operated by a representative of a PA S corporation or partnership if the representative acted as an independent contractor.

- **Operation Wholly Outside Pennsylvania**

If the operation of the business is wholly outside Pennsylvania, the entity cannot allocate or apportion to Pennsylvania any item of income (loss), cost, or expense that it derives or incurs. The operation of a business is wholly outside Pennsylvania if, during the taxable year:

- The entity does not conduct in Pennsylvania any acts or transactions in the ordinary course of operating its business; or
- The entity only conducts in Pennsylvania acts or transactions in the ordinary course of operating its business that, with a fair measure of permanency or continuity, are either or both of the following:
 - The solicitation of orders or sales of tangible personal property which are sent outside Pennsylvania for approval or rejection and, if approved, are filled by shipment or delivery of goods or services from a point outside Pennsylvania; or
 - The solicitation of orders in Pennsylvania by the entity or entity representative, to a prospective customer, and such customer sells entity's product to its customers via solicitation as described in bullet point above.

For purposes of the above, an entity is not engaged in business activities within Pennsylvania during a taxable year merely by reason of sales of tangible personal property in Pennsylvania or the solicitation of orders for sales of tangible personal property in Pennsylvania on behalf of the entity by one or more independent contractors that maintain an office in Pennsylvania solely for

making sales or soliciting orders for sales.

- **Operation Partly Within Pennsylvania**

When an entity operates a business that is neither wholly within nor wholly outside Pennsylvania under the above definitions, it allocates by separate accounting if:

- The business operations within Pennsylvania and the business operations outside Pennsylvania constitute independent profit centers. This means there are no transfers of finished or partly finished goods, raw materials, supplies, services, or operational assets interspersed; and each center is free to buy outside; and because of geographical location, no center is in direct competition with another, and
- The entity keeps its books so that the amounts of revenues, costs, and expenses attributable to Pennsylvania operations can be properly disclosed.

Otherwise, the entity must complete a *PA-20S/PA-65 Schedule H*.

Submit a statement that lists all places both within and outside Pennsylvania where the PA S corporation or partnership conducts business activity or farming. Include the street address, city, state, and the type of business, profession or farm.

Real Estate and Tangible Property (Property Factor)

The property factor is a fraction. The numerator is the average value of real and tangible personal property employed in the business and located in Pennsylvania. The denominator is the average value of the real and tangible property employed in the business everywhere. For purposes of calculating the property factor:

- The PA S corporation or partnership values owned property at its original cost.
- Real property includes real property the entity rents and uses in the business.
- The entity values rental property by multiplying the gross rents paid during the taxable year by eight.
- If the values of the Pennsylvania real or tangible personal property that the entity employs in its business are zero at the beginning of any calendar month during its taxable year, the entity determines its average value of property by averaging the values at the beginning and ending of the taxable year. Otherwise, the entity determines its average value of property by averaging the monthly values.
- Gross rents are the actual sum of money or other consideration paid directly or indirectly by the PA S corporation or partnership or for its benefit for the use or possession of the property. Gross rents include:
 - The amount paid for the use or possession of real property or any part thereof, whether designated as a fixed sum of money or a percentage of sales, profits, or otherwise.
 - The amount paid as additional rent, or instead of rent, the amount the entity paid in interest, taxes, insurance, repairs, or other amounts under the terms of a lease or other arrangement.
 - The portion of the cost of any improvement to real estate made by or on behalf of the taxpayer which reverts to the owner or the lessor upon termination of the lease or other arrangement based on the unexpired term of the lease commencing with the completion date of the improvement, or the life of improvement, if its life expectancy is less than the unexpired term of the lease. If the entity erects, or another entity erects on behalf of

the entity, a building on leased land, the entity determines the value of the land by multiplying the gross rent by eight and the value of the building in the same manner as if owned by the PA S corporation or partnership. The proportional part of the cost to an improvement (other than the building on leased land) is generally equal to the amount of allowable amortization in calculating Pennsylvania net income, whether the lease does or does not contain an option of renewal.

- Gross rents shall not include:
 - Any portion of a payment or credit to the proprietor of the business, or to a shareholder in a PA S corporation or partner in a partnership conducting the business for the use of real property,
 - Amounts payable for separate charges for water and electric service furnished by the lessor,
 - Amounts payable for storage if no designated space under the control of the taxpayer as a tenant is rented for storage purposes,
 - That portion of any rental payment that, in the discretion of the department, is applicable to property subleased by the taxpayer and not used by him or her in the carrying on of the business.

Wages, Salaries, Commissions, and Other Compensation (Payroll Factor)

The payroll factor is a fraction. The numerator is the total current employee wage and salary expense for the taxable year the PA S corporation or partnership incurs in connection with its business activity within Pennsylvania. The denominator is the total current employee wage and salary expense the entity incurs in connection with its business everywhere.

The entity incurs employee wage and salary expense in connection with its business activity in Pennsylvania if one of the following applies:

- The employee performs personal services entirely within Pennsylvania, or
- The employee performs personal services outside Pennsylvania that are incidental to the usual services the employee performs in Pennsylvania, or
- The employee performs some personal services in Pennsylvania, and at least one of the following applies:
 - The employee's base of operations is in Pennsylvania.
 - The place from which the employee receives direction or control is in Pennsylvania.
 - The employee is a resident of Pennsylvania.

The term base of operations refers to the place or fixed center from which the individual works. An individual's base of operations may be their business office, or a place at which the employee is to receive their directions and instructions if their contract of employment so specifies. In the absence of more controlling factors, an individual's base of operations may be the place to which they have their business mail, supplies, and equipment sent, or the place where they maintain their business records.

Sales (Sales Factor)

The sales factor is a fraction. The numerator is total gross receipts derived from sales in Pennsylvania during the taxable year. The denominator is total gross receipts derived from all sales during the taxable year.

For purposes of calculating the sales factor, only sales of stock in trade or inventory held primarily for sale

to customers in the ordinary course of the business, sales of services to customers, and sales of operational assets shall be taken into account. A sale of stock in trade or inventory is in Pennsylvania if:

- The seller delivers or ships the property from outside Pennsylvania into Pennsylvania to any purchaser other than the federal government.
- The seller delivers or ships the property from Pennsylvania and the purchaser is the federal government.
- The seller delivers or ships the property from Pennsylvania to another state or country, and the other state or country has no jurisdiction to tax the net income of the business derived from such sales.
- The seller delivers or ships the property from a point within Pennsylvania to a purchaser in Pennsylvania. A sale of services is in if the seller performs the services wholly within Pennsylvania.

A sale of services is in Pennsylvania if the seller performs a greater portion of the services in Pennsylvania than outside Pennsylvania, based on costs of performance. A sale of an operational asset that is in Pennsylvania is a sale of property within Pennsylvania.

Allocating Gains or Losses from the Disposition of Tangible Property

Refer to PA Personal Income Tax Guide - Net Gains (Losses) from the Sale, Exchange or Disposition of Property.

Gains or Losses from the Disposition of Intangible Personal Property

Refer to PA Personal Income Tax Guide - Net Gains (Losses) from the Sale, Exchange or Disposition of Property, and PA PIT Bulletin 2005 -02 Gain or Loss Derived from the Disposition of a Going Concern.

Interest Income

Generally, the PA S corporation or partnership allocates any item of interest, cost, expense, or liability incurred in the production of interest to Pennsylvania.

However, special rules apply with respect to the following:

- Interest the PA S corporation or partnership derives from, and costs, expenses, or liabilities the PA S corporation or partnership incurs in connection with, purchase money mortgages on real estate or land contracts,
- Interest the PA S corporation or partnership derives from, and costs, expenses, or liabilities the PA S corporation or partnership incurs in connection with, assets that it employs as working capital (generally current assets) in its business and from accounts and notes receivable from sales or products or services it sells in the ordinary course of business, and
- Interest incidental to the production or collection of rental or royalty income.

The PA S corporation or partnership apportions such items under the rules applicable to apportioning net profits (losses). Therefore, classify interest income associated with current assets as net profits from a business, profession or farm.

Dividend Income

Generally, the PA S corporation or partnership allocates any item of dividend, cost, expense, or liability incurred in the production of dividends to Pennsylvania. The special rules for allocating interest income, described above, also apply to dividend income.

Therefore, generally classify dividend income associated with current assets as net profits from a business, profession or farm.

Rental Income From Real Estate

Rent that the PA S corporation or partnership derives from real estate, and costs, expenses, and liabilities the entity incurs in the production or collection of such rents are allocable to Pennsylvania only if the

rental property is in Pennsylvania.

Rental Income From Tangible Personal Property

The PA S corporation or partnership allocates the rent it derives from tangible personal property that it does not employ in its business operation, and costs, expenses and liabilities that it incurs in the production or collection of such rents, by multiplying the net rent by a fraction. The numerator is the number of days the property is physically in Pennsylvania during the rental period. The denominator is the number of days for all rental periods in the taxable year.

If the physical location of the property during the rental period is unknown, the entity allocates it to the state or country in which the property was located at the time the rental payer obtained possession.

Royalties from Real Property

Proceeds derived from non-operating interests in coal, oil, gas, or other minerals in place and costs, expenses, and liabilities incurred in the production of such receipts are allocable to Pennsylvania only if the property from which the operating interests serves is located in Pennsylvania.

Royalties From Patents and Copyrights

The PA S corporation or partnership allocates patent and copyright royalties that are not includable in the calculation of net profits from the operation of a business, and the costs, expenses, and liabilities incurred in the production and collection of such royalties to Pennsylvania only if and to the extent that:

- The payer employed the patent in the production, fabrication, manufacturing, or other processing in Pennsylvania, or
- The payer produced the patented products in Pennsylvania, or
- The payer originates the printing or publication in Pennsylvania.

Allocating Income from Estates and Trusts

Estate or trusts must provide to each beneficiary a *PA-41 Schedules RK-1 and NRK-1*, detailing the beneficiary's share of income, credits and distributions during the taxable year. The *PA-41 Schedules RK-1 and NRK-1* lists each beneficiary's resident taxable income or nonresident taxable income (respectively). The nonresident taxable income represents the beneficiary's total net income or gain derived through the estate or trust which the beneficiary must allocate to Pennsylvania.

Income from Pass Through Entities

Pass Through entities must provide to its entity owners a Schedule RK-1 and NRK-1 detailing the entity owner's share of pass through income and losses during the taxable year. The income and losses are already classed and apportioned for Pennsylvania purposes as reported on the Schedule RK-1 and NRK-1 received from the pass through entity.

LIMITED LIABILITY COMPANY (LLC)**Filing Requirements**

- A limited liability company that elects to file as a **C corporation** for federal income tax purposes files as a C corporation for Pennsylvania and is subject to Pennsylvania corporate net income tax, reported on the RCT-101, PA Corporate Tax Report. A limited liability company that files as a C corporation with the IRS does not file the PA-20S/PA-65 Information Return.
- A limited liability company that elects to file as an **S corporation** for federal income tax purposes and has not elected out of PA Subchapter S status for Pennsylvania by filing REV-976, Election Not To Be Taxed as A Pennsylvania S Corporation, must file as an S corporation for Pennsylvania using the PA-20S/PA-65 Information Return. The members are subject to personal income tax.
- A limited liability company that elects to file as a **partnership** for federal income tax purposes files as a partnership for Pennsylvania using the PA-20S/PA-65 Information Return. The partners are subject to personal income tax.
- **Income Reported on Federal Tax Return of an Individual**
For personal income tax purposes, a single member limited company (SMLLC) owned by an individual or a limited liability company jointly owned by husband and wife is a disregarded entity.

The income of the limited liability company is reported on PA-40 Schedule C, Profit or Loss from Business or Profession, or PA-40 Schedule E, Rent and Royalty Income (Loss), of the member's PA-40, Pennsylvania Income Tax Return, and the single-member limited liability company does not file a PA-20S/PA-65 Information Return. Examples include rental property or partnership interest held by a limited liability company.

- **Income Reported on Federal Tax Return of another Business Entity**

The income of a SMLLC owned by another entity is reported on the tax return of the member as if earned by the member.

Refer to [PA Filing Requirements for Corporate Net Income Tax and Personal Income Tax Purposes](#).

PA-20S/PA-65 SCHEDULE M

Reconciliation of Federal Taxable Income to Pennsylvania-Taxable Income

Use Part A to classify federal taxable income (loss) as shown on federal Form 1120S or the federal Form 1065 for Pennsylvania purposes. The entity must classify its federal amounts using Pennsylvania personal income tax rules.

Use Part B to reconcile from the entity's federal business income (loss) and rental/royalty income (loss) to its Pennsylvania income (loss). If the entity is separately allocating its income, keeps separate books and records for financial statement

purposes, and there are no business transactions between multiple businesses, the "PA Allocated Income (loss)" column, and the "Total Income (loss) Total Business Income (loss) before Apportionment" column will be completed. If the entity is apportioning its income, only the Total column will be completed.

Important: Use *PA-20S/PA-65 Schedule M* for business income (loss) or rental/royalty income (loss). The entity should complete the appropriate PA-20S/PA-65 Schedules A, B, and D for all other income classes. Use of PA-20S/PA-65 Schedule M for the other income classes results in the improper classification of income and reporting errors.

Refer to PA Personal Income Tax Guide - Net Gains (Losses) from the Sale, Exchange, or Disposition of Property.

Refer to [PA Partnerships and PA S Corporations Entity](#) Distinctions.

PA-20S/PA-65 SCHEDULE M, PART A

- **Classifying Federal Income (Loss) for Pennsylvania Personal Income Tax Purposes**

Use Part A to classify the federal amounts from federal Form 1120S, Schedule K or federal Form 1065, Schedule K.

For each line, analyze the components of the federal amounts. Then, classify the federal amounts to the applicable Pennsylvania income class in its entirety, or the appropriate portion of each amount, without adjustment for Pennsylvania personal income tax rules. The partnership or PA S corporation should transfer amounts from columns (c) through (e) to the corresponding PA Schedules. Columns (b) and (f) are reported on PA-20S/PA-65 Schedule M, Part B, for further adjustment as required.

- **Pass Through Income from Another Pass Through Entity**

If the partnership or PA S corporation completing this PA-20S/PA-65 Information Return received a PA-20S/PA-65 Schedule RK-1 and/or NRK-1 from the other entity on which it is a member, it already has the classified and apportioned income (loss) amount for completing PA-20S/PA-65 Schedule M, Part A.

- **Partnership Example**

The ABC partnership is a partner in the XYZ partnership. The ABC partnership receives an RK-1 from the XYZ partnership that includes Pennsylvania-taxable business income (loss) from

operations in the amount of \$1,000, interest income in the amount of \$500, net gain (loss) from the sale, exchange or disposition of property in the amount of \$10,000, and net income (loss) from rents, royalties, patents, and copyrights in the amount of \$3,000. The ABC partnership will classify on Line 1b of their PA-20S/PA-65 Information Return the \$1,000 of PA- taxable business income (loss) from operations as share of income from all other entities. The \$500 of interest income will be classified on PA-20S/PA-65 Schedule A, Line 1. The \$10,000 of net gain (loss) from the sale, exchange, or disposition of property will be classified on PA-20S/PA-65 Schedule D, Line 9, or Line 19.

The \$3,000 of net income (loss) from rents, royalties, patents and copyrights will be classified on their PA-20S/PA-65 Schedule E, Line 23, or Line 24.

- **PA-20S/PA-65 Schedule M, Part B**

Part B is similar to, but more specific than the PA Schedule C that individuals, estates, and trusts use to reconcile federal income (loss) for Pennsylvania personal income tax purposes.

For line-by-line instructions for PA-20S/PA-65 Schedule M, Part A and Part B, please see *PA-20S/PA-65 Schedule M Instructions* on the department's website.

PENALTIES, ADDITIONS AND FEES

If a taxpayer fails to include in taxable income an amount more than 25 percent of the taxable income that was reported by reason of negligence or intentional disregard of rules and regulations but without intention to defraud, there shall be added an amount equal to 25 percent of the amount of underpayment. See Section 352(b)(2).

Any partnership, Pennsylvania S corporation, estate, or trust required to furnish an information return who furnishes a false or fraudulent return shall be subject to a penalty of \$250.00 for each failure.

Any partnership, S corporation, estate, or trust that does not file a return will be penalized \$250 for each failure. See Section 352(f). For a partnership and S corporation a \$250 penalty is imposed for failure to file the PA-20/PA-65. In addition, a \$250 penalty is imposed for each missing RK-1, NRK-1 and Schedule H-Corp. If the entity files the required returns, the \$250 penalty per failure will not be imposed. However, if the entity has nonresident withholding tax and or corporate net income tax withholding due with the nonfiled returns, interest and penalty will be applied.

FRAUDULENT INVESTMENT SCHEMES

Refer to Personal Income Tax Bulletin 2010-02, Guidance for Investors in Fraudulent Investment Schemes.

TABLES

Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for Partnerships

A partnership should use the PA-20S/PA-65 Schedule M, Reconciliation of Federal-Taxable Income to Pennsylvania-taxable Income to reconcile from federal ordinary income (loss) to Pennsylvania-taxable income (loss) from business, profession, or farm operations, and from rental or royalty income (loss).

In many instances, Pennsylvania personal income tax law and regulations do not provide specific treatment similar to federal tax laws. This is especially true with regard to federal elections concerning the timing of income and expense items. Taxpayers should not use federal elections to determine Pennsylvania personal income tax income (loss).

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
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§ 108	Exclusion of cancellation of indebtedness (COD) income	<p>Pennsylvania does not follow federal treatment.</p> <p>Refer to PA Personal Income Tax Guide - Cancellation of Debt for Pennsylvania Personal Income Tax Purposes.</p> <p>Refer to PIT Tax Bulletins 2009-02 through 2009-06</p>
§ 179	Election to expense certain depreciable business assets	<p>Pennsylvania follows federal treatment.</p> <p>However, any changes made to IRC § 179 after Jan. 1, 1997 are not applicable to Pennsylvania. The Pennsylvania § 179 expense is limited to \$25,000 and will be phased out for purchases in excess of \$200,000. Pennsylvania allows a carry-over of the excess.</p> <p>Refer to Informational Notice- Personal Income Tax 2012-05.</p>
§ 469	Passive or portfolio income	Pennsylvania does not follow federal treatment.
§ 481(a)	Income resulting from a change in accounting method is recognized over 4 years.	Income is taxable in the year of the accounting method change.
§ 704(b)	Special allocations with substantial economic effect	Pennsylvania follows federal treatment.
§ 704(c)	Allocations with respect to pre-contribution gain inherent in contributed assets	Pennsylvania follows federal treatment.
§ 704(d)	Limitation of losses to the extent of adjusted basis	Pennsylvania follows federal treatment; however, there is no provision for carryover of losses. For PA PIT, a partner must reduce their basis in their partnership interest by losses, but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income tax of another state or country. If losses are not used, the basis must be reduced by the partner's share of straight-line depreciation
§ 705(a)	Determination of basis of partner's interest (general rule)	Pennsylvania follows federal treatment.
§ 706(c)	Federal closing of the books	Pennsylvania follows federal treatment.
§ 707(a)	Federal disguised sale rules	Pennsylvania follows federal treatment.

§ 707(c)	Guaranteed payments for the use of capital – unreasonable guaranteed payments	Pennsylvania follows federal treatment.
§ 707(c)	Guaranteed payments for the use of capital or other services	<p>Pennsylvania does not follow federal treatment for guaranteed payments for services. Under PA tax law, to the extent paid for other services or for the use of capital, a guaranteed payment is:</p> <p>a. A withdrawal proportionately from the capital of all partners;</p> <p>b. A gain from the disposition of the recipient’s partnership interest and a loss from the disposition of the other partners’ partnership interests, to the extent derived from the capital of the other partners; and</p> <p>c. A return of capital by the recipient to the extent derived from his/her own capital.</p> <p>Pennsylvania allows the deduction</p>
§ 709(a)	Treatment of organization and syndication fees (general rule)	Pennsylvania follows federal treatment.
§ 722	Basis of Contributing Partner’s Interest	Pennsylvania follows federal treatment.
<p>§ 721</p> <p>731</p> <p>§ 733</p>	<p>Contribution of property to a partnership on a tax-free basis</p>	<p>Pennsylvania generally follows federal treatment. Neither the partnership nor the partners, recognize gain or loss in the case of a contribution of property in exchange for an interest in the partnership.</p> <p>The partners recognize gain or loss in the following circumstances:</p> <ul style="list-style-type: none"> • The purpose of the contribution was to affect an exchange of property between two or more partners; or • The contributing partner receives, in exchange for his or her contribution, an interest in the partnership plus other property or cash. <p>Pennsylvania has not adopted the following concepts: 731(c)(3)(C)(iv) – Look-Thru of Partnership Tiers, 731(c)(5) – Subsection Disregarded in Determining Basis of Partner’s Interest in Partnership and of Basis of Partnership Property.</p> <p>Pennsylvania has not adopted the following concepts: 732(d) – Special Partnership Basis to Transferee, 732(f) – Corresponding Adjustment to Basis of Assets of a Distributed Corporation Controlled by a Corporate Partner.</p>
§ 752	Increases or decreases in liabilities create deemed cash contribution or distributions to partner	Pennsylvania follows federal treatment.

§ 732(d) § 734(b) § 743(b) § 754	Election to step-up or down basis upon certain events	Pennsylvania does not follow federal treatment.
§ 1031	No gain (loss) recognized on any like-kind exchange transactions.	Pennsylvania does not follow federal treatment.
NA	Tax benefit rule (requirement to adjust basis)	For Pennsylvania PIT, a partner must reduce their basis in their partnership interest by losses, but only to the extent that the losses reduce either the income subject to PA tax or the income tax of another state or country. If losses are not used, the basis must be reduced, but not below zero, by the partner's share of straight-line depreciation.

Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for Partner's Outside Basis Calculation

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Personal Income Tax Treatment	Pennsylvania Basis Reduction Rule for Depreciation
§ 465	Federal loss not allowed due to federal-at-risk limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal-at-risk carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 469	Federal loss not allowed due to federal passive loss limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal passive loss carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.

§ 704	Federal loss not allowed due to federal basis limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. The loss is only allowed if the partner is responsible for making up losses to the partnership. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal loss carryover	There is no carryover of a loss for Pennsylvania personal income tax.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
	Federal loss allowed because of federal basis. For Pennsylvania personal income tax no income to offset in class	No loss allowed for Pennsylvania personal income tax against any other class of income. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of Pennsylvania personal income tax adjustments	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Do not use federal loss.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.

Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for PA S Corporations

Reconciliation of Federal-Taxable Income to Pennsylvania-Taxable Income

The PA S corporation should use the PA-20S/PA-65 Schedule M, Reconciliation of Federal-Taxable Income to Pennsylvania-taxable Income to reconcile from federal ordinary income (loss) to Pennsylvania-taxable income (loss) from business, profession, or farm operations, and from rental or royalty income (loss).

In many instances, Pennsylvania personal income tax law and regulations do not provide specific treatment similar to federal tax laws. This is especially true with regard to federal elections concerning the timing of income and expense items. Taxpayers should not use federal elections to determine Pennsylvania personal income tax income (loss).

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
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§ 108	Exclusion of cancellation of indebtedness (COD) income	<p>Pennsylvania does not follow federal treatment.</p> <p>Refer to PA Personal Income Tax Guide - Cancellation of Debt for Pennsylvania Personal Income Tax Purposes.</p> <p>Refer to PIT Tax Bulletins 2009-02 through 2009-06</p>
§ 179	Election to expense certain depreciable business assets	<p>Pennsylvania follows federal treatment. However, any changes made to IRC § 179 after Jan. 1, 1997 are not applicable to Pennsylvania, including the PA § 179 expense is \$25,000 and will be phased out for purchases in excess of \$200,000.</p> <p>Refer to Informational Notice- Personal Income Tax 2012-05.</p>
§ 338(h)(10)	Election to treat a stock as an asset sale	Pennsylvania does not follow federal treatment.
§ 351	Contribution of property to a corporation on a tax-free basis	Pennsylvania follows federal treatment.
§ 1031	No gain (loss) recognized on any like-kind exchange transactions.	Pennsylvania does not follow federal treatment.
§ 1361	One class of stock requirement Qualified Subchapter S Subsidiaries (QSSS)	<p>Pennsylvania follows federal treatment.</p> <p>Pennsylvania permits qualified subchapter S subsidiaries.</p>
§ 1362	Election of S corporation	Pennsylvania follows federal treatment for tax years beginning on or after Dec. 31, 2005..
§ 1362(d)	Passive income test	Pennsylvania does not follow federal treatment.

§ 1368	Accumulated Adjustments Account (AAA)	<p>Calculation required for years when PA S status is in place.</p> <p>Federal subchapter S corporations that have been Pennsylvania S corporations throughout their corporate existence always should have tracked their Pennsylvania adjustments account and Pennsylvania accumulated earnings and profits, if applicable, to provide the information required for resident shareholders to correctly report distributions.</p> <p>Federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006 similarly should track Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits. However, it may be extremely difficult to obtain the necessary information to calculate the initial Pennsylvania accumulated earnings and profits.</p> <p>The Pennsylvania Department of Revenue will allow a transitional election by federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006. The department may allow such a "new" Pennsylvania S corporation taxpayer to elect to use its federal accumulated adjustments account as the functional equivalent of its Pennsylvania accumulated earnings and profits.</p>
§ 1374	Built-in-gains tax	<p>Pennsylvania generally follows federal treatment. Pennsylvania does not follow federal for 25 percent passive income test. If any built-in-gains tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation), the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.</p>
§ 1377	Election to terminate year	Pennsylvania follows federal treatment.
NA	Tax Benefit Rule	<p>For Pennsylvania purposes, a shareholder must reduce basis in the S corporation by losses but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income tax of another state or country. If losses are not utilized, the basis must be reduced by the shareholder's share of straight-line depreciation.</p>

Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for S Corporation's Outside Basis Calculation

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Personal Income Tax Treatment	Pennsylvania Basis Reduction Rule for Depreciation
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<p>§ 465</p>	<p>Federal loss not allowed due to federal at risk limitations</p>	<p>Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.</p>	<p>Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.</p>
	<p>Federal loss for year higher than Pennsylvania loss as a result of federal at risk carryover</p>	<p>There is no carryover of a loss for Pennsylvania personal income tax purposes.</p>	<p>Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.</p>
<p>§ 469</p>	<p>Federal loss not allowed due to federal passive loss limitations</p>	<p>Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.</p>	<p>Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.</p>
	<p>Federal loss for year higher than Pennsylvania loss as a result of federal passive loss carryover</p>	<p>There is no carryover of a loss for Pennsylvania personal income tax purposes.</p>	<p>Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.</p>
<p>§ 1367</p>	<p>Federal loss not allowed due to federal basis limitations</p>	<p>Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.</p>	<p>Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.</p>
	<p>Federal loss for year higher than Pennsylvania loss as a result of federal loss carryover</p>	<p>There is no carryover of a loss for Pennsylvania personal income tax.</p>	<p>Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.</p>
	<p>Federal loss allowed because of federal basis. For Pennsylvania personal income tax no income to offset in class</p>	<p>No loss allowed for Pennsylvania personal income tax against any other class of income. There is no carryover of a loss.</p>	<p>Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.</p>
	<p>Federal loss for year higher than Pennsylvania loss as a result of Pennsylvania personal income tax adjustments.</p>	<p>Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Do not use federal loss.</p>	<p>Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.</p>

PA Filing Requirements for Corporate Net Income Tax and Personal Income Tax Purposes

LLC Type	Federal Classification:	CNI Tax			PIT
Multiple members <ul style="list-style-type: none"> • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S. § 8925 	Regular corporation Submit RCT-101 and federal Form 1120	YES			NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: <ul style="list-style-type: none"> • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2) 	YES			NO
	Subchapter S corporation Federal & Pennsylvania Submit PA-20S/PA-65 Information Return and: <ul style="list-style-type: none"> • Federal Form 1120S 	YES (for net recognized built-in gains only)			YES
	Partnership Submit PA-20S/PA-65 Information Return <ul style="list-style-type: none"> • Federal Form 1065 	NO			YES
Single member <ul style="list-style-type: none"> • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S. § 8925 	Regular corporation Submit RCT -101 and: <ul style="list-style-type: none"> • Federal Form 1120 	YES			NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: <ul style="list-style-type: none"> • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2) 	YES			NO
	Subchapter S corporation Federal & Pennsylvania Submit PA-20S/PA-65 Information Return and: <ul style="list-style-type: none"> • Federal Form 1120S 	YES (for net recognized built-in gains only)			YES
	Disregarded entity (sole proprietorship owned by a natural person) <ul style="list-style-type: none"> •) Submit PA-40 & required schedules	NO			YES

	<p>Disregarded entity (a branch or division) - Income for the disregarded entity is filed with parent RCT-101 or PA-20S/PA-65 Information Return</p>	NO			YES
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LLC Type	Federal Classification:	CNI Tax		Loans Tax	PIT
Restricted Professional Company (RPC) * <ul style="list-style-type: none"> • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S. § 8925 • 15 Pa. C.S. § 8997 	Regular corporation Submit RCT-101 and federal Form 1120	YES		YES	NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: <ul style="list-style-type: none"> • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year 	YES		YES	NO
	Subchapter S corporation federal & Pennsylvania Submit PA-20S/PA-65 Information Return and: <ul style="list-style-type: none"> • Federal Form 1120S 	YES (for net recognized built-in gains only)		YES	YES
	Partnership Submit PA-20S/PA-65 Information Return	NO		NO	YES
	Disregarded entity (sole proprietorship owned by a natural person) Submit PA-40 & required schedules	NO		NO	YES

* A Restricted Professional Company (RPC) engaged in activities other than activities authorized for an RPC is subject to corporation taxes and required to file the RCT-101.

PA Partnerships and PA S Corporations Entity Distinctions

Description	PA Partnerships	PA S Corporations
Entity Election	Not applicable	Follows federal treatment.
Built-In Gains Tax	Not applicable	Follows federal treatment.
Share of liabilities as part of basis	Liabilities included in basis.	Liabilities not included in basis, unless shareholder lends directly to PA S corporation.

Contribution To Owner's Retirement	Not deductible for partners.	Deductible for shareholder/employees only per plan.
Corporate Net Income Tax	Not applicable to partnerships, unless filing as a corporation for federal purposes.	Only if built-in gains tax applies.
Corporate Net Income Tax	Corporate partners will reflect their allocable share of partnership income (loss) on their respective RCT-101, PA Corporate Net Income Tax Return.	If the S corporation has built-in gains tax it is required to file a RCT-101, PA Corporate Net Income Tax Return and a PA-20S/PA-65 Information Return.
Health Insurance Premiums	Not deductible for premiums paid to partners. Not included as guaranteed payments.	Entity can deduct premiums paid for shareholder employees if it is a non-discriminatory plan. Not included as wages for shareholder.

Classifying Federal Schedule K Lines for Pennsylvania Personal Income Tax Purposes

Net income (loss) from rental real estate activities	<ul style="list-style-type: none"> • If the rental activity includes providing significant services (e.g. hotel) - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If the rental activity does not include providing significant services - Part III, Line 6. • If the rental activity includes providing significant services (e.g. rental of tangible personal property) - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If the rental activity is an investment property and does not include providing significant services - Part III, Line 6.
Interest income	<ul style="list-style-type: none"> • If derived from assets employed as working capital in a business, profession, or farm or from accounts and notes receivable from sales of products or services sold in the ordinary course of business, generally current assets - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If derived from assets that are held for long-term investment purposes or otherwise serve an investment function, generally long-term assets - Part III, Line 3.
Dividend income	<ul style="list-style-type: none"> • If derived from assets employed as working capital in a business, profession or farm, or from accounts and notes receivable from sales of products or services sold in the ordinary course of business, generally current assets - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If derived from assets that are held for long-term investment purposes or otherwise serve an investment function, generally long-term assets - Part III, Line 4.

<p>Sale of property federal Form 4797</p> <p>Net IRC § 1231 gain (loss) other than due to casualty or theft</p>	<ul style="list-style-type: none"> • If from a sale, exchange, or disposition of property used in the business, profession, or farm, and the proceeds reinvested and used to acquire similar property used in the same kind of business - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If from a sale, exchange, or disposition of property NOT USED in the ordinary course of operating the business, profession, or farm as described above or there are no proceeds - Part III, Line 5.
<p>Guaranteed payments to partners</p>	<ul style="list-style-type: none"> • Guaranteed payment treatment for partners (partnerships only)
<p>Other income (loss)</p>	<ul style="list-style-type: none"> • Determine the appropriate Pennsylvania income class from the activity, operation, and transactions (and purpose) that generated the income (loss). Include the amount on the applicable line of the PA-20S/PA-65 Information Return.

BASIS WORKSHEETS

REV-998 – Shareholder Tax Basis in PA S Corporation Stock Worksheet and

REV-999 – Partner PA Outside Tax Basis in a Partnership Worksheet

REV-998 is used by owners in a PA S corporation and the REV-999 is used by partners to calculate each owner's basis in that entity. Both forms are available on the department's website.

TAX WORKSHEET FOR NON PENNSYLVANIA TAXES PAID ON INCOME (SCHEDULE M)

REV-1190, Tax Worksheet for PA-20S/PA-65 Schedule M, Part B, Section E, Line a

For tax year 2012, the tax worksheet for PA-20S/PA-65 Schedule M, Part B, Section E, Line a has been changed to REV-1190. REV-1190 (available on the department's website) must be attached to PA-20S/PA-65 Schedule M when reporting non-Pennsylvania taxes paid on income.